AGENCY ISSUES AND THE EFFECTS OF CORPORATE GOVERNANCE MECHANISMS ON AGENCY COSTS IN CHINESE LISTED COMPANIES

by

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A Thesis Submitted in Fulfilment of the Requirements for the Degree of Doctor of Philosophy of Cardiff University

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Abstract

Two types of agency problems tend to predominate in the modern corporations, i.e., principal-agent (owner-manager) conflicts and principal-principal (large shareholder appropriation) conflicts. This PhD project aims to identify the principal-principal agency problems, to investigate contextual factors that affect the usefulness of governance mechanisms, to explore satisfying ways to measure agency costs, and to test the effectiveness of selected corporate governance mechanisms in mitigating agency costs in Chinese listed companies.

The main discussions lie in the causes and formations of Type II agency issues, and how effective governance mechanisms work to mitigate these issues. Both qualitative and quantitative analyses are used. An in-depth case study is undertaken and a sample of 6344 observations of Chinese listed companies during 2000-2005 is used in econometric models to examine the role of various governance mechanisms in alleviating agency costs.

There are some significant findings. State ownership does not have constant detrimental impact on firm performance or directly contribute to agency costs. Legal person ownership is found to be most effective in reducing agency costs but has similar impact as state ownership for performance. Foreign ownership has mix results and managerial ownership is negligible.

Board and external auditing both have significant impact on firm performance and agency costs in different ways, as well as various control variables. In terms of direct measurement of agency costs, other receivables seem to generate most significant results, while free cash flow does not. Return on equity/asset also has significant results as predicted. This is a comprehensive study to contribute to existing literature on Type II agency problems and empirical research in China.

Findings on these aspects will help the listed companies devise effective measures for improving corporate governance practice in China and other transitional economies. An improved corporate governance system will strengthen Chinese companies' competitiveness on global market.

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Chapter 1 Introduction

This chapter will introduce the research background, establish research objectives, justify the theory and methodologies applied, and present the detailed structure of the thesis in terms of chapter outline.

1.1 Research Background

Although Berle and Means carried out systematic analysis and research on separation of ownership and control as early as in 1932, the theory of corporate governance has developed significantly only from the 1980s.

Corporate governance deals with the separation of ownership and control and attracts many research efforts following the development of modern corporations. Traditional corporate governance theories divide the patterns into two major types: the market-oriented one as in the UK and the US (Moerland, 1995), and the stakeholder one as in Germany and Japan (Rubach & Sebora, 1998). In most East-Asian countries the family-control pattern is similar to those in Germany and Japan in that the large shareholder directly controls the corporation. The difference is that large shareholder in East Asia is a shareholding family while in Germany and Japan banks or large financial groups.

More recently, some corporate governance researchers have carried out studies within Russia and some East-European countries, and come up with the insider-control patterns. The insider-control pattern in these countries appears because they are in a transitional period from a planned economy to a market economy, which results in the slow development of market mechanisms and imperfection of related laws and regulations (Meyer, 2002). China and other East European companies are experiencing transformation from plan economy to market economy, so that they need to reorganise the state owned enterprises (SOEs). On the one hand, they want to use the experience of western corporate governance patterns; on the other, they want to seek better patterns that suit their own settings.

Numerous works have been done in examining agency issues in modern companies. However, in China, the study of agency problems began quite late and the corporate control mechanisms are rather underdeveloped.

In China, there are potentially various problems with corporate governance mechanisms, e.g. systematic (market related) defects and imperfect market developments, immature laws and regulations. Agency problem of Chinese SOEs is potentially far more serious than that of most western companies, because the management is only a political representative of the state.

Many of the listed companies in China are essentially still state owned. The state is the absolute controlling shareholder. Such an ownership structure leads to a lack of managerial initiatives, which further results in misinformed business decisions. The state has incentives to finance the SOEs in achieving economically inefficient objectives other than profit maximisation, which other minority shareholders pursue. Minority rights are limited in the sense that they can seldom vote for crucial events or appointment/dismissal of directors. Chen et al (2009) remark that the problems associated with state ownership still linger over listed firms because despite the introduction of a modern corporate governance structure, the effectiveness of such a framework is questionable. For example, there is limited protection given to the minority and individual shareholder interests as the judiciary and legal system are relatively primitive, and hence shareholder interests are often ignored or abused (Firth et al, 2008).

There are potentially two types of agency problems, which will be discussed in detail in the literature review chapter. The first type is when the managers pursue objectives that are different from those of the owners, as per Berle and Means (1932), e.g. managers may steal assets or invest in projects with a negative net present value (NPV) through fraudulent transactions, shirk their duties, pay themselves excessive salaries and perquisites, and avoid risk by refusing to take innovative actions and foregoing growth opportunities when bonus is cost or profit related.

The other type of agency problem arises when a dominant shareholder takes actions that expropriate wealth away from minority investors. Examples include transactions between listed companies and the controlling shareholder dealt at prices that are disadvantageous to small shareholders, such as asset sales and purchases, intercompany indebtedness, and sales and purchases of goods and services at such prices. This second type of agency problem is the focus of this thesis. In particular, it is the subject of the case study chapter, as well as underpinning the design of measures of agency costs. This will be illustrated further in the

later chapters.

1.2 Research Objectives

The objective of this study is threefold.

(1) The study aims at identifying agency issues in Chinese listed companies.

There are some general grounds for the study. As we all know, in the modern economy, profit maximisation is the principle goal of any company, except for non-for-profit organisations or government bodies etc that are outside of the scope of the study. To achieve the goal, two major factors are to be considered – revenue and cost, as can be seen from any financial statements. Following the financial scandals within recent years and financial crisis, corporate governance and internal controls and processes become a hot topic both in theory and in practice. Investors start to buy the company rather than buy the shares, meaning that investors are keen to understand, if not participate in, the operations of companies where they invest, because essentially they own the company and it is their money the company is funded. Besides those more obvious production costs and overheads, agency costs always appear complex and less straightforward. Currently there is an ocean of studies on corporate governance practices in China, as will be discussed in later chapters. However, very few actually explore agency issues, apart from those quoted from the literature, in the real business world.

This study is to analyse the institutional environment within which Chinese listed companies operate so that the results and findings are more relevant and specific. The Chinese market has its own uniqueness for business and capital arrangements, so it should be worthwhile to explore these special characteristics within the Chinese context. Particularly, the distinctive setting of China's financial markets and the prominent features of Chinese listed companies are examined. This is important because it provides a background of data source and explains why the results can be different from prior studies in the western economies. Through an in-depth case study, some insightful facts will be revealed regarding which agency problems are more obvious and severe in China and which ones are less concerned as compared with the literature. The case study involves interviews with various players, e.g. policy maker, shareholder, management, financier, and regulator, in the Chinese market so as to obtain understanding of real businesses. Their different perspectives in aggregate can serve to explain the results from empirical study. Therefore, the conclusions from this study will

contribute to the literature by its completeness of discussion.

(2) The study also aims at developing some direct measurements of agency costs to be used in the Chinese settings.

Agency costs are generally regarded as the result of the agents requesting company wealth through personal behaviour apart from seeking value maximisation. There are some important papers identifying agency problems. In 1976, Jensen and Meckling defined agency costs as being the sum of the cost of monitoring management, bonding the agent to the principal and any residual losses incurred to prevent shirking by agents.

Based on their discussion, there are two groups of research in defining agency costs. The first group uses direct measurement of agency costs, including Ang, Cole, and Lin (2000), and Singh and Davidson (2003). Ang et al (2000) measure agency costs in two ways: (1) as the difference in dollar expenses, between a firm with a certain ownership and management structure and the no-agency-cost base case firm; and (2) as the ratio of annual sales to total assets (SOA). Singh and Davidson (2003) extend their work to large publicly traded corporations and focus on a firm's selling, general, and administrative expenses including "managerial salaries, rents, insurance, utilities, supplies, and advertising costs". However, their studies are carried out among US companies. Firth, Fung, and Rui (2008) investigate agency issues in Chinese listed companies without modifying the measurement,[1] although they are still focusing on Type I agency problem.

The second group uses firm performance as an inverse indicator of agency costs, including Morch, Shleifer, and Vishny (1988)[2] and Agrawal and Knoeber (1996),[3] who use Tobin's Q, while Xu, Zhu, and Lin (2005) make a small modification by using return on assets (ROA).[4]

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[1] As in Firth et al (2008), "Operating, general and administration (OGA) expenses are incurred in sales activities, and expenses are incurred in organising and managing the operations and production including expenses incurred by the Board of Directors. Additional expenses under the heading of OGA are incurred due to managerial discretion and these are positively related to agency costs. Therefore, higher agency costs will lead to a higher OGA expenses to sales ratio."

[2] Morck et al (1988) use non-linear OLS specification of effects of managerial ownership on Tobin's Q, measured by firm's market value over replacement cost of the physical assets. By using a sample of 371 firms from 1980 Fortune 500 list, they find that firm value rises with ownership in 0-5% region, decrease in 5-25% region to attain minimum level, and increase again above 25% ownership but at a decreasing rate.

[3] The mechanisms are six corporate governance mechanisms (insider ownership, institutional ownership, large shareholder monitoring, outside directors, managerial labour markets, and market for corporate control) and debt. Their sample is 400 large US firms. When they use univariate OLS regressions they suggest link between performance and insider ownership, outside directors, debt and market for corporate control; when using a multivariate OLS regression, insider ownership is no longer significant; when using a simultaneous-equations system, debt and market for corporate control stop being significant.

[4] Xu et al (2005) calculate returns on assets (ROA) as the ratio of before-tax profits over the book value of total assets.

This study will use the proxies mentioned above, i.e. SOA, administrative expenses (ADM), as well as Tobin's Q and ROA for comparison with the literature. It will also develop new proxies such as free cash flow (FCF) and other receivable accounts (ORC) for direct measurement of agency costs in Chinese listed companies. This has been among the very few attempts in literature and generated some interesting results, as will be discussed in the econometric analysis chapter. Measurement of agency costs are examined and specified for empirical studies with Chinese listed companies. This can provide a platform for future research in the similar field.

(3) The study further aims at testing how a selection of corporate governance mechanisms affects agency costs in Chinese listed companies. The selection is based on a review of the literature as well as the Chinese institutional background.

Several studies assess the effectiveness of various corporate governance mechanisms in Chinese listed companies, e.g., Tam (2000) and Firth, Fung, and Rui (2007)[5] on the board of directors; Dahya, Karbhari, and Xiao (2003)[6] on the supervisory board; Firth, Fung, and Rui (2003) and Wang (2003) on ownership structure; Xiao, Zhang, and Xie (2000) and Lin, Tang, and Xiao (2003) on external auditing.

However, these studies do not explicitly relate corporate governance mechanisms to agency costs and the empirical results are mixed, as will be discussed in the literature review chapter. This study is therefore meant to be a comprehensive project by exploring the impact of different selected governance mechanisms on agency costs. Moreover, the study identifies and justifies corporate culture as one of the newest governance mechanisms, which can be explored further in future studies.

The three aspects of this study are completed systematically by utilising both qualitative and quantitative methods so that a comprehensive understanding of Type II agency issues and corporate governance practices in Chinese listed companies is presented. The results will therefore be of theoretical and methodological use to the literature and for future research.

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[5] They use the size of the board, the proportion of outside directors on the board, chairperson-CEO duality, and non-executive directors (calculated as the proportion of no-pay directors to the total number of directors on the board) to proxy the effectiveness of Board of Directors in their study. Earnings informativeness is proxied by the earnings-returns relationship and discretionary accruals. Their data are information from 549 listed companies' annual reports and their stock market performances over 1998-2000 (Firth et al, 2007).

[6] They interviewed a total of 28 directors, supervisors, and executives in 16 Chinese listed companies with four panels of experts including financial analysts, academics, and governmental officials (Dahya et al, 2003).

1.3 Theoretical Foundation

There are five main theories concerning the function of corporate governance, among which the agency theory is most widely accepted and it plays an important role in the formation of corporate governance mechanisms in practice. The other four theories are stewardship theory, property rights theory, game theory, and stakeholder theory. They will be discussed one by one in the theory chapter to justify why agency theory is chosen as a foundation of this study. In this section, agency theory will be highlighted to set up a framework for the whole thesis.

The Type I agency theory focuses on the principal-agent relationship as suggested by Jensen and Meckling (1976). With the separation of ownership and control, increasing complexity and specialisation of operation and management in modern companies, the owner of the companies – the shareholders – gradually do not have the expertise to run the companies directly. Instead, they entrust professional managers to run the companies for them. Agency problems arise because the principals cannot observe agents' actions or lack information when agents undertake actions, and because the agents take advantage of their positions and engage in actions that allow them to benefit personally at the expense of shareholders. Therefore, conflicting interest might arise between them and losses caused by these conflicts render agency costs, which include the loss of value of principals' financial claims in the firm and costly remedial actions taken by principals.

Type II agency theory focuses on the conflicts between outside and controlling shareholders (Shleifer & Vishny, 1997), i.e. principal-principal problems, which has been the major concern of many research conducted in China as mentioned earlier because it is deemed more relevant in Chinese listed companies. This is due to the fact that many listed companies in China are spin-offs from SOEs and the state retains dominant control over their operations through various channels. This is in consistency with agency theory in that conflicts between outside shareholder and controlling shareholders exist where there are controlling shareholders, especially in developing economies (Young et al, 2002). Some Chinese capital market scandals also relate to large shareholder control, as will be discussed in the coming chapters.

Typical agency issues are: 1) Conflict of interest – since the managers (representing large shareholders or government authorities) may have different interest from the company, their economically inefficient goals other than profit maximisation will be achieved at the expense

of company value. 2) Information asymmetry – minority shareholders will not completely possess the information as the managers have, so that they occur supervision cost (e.g. setting up administration or hiring a third party for supervision). A typical cost would be audit fees incurred when appointing external auditors to conduct various checks on the management reporting activities.

Agency theory hence provides an advantageous basis for analysing corporate governance mechanisms and company performances in China. This is justified further in the theory chapter.

1.4 Research Methodology

This research project uses both qualitative with quantitative empirical data and analysis to investigate agency issues and how corporate governance mechanisms affect them in Chinese listed companies.

In order to achieve objectives 1 and 2, qualitative methods are used to help make the study in greater depth and detail. Approaching fieldwork contributes to the openness of inquiry, as well as increases the understanding of the cases and situations in a distinctive setting. Therefore, one case study is undertaken to identify unique agency problems in Chinese listed companies and investigate contextual factors that affect the effectiveness of various corporate governance mechanisms. The case study is carried out in one of the biggest SOEs in Shenzhen, the Shenzhen Economic Special Zone Development Group Co. & Ltd. (SDG). Firstly surveys are used to obtain data about real world environments to find out how general people in the listed companies view agency problem through small questionnaires and casual interviews. Moreover, formal and semi-formal interviews are arranged with executives, board members, financial directors, and managers to collect in-depth opinions and data in its natural setting. The interviews also involve government regulators and controlling members outside the company. With these interviews, "how" and "why" questions are asked to understand the nature and complexity of the agency problems taking place in the companies.

By means of the case study in this single organisation, which is conducted in an area where few previous studies have been undertaken, it attempts to describe the agency problems that exist in reality with Chinese listed companies. There were two stages of the case study. First stage was carried out after initial research questions design. Casual interviews and small questionnaires were used to collect information about agency issues in large Chinese

state-owned enterprises and listed companies. The interview questions were mostly open-ended, aiming at investigating undisclosed information and encouraging interviewees to make critical comments. After the interviews, some questions were found to be more useful and need further clarification, while there were some other perspectives arising from the interviews and forming parts of the final interview schedule. The second stage was carried out after initial econometric analysis. The interview questions were focusing on specific agency problems in the company, aiming at exploring the validity of proposed agency costs measurements in large Chinese state-owned enterprises (SOEs) and listed companies.

In achieving objectives 3, quantitative method is used to directly test the impact of chosen mechanisms on agency costs. Firm-specific data are obtained from publicly available databases that are derived from the audited financial statements of Chinese listed companies. Different databases are used to generate a more complete dataset while their consistency is checked. Only publicly listed companies incorporated in mainland China and listed on Shanghai and Shenzhen stock exchanges will be examined in this study. Those listed on Hong Kong, Macao, and Taiwan are excluded to avoid potential confounding effects caused by institutional differences.

Quantitative analysis allows powerful statistical testing of hypotheses using a particular data set while qualitative analysis facilitates a great insight into contextual issues such as why certain corporate governance mechanisms are effective and why agency costs are measured differently in the Chinese context. More specifically, quantitative methods require the use of standardised measures to give a broad set of findings presented concisely and efficiently. The main numerical methods that will be using are the ordinary least square (OLS) econometric regressions, together with two-stage least squares (2SLS) simultaneous equations system. Further details about model specification etc will be discussed in chapter 6.

As quantitative methods are structured and logical while qualitative methods are intuitive and profound, they comprise alternative strategies for research, which generate useful results that can be checked against each other and enhance the validity of findings. By utilising both secondary data analysis and the case study, a more comprehensive investigation of the research questions can be conducted to provide a more precise answer to them. More specifically, as this study is concerned, the case study is used to help formulate the hypotheses and define the variables, as well as interpret the results from hypothesis testing.

1.5 Structure

There are altogether seven chapters in this thesis.

Chapter 2 reviews the current literature about theories on corporate governance practices around the world. Alternative theories are also talked about, e.g. stewardship theory, stakeholder theory, property rights theory, and game theory, including strengths and weaknesses in explaining corporate governance patterns. It then discusses the agency theory and its main aspects, such as moral hazard and adverse selection, and evidence of agency issues, e.g., empire building, tunnelling, and entrenchment. It also provides a discussion over the merits and critics of agency theory and states the reason why it is chosen as a theoretical foundation and how it is applied in this thesis. The purpose of this chapter is to select an appropriate theoretical framework on which this study focuses.

Chapter 3 lists governance mechanisms with examples from the enormous literature. Agency problems in the Chinese listed companies will be particularly explained and evidence will be given. It then provides a further review of the mechanisms within the agency theory framework, as it is the foundation of the thesis and is used to analyse the Chinese institutional background, devise research question and hypotheses, and examine the results.

Chapter 4 introduces the general background in China, which provides an institutional environment, where Chinese listed companies operate, to undertake the quantitative and qualitative research. The introduction includes the development of corporate governance structure with SOE reform process, the development of the Chinese capital market, the distinctive characteristics of the Chinese listed companies that cause governance problems, and the causation of agency problems. Furthermore, it gives a depiction of how corporate governance mechanisms are developed in controlling agency problem. Selected internal and external corporate governance mechanisms are discussed in detail in the chapter.

Chapter 5 is the case study in the group company SDG and its subsidiaries to explore real agency issues and ways in which corporate governance mechanisms affect agency costs. The chapter begins with an explanation of case study methodology and provides a summary of interviewees' information included in the research procedure. It then gives brief background introduction of the case companies, including basic structure and financials. The main part of the chapter lies in an analysis of agency issues and agency costs in Chinese listed companies,

both theoretically and practically, so that effectively ways of measurement are identified through the discussion. Corporate governance mechanisms, both internal and external ones, are also examined in influencing on agency costs.

Chapter 6 is the quantitative analysis, including hypothesis development, description of data sources, definition and summary statistics of relevant variables, and econometric models and analysis. A number of testable hypothesis are formulated in order to facilitate statistical testing. The rationale for the statistical analysis techniques used in this study is discussed. The source of data and measurement of variables are also given in this chapter. All the results are presented in neat tables for illustration. Diagnostic statistics and sensitivity tests are reported as well. The evidence collected from the case study is used to explain conflicting results and those that contradict hypothesis.

Chapter 7 concludes the whole thesis. It sums up the main findings and key conclusions, empirical and theoretical contributions, implications of the results, research limitations, and future research opportunities.

The remaining part consists of appendices and bibliography.

Chapter 2 Literature Review

2.1 Introduction

Over the past several decades, much of the corporate governance research has advanced theoretical models to explain the governance pattern and to provide empirical evidence concerning whether the theoretical models have explanatory power when applied to the real business world. The focus of both academic research and practical financial analysis has been on those large corporations with publicly traded debt and equity securities that dominate economic life throughout the developed world. There are two well-cited literature surveys of corporate governance, one by Hawley and Williams (1996),[7] and the other by Shleifer and Vishny (1997). Although the latter is not restricted to the US, its scope is limited to their specialised definition of corporate governance.[8]

This chapter and the next chapter are therefore to do something different, i.e. review relevant literature that would be helpful in identifying theories, corporate governance mechanisms, and agency issues in the Chinese listed companies. In particular, this chapter will review relevant theories and identify one that applies to the Chinese setting for the purpose of this study, where a theoretical framework can be set up for the whole thesis, and in particular the case study in chapter 5, and the econometric models in Chapter 6. The next chapter will review what has been done in literature about corporate governance mechanisms and agency costs. It serves to identify gaps and weaknesses of previous studies and provides support for designing case study and econometric models as well. Both chapters will start from general literature from worldwide researches then focus on studies in China, so that specific theory and governance mechanisms can be sufficiently and appropriately selected.

In the following parts, the main theories concerning performance of modern corporations will be referenced in detail in order to set up the research background and provide evidence of comparison of theories based on which the study is carried out. Sections 2 to 5 discuss other theories, e.g. stewardship theory, stakeholder theory, property rights theory, and game theory, including strengths and weaknesses in explaining corporate governance patterns so that the

[7] This is the literature review of corporate governance as a background paper in the US for the Organisation for Economic Cooperation and Development (OECD) (Turnbull, 1997).

[8] Shleifer and Vishny (1997) explicitly state, "While we pay some attention to cooperatives, we do not focus on a broad variety of non-capitalist ownership patterns, such as worker ownership and non-profit organisations."

non-adoption of these theories is fully justified. In Section 6, the agency theory and its main aspects, such as moral hazard and adverse selection, as well as evidence of agency issues, e.g., empire building, tunnelling, entrenchment, and poison pills are discussed, to give a full explanation of agency problems. Type I and Type II agency issues are discussed separately for the purpose of this study. It further discusses how agency costs are defined in the literature and this study, followed by analysing the merits and criticisms for agency theory and justifying it as the foundation of this study. Section 7 concludes the chapter.

2.2 Stewardship Theory

Stewardship theory has been introduced as a means of defining relationships based upon other behavioural premises (Donaldson & Davis, 1991). According to the stewardship theory, a steward is motivated to work towards organisational objectives and therefore control and incentive costs needed with an agent could be saved. On the other hand, control measures could be even counterproductive because they undermine pro-organisational behaviour by lowering motivation. Donaldson and Davis (1991) have argued that stewards' pro-organisational actions are best facilitated when the corporate governance structure gives them high authority and discretion (Davis et al, 1997).

Stewardship theory has garnered researchers' attention, both as a complement and a contrast to agency theory (e.g., Davis et al, 1997).[9] Whereas agency theorists view executives and directors as self-serving and opportunistic, stewardship theorists describe them as frequently having interests that are isomorphic with those of shareholders (Davis et al, 1997). This is not to say that stewardship theorists adopt a view of executives and directors as altruistic; rather they recognise that there are many situations, in which executives conclude that serving shareholders interests also serves their own interests (Lane et al, 1999). Yet stewardship theory is imperfect alone to explain all behaviour.

However, there is not enough evidence which theory works in different circumstances because empirical studies have given mixed results. Application of stewardship theory in design of corporate governance systems would have some benefits but on the other hand, it would also contain the risk that behaviour of an agent would appear instead of stewards.

An overview of agency and stewardship theoretical foundations is presented below:

[9] For a detailed comparison between stewardship theory and agency theory please refer to Davis, Schooman, and Donaldson (1997) "Toward a Stewardship Theory of Management" in Academy of Management Review.

Table 2.1: Overview of agency and stewardship theoretical foundations

	Agency Theory	**Stewardship Theory**
Model of Man	Economic man	Self-actualising man
Behaviour	Self-serving	Collective serving
Psychological Mechanisms		
Motivation	Lower order/economic needs (physiological, security, economic) Extrinsic	Higher order needs (growth, achievement, self-actualisation) Intrinsic
Social Comparison	Other managers	Principal
Identification	Low value commitment	High value commitment
Power	Institutional (legitimate, coercive, reward)	Personal (expert, referent)
Situational Mechanisms		
Management Philosophy	Control oriented	Involvement oriented
Risk orientation	Control mechanisms	Trust
Time frame	Short term	Long term
Objective	Cost control	Performance enhancement
Cultural Differences	Individualism High power distance	Collectivism Low power distance

Source: Davis et al. (1997)

One of the underlying assumptions of agency theory is that there exists goal divergence between shareholder and the manager, or between controlling and minority shareholders, which therefore necessitates measures and rewards to make sure that individuals who pursue their own self-interest will also pursue the collective interest (Eisenhardt, 1989). Executive compensation and board of directors (BOD) are common governance mechanisms in agency theory to make sure that the managers sing in tune with the owners (Davis et al, 1997). Stewardship, on the other hand, has the assumption that behaviours of executive are aligned with the interests of the principals and hence we are less likely to find the installation of a board. This is clearly not the case in China, because managers require closer supervision by the board and the board oversees the actions of the management.

2.3 Stakeholder Theory

Stakeholder theory is mainly developed by Freeman (1999), postulating that various constituents, such as capital suppliers and non-investor stakeholders, possess legitimate and equal claims on a modern corporation (e.g., Donaldson & Preston, 1995). A stakeholder in an organisation is (by definition) any group or individual who can affect or is affected by the achievement of the organisation's objectives. This definition implies that to the traditional list of stakeholders managers needed to add governments, competitors, consumer advocates, environmentalists, special interest groups, and the media.

According to agency theory, all other stakeholders of the business are largely irrelevant and if they benefit from the business then this is coincidental to the activities of management in running the business to serve shareholders. This focus upon shareholders alone as the intended beneficiaries of a business has been questioned considerably from many perspectives, which argue that it is either not the way in which a business is actually run or that it is a view that does not meet the needs of society in general.

Conversely, stakeholder theory argues that there is a whole variety of stakeholders involved in the organisation and each deserves some return for their involvement. According to stakeholder theory, therefore benefit is maximised if the business is operated by its management on behalf of all stakeholders and returns are divided appropriately amongst those stakeholders, in some way that is acceptable to all. Unfortunately, a mechanism for dividing returns amongst all stakeholders which has universal acceptance does not exist, and stakeholder theory is significantly lacking in suggestions in this respect (Sternberg, 1997). Nevertheless, this theory is based upon the premise that operating a business in this manner achieves, as one of its outcomes, the maximisation of returns to shareholders, as part of the process of maximising returns to all other stakeholders. This maximisation of returns is achieved in the long run, through the optimisation of performance for the business to achieve maximal returns to all stakeholders. Consequently, the role of management is to optimise the long-term performance of the business in order to achieve this end and thereby reward all stakeholders, including themselves as one stakeholder community, appropriately (Crowther & Martinez, 2007).

These two theories can be regarded as competing explanations of the operations of a firm, which lead to different operational focuses and to different implications for the measurement

and reporting of performance. It is significant however that both theories have one feature in common. This is that the management of the firm is believed to be acting on behalf of others, either shareholders or stakeholders more generally. They do so because they are rewarded appropriately and much effort is therefore devoted to the creation of reward schemes that motivate these managers to achieve the desired ends. Similarly, much literature is devoted to the consideration of the effects of reward schemes on managerial behaviour and suggestion for improvements (see for example Child, 1975; Freeman & Reed, 1983; Briers & Hirst, 1990; Marens & Wicks, 1999).

It should come as little surprise that stakeholder theory is not without opposition among management scholars. The most prominent opponents probably are Sternberg and Jensen, among the founding fathers of modern corporate governance theory. Sternberg (1997) tends to emphasise the ethical aspects, arguing that stakeholder theory cannot be justified. In brief, it is argued that the fact that some groups may have power over the corporation does not give those groups legitimate authority over it, or the right to hold it to account. Stakeholder theory, so runs the argument, is both "deeply dangerous and wholly unjustified" because it "undermines private property, denies agents' duties to principals, and destroys wealth."

Jensen (1993) also employs strong words to criticise stakeholder theory, focusing primarily on the problem of multiple maximands. Jensen's reasoning weaves together several arguments. First, there is an economic theory argument, under which maximising the firm's financial value, defined as the sum of equity and other financial claims on the firm, is efficient. Second, there is a governance argument, according to which managers that owe duties to several stakeholders are accountable to none and are bound to prefer their own self-interest. Third, Jensen makes a political objection, because, as a basis for action, stakeholder theory politicises the corporation. Finally, and most importantly, Jensen makes a psychological argument. Stakeholder theory is deficient under this argument because it confuses managers, and confusion is bound to handicap the firm. The novelty in Jensen's position lies not in the economic analysis but rather in the stress; he puts on the psychological drawbacks of stakeholder theory (Licht, 2004).

As Chinese listed companies are concerned, stakeholders, e.g. shareholders, lenders, directors, employees, customers, suppliers, government and society as a whole, are without doubt important to a modern corporation. The objectives of all these groups need to be considered by good company managers when making decisions. One of the principles of the market

economy is that if the owners of businesses attempt to achieve maximum profitability and earnings this will help to increase the wealth of society. As a result, it is usually assumed that a proper objective for private sector organisations is profit maximisation, i.e. the financial manager is concerned with managing the company's funds on behalf of shareholders, and producing information which shows the likely effect of management decisions on shareholder wealth. Considering other stakeholder groups is supplementary in the decision making. During the course, personal incentives come into playing so agency problems arise, especially when the objectives of the stakeholders are often conflicting due to heavy government interference among Chinese listed companies.

2.4 Property Rights Theory

It has been argued that shareholders should have rights to determine how their property is used, as should an owner of any asset under private property rights. Etzioni (1998) suggests that this view of shareholders property rights, which are both moral and legal, is "widely embedded in the American political culture" and therefore needs no further introduction. The property rights theory of firm and market organisation is unarguably a path-breaking contribution (Grossman & Hart, 1983). The property rights approach has an important implication: the purchase of physical assets leads to control of human capital, as it is in a worker's self-interest to put more weight on her/his boss's objectives as this will put her/him in a stronger bargaining position with her/his boss later. This implication helps us understand integrations where the control of organisational assets (or organisation capital) rather than the physical capital is the crucial part (Klein, 1988).

In spite of the accomplishments, property rights theory makes limited appeal to data, because it yields very few refutable implications and is indeed very nearly untestable (Whinston, 2001). Another drawback of the property rights approach is that it makes no distinction between ownership and control. Clearly this is not applicable to the Chinese listed companies, as will be further explained in the institutional background chapter.

2.5 Game Theory

An influential strand of the literature on capital structure that has used game theoretic concepts is concerned with agency costs. Jensen and Meckling (1976) point to two kinds of agency problems in corporations. One is between equity holders and bondholders and the other is between equity holders and managers. The first arises because the owners of a levered

firm have an incentive to take risks; they receive the surplus when returns are high but the bondholders bear the cost when default occurs. Diamond (1989) has shown how reputation considerations can ameliorate this risk shifting incentive when there is a long time horizon. The second conflict arises when equity holders cannot fully control the actions of managers. This means that managers have an incentive to pursue their own interests rather than those of the equity holders. Grossman and Hart (1983) and Jensen (1986) among others have shown how debt can be used to help overcome this problem.

Game theory, however, indicates that equilibrium based on reputation is quite fragile (Rasmusen, 1989). For example, Kreps (1990) shows that reputation will enforce a contract between the two players only when there is some uncertainty about the length of the game (Dobson, 2007), or when there is uncertainty about the rationality of one of the players (i.e., whether they are both self-interested wealth maximisers). Indeed, even when one of these conditions is met, the agent's desire to maintain his/her reputation may induce him/her to honour the contract only at some of the time. Similarly, in one of the most extensive game theory models yet developed – namely Diamond's (1989) model of reputation acquisition in debt markets – agents never actively strive to build reputations. Some merely acquire reputations for timely debt repayment through luck. Once acquired these reputations may be actively maintained until the endgame is reached: at which point agents revert to opportunistic behaviour. Reputation or signalling, therefore, may work as contractual enforcement mechanisms in some stages of some contractual situations. However, they will not work, or at least not work costless in many environments. Furthermore, in equilibrium, the cost is invariably borne by the agent. Thus, once again, agents do not benefit from opportunistic behaviour; wealth maximisation is not achieved, for either the individual or the aggregate.

In a broader context, Bowie (1991) makes a similar observation, "It only pays to lie or cheat when you can free ride off the honesty of others... The conscious pursuit of self-interest by all members of society has the collective result of undermining the interests of all." Economic game theory, therefore, provides no normative justification for viewing financial-economic rationality as a behavioural ideal.

2.6 Agency Theory

The shareholder theory of the firm is often referred to as agency theory, as the role of the management of a firm is to act as the agents of the shareholders. The separation of ownership and control that is apparent in large modern companies, presents the most common way for a

business to be organised. This separation leads to what is known as the principal-agent (Type I) relationship.

2.6.1 Type I Agency Theory

Based on Jensen and Meckling (1976), there is an agency relationship when the actions of one individual affect both his/her welfare and that of another person in an explicit or implicit contractual relationship. The individual who undertakes the actions is the agent and the person whose welfare, measured in monetary terms, is affected by agent's actions is called the principal. In an agency relationship, the principal wants the agent to act in the principal's interest. However, the agent is expected to have his/her own interest and consequently, s/he may not act in the principal's best interests: "We define an agency relationship as a contract under which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties to the relationships are utility maximisers, there is a good reason to believe that the agent will not always act in the best interests of the principal." Then, the principal's problem is consequently to design an incentive contract that induces the agent to undertake actions that will maximise the principal's welfare.

However, both the principal and agent are confronted with uncertainty. This uncertainty may appear in various ways. First, the principal is uncertain about actions undertaken by the agent and/or information held by the agent. The mainstream-economic theory terms the principal's uncertainty state asymmetric information. There is a state of asymmetric information because the agent holds information that the principal does not. Second, uncertainty bears on the outcomes of the agent's actions. An agent is uncertain about the outcomes of his/her actions. For the principal, this latter phenomenon manifests itself more precisely in the fact that the principal is uncertain about the causality between agent's actions and the outcomes. This state of uncertainty and the resulting state of asymmetric information that exists between the principal and their agent impose certain constraints that complicate the forming of the contract.

Assumed within Type I agency theory is a lack of goal congruence between the principal and agent and that it is costly or difficult to confirm the agent's actions (Eisenhardt, 1989). In saying this, it is suggested that, left to their own devices, the agents will prefer different options to those that would be chosen by the principals. The agents would make decisions and follow courses that further their own self-interest as opposed to that of the principal. This

assumption that agents' behaviour will be driven by their own self-interest and nothing else has been criticised as being an overly simplistic conception of human behaviour (Williamson, 1985). It is argued that in addition to self-interested motives, altruism, irrationality, generosity, genuine concern for others etc. also characterise multi-faceted human behaviour. Sen (1987) agrees and actually states, "To argue that anything other than maximising self-interest must be irrational seems altogether extraordinary."

Within the legal systems of the UK, the US, and most western countries the managers of a business have a fiduciary duty to the owners of that business. This duty to shareholders is "more general and proactive" than the regulatory or contractual responsibilities to other groups (Marens & Wicks, 1999). These more general duties have also been used as a justification of the appropriateness of agency theories of the firm. The purpose and meaning of fiduciary duty were considered by Marens and Wicks (1999) who suggest that in fact this duty does not limit managers to a very narrow shareholder approach. They argue that the purpose of the fiduciary duty was originally designed to prevent managers undertaking expenditures that benefited them (Berle & Means, 1933). As such, Marens and Wicks (1999) suggest, "virtually any act that does not financially threaten the survival of the business could be construed as in the long-term best interest of shareholders." Thus, agency theory argues that managers merely act as custodians of the organisation and its operational activities and places upon them the burden of managing in the best interest of the owners of that business.

2.6.2 Type II Agency Theory

Many of the listed companies in China are state owned. The state is the absolute controlling shareholder. Such an ownership structure leads to a lack of managerial initiatives on the one hand, and misinformed business decisions on the other. As in Morck et al. (1988), concentrated ownership combined with an absence of effective external governance mechanisms results in more frequent conflicts between controlling shareholders and minority shareholders. This has come to be known as the principal-principal model of corporate governance, which centres on conflicts between the controlling and minority shareholders in a firm (Dharwadkar et al., 2000). In the following paragraphs, the nature, cause, and consequences of the principal-principal conflict will be discussed within the background of Chinese listed companies.

Chinese SOEs are known for their many social-welfare responsibilities. The state has incentives to finance the SOEs in achieving economically inefficient objectives other than

profit maximisation, which other minority shareholders pursue. Because of these policy burdens and inefficient management, they are hugely unprofitable and heavily indebted. To prepare SOEs for public listing, the government has to restructure them from traditional SOEs into share-holding companies, such as in the SDG case as will be discussed in detail in the Chapter 5. The goal of restructuring, which involves reorganisation of existing assets, injection of new capital, and layoff of excess labour, is to separate the entities to be listed on the stock exchange from the social obligations of their SOE predecessors.

In such cases, the most profitable part of the firm is carved out for public listing while the parent company keeps the excess workers, obsolete plants, and the financial and social liabilities. Sometimes the carve-outs may come from several SOEs, in which case the parent companies may or may not merge into one entity and there is typically one main parent company who contributes most of the assets. This parent company will later become the largest shareholder of the listed company and have dominant control. Minority rights are limited in the sense that they can seldom vote for crucial events or appointment/dismissal of directors. Large shareholders can put related but less qualified members in key positions (Faccio et al, 2001), purchase supplies and materials at above-market prices or selling products and services at below-market price to organisations owned by or associated with controlling shareholders (Chang & Hong, 2000), and/or engage in strategies which advance personal or political agendas at the expense of firm performance such as excessive diversification (e.g. the SDG case). Because management is merely a political representative of the state, agency problem of Chinese SOEs is potentially far more serious than of most western companies. These are related to Type II agency issues, i.e. between large and minority shareholders. The problem of dominance of a single shareholder, i.e. the state, existed in Chinese listed companies is an inherent and fundamental issue in China capital market, which will be examined further in the next chapter.

The root of this Type II agency issues is dominant ownership. As per Gedajlovic et al (2004), emerging economy firms may rely more heavily on dominant ownership for corporate governance reasons. This is because in China, external governance mechanisms such as product markets, labour markets, takeover markets, and other external factors are corrupted or ineffective and thus less effective in governing top managers (La Porta et al, 1998).

Large shareholders' expropriation of minority shareholders' interests prevails in practice even after several reforms on non-tradable shares. To maximise their own interests, large

shareholders have an incentive to expropriate minority shareholders' interests by their absolute privilege of shares held and information acquired through direct control over the listed companies and appointed management team. For example, in the course of full-circulation of A-Shares, large shareholders are likely to take tunnelling measures to lower their average cost of shares purchased before the promised non-tradable time of shares in order to maximise their own interests and hence damage company value. There are some empirical findings: (1) share prices of private placement facing to large shareholders and large shareholders' related parties are significantly different from those facing to institutional investors, this implies that large shareholders expropriate minority investors' interests through deliberate manipulations of financial decision; (2) large shareholders are likely to self-serve through insider trading in the processes of private placement; (3) it is hard to believe that large shareholders did inject high quality assets to controlled companies as they promised in the process of private placement from a perspective of changes in financial position before and after the injections.

Another evidence of large shareholder expropriation is the related party transactions (RPT). The first main type of transactions is transfer pricing for goods and services, which occurs during everyday operations within the companies such as sale of products and services and rental of plants and machineries. Large shareholders can tunnel cash out of their listed subsidiaries by setting unfair transfer prices. The second main type of transactions relates to large shareholder forcing listed subsidiaries to provide generous trade credits for the business transactions in the form of account receivable and advance payments. In this way, the listed companies are essentially financing the working capital of the related parties. CSRC introduced a regulation that prohibits large shareholders from forcing trade credits from the companies they control (CSRC 2004, Ruling 118); however this practice is still widely spread. The use of account receivables as proxy for agency costs is also inspired from this analysis, as will be discussed later in the Chapter 6.

2.6.3 Agency Problems

Agency theory argues that under conditions of incomplete information and uncertainty, which characterise most business settings, two agency problems arise: adverse selection and moral hazard. Adverse selection is the condition under which the principal cannot ascertain if the agent accurately represents her/his ability to do the work for which s/he is being paid. Moral hazard is the condition under which the principal cannot be sure if the agent has put forth maximal effort (Eisenhardt, 1989).

"Moral hazard may be defined as actions of economic agents in maximising their own utility to the detriment of others, in situations where they do not bear the full consequences or do not enjoy the full benefits of their actions (due to uncertainty and incomplete or restricted contracts), which prevent the assignment of full damages (benefits) to the agent responsible" (Kotovitz, 1987). In moral hazard, the agent moves first and takes some action that the principal cannot observe. There may be no informational asymmetry and the agency problem may simply stem from the principal's inability to control the actions of the agent. Or there may be informational asymmetry in which case the agency problem stems from the principal's inability to observe directly some information that affects the actions or the performance of the agent. The principal's problem is to establish a contract that induces the agent to take actions that the agent does not want to take, but that the principal values.

The classic agency problem of this type is managerial perquisite consumption (Dobson, 2004). As a firm moves from private to public ownership, there is a separation of ownership and control. The owners bear the cost of managers' perquisite consumption (e.g., business lunches, corporate jets, generous stock-option packages, etc.) but the managers make the decisions on how many "perks" to consume. Barring effective accountability – in other words barring a resolution to the agency problem – a "rational" wealth-maximising management, who no longer bears the full cost of its "perks", may be predisposed to consume perks to an excessive degree, i.e., to a degree that compromises the value of the firm as a whole.

The principal-agent literature shows that, to reduce moral-hazard problems and minimise costs associated with these problems, contracts must have a "carrots and sticks"[10] format. As in Padilla (2002), the principal must induce the agent to take the most appropriate action that will maximise their expected utility. In order to do so, the principal must design a contract that balances incentives and risk sharing as well as rewards and punishments. The basic idea is to reward the agent when the desired outcome is relatively more likely due to their actions and penalise them if the desired outcome is relatively less likely due to inappropriate action by them (Kreps, 1990). This is the very general conclusion of principal-agent models regarding to moral-hazard problems.

Most of agency literature, besides this general conclusion, generally focuses on technical aspects regarding structure of preferences, the nature of uncertainty and the informational structure of the environment (e.g., Holmstrom, 1982; Grossman & Hart, 1983; and Mirrlees,

[10]The expression is due to Mirrlees (1997).

1997) and examines how these aspects are affected when variations are introduced in the models. Examples of variations that can be found in the literature are moral hazard in the context of many principals and many agents (Holmstrom, 1982), moral hazard in the context of long-term contracts (Lambert, 1983), or the effect of time on moral hazard (Holmstrom, 1999). The moral hazard issue is more relevant to Type I agency issues because it exists mainly in a principal-agent relationship.

This agency literature has also focused its work on another agency problem, namely, adverse selection. In the standard scenario, a monopolist, who is trying to price discriminate between buyers with different (privately known) willingness to pay, or a regulator, who wants to obtain the highest efficient output from a utility company with private information about its cost is typical applications of adverse selection (Cabrales & Charness, 2000). In the Chinese context, an adverse-selection problem appears when the agent (or principal rather, representative of large shareholder) possesses information that may prove useful to their decision-making and the principal (minority shareholder) does not know it. Therefore, the minority shareholders cannot know if the management has made the most appropriate decision in light of the information possessed by them precisely because the minority shareholder does not have this information. They face up, strictly speaking, to an asymmetric-information problem.

2.6.4 Evidence of Agency Issues

Since corporate shares are largely held by the state, those with minority shares lack incentive or capability to administer managers, who are representatives of largest shareholder, and therefore the managers own ample control over the company even they have no or little stakes. This is merely the cause of Type II agency problems. There is much behaviour characterising the agency problems, among which empire building, tunnelling, entrenchment, and poison pills are mostly seen and serious ones.

2.6.4.1 Empire Building

Based on Jensen and Meckling (1976), managers can pursue empire building with firm resources in many ways, among which consumption of perquisites is mostly known and widely concerned. For example, luxury office sites and equipments or personal consumptions with firm wealth are both ways of manifestation (Burrough & Helyar, 1990). Besides, a main representation of empire building includes blind investments that exceed the capability of

rational expectations. This is truly the case in many Chinese SOEs and SDG will serve as a typical example in the case study chapter. Obviously, empire building can harm firm wealth (shareholder value) and benefit the mangers themselves, as in Grossman and Hart (1988).

There are a lot of literature on the analysis of empire building and the serious results these individual behaviours bring to the firm. For example, in his cash flow framework, Jensen (1986) analyses the managerial behaviour in reinvestment with free cash flows. He mentions that in the mid 1980s, although the market value of crude is 6 dollars per barrel, many petroleum-producing firms still put their huge free cash flows into crude exploit activities at the cost of 20 dollars per barrel, instead of attributing them to shareholders as dividends. He then concludes that managers reinvest free cash flows in order to enlarge firm size for their own benefits.[11]

On the other hand, empire building jeopardising shareholder value has also been empirically proved in the literature. For instance, mergers and acquisitions (M&A) are recognised as a means of enlarging firm size. However, significant negative abnormal returns are reported in several studies during M&A announcement period (Roll, 1986). Morck et al (1990), Bhagat et al (1990), Lang and Stulz (1994), and Comment and Jarrell (1995) also find evidence on multi reinvestments impairing firm value.

Especially, when managers have none or few firm stakes, the negative abnormal returns during M&A periods are more significantly figured (Rosenfeld, 1985), while firms with lower Tobin's Q and higher cash flows have greater impairments to firm value through multi reinvestments (Lang et al, 1991). These further confirm Jensen (1986) hypothesis of free cash flows, that is, when managers have fewer stakes of the firm, when there are fewer investment opportunities, and when there are more free cash flows, the empire building behaviour is more serious and the conflicts between managers and shareholders are more intense.

This also applies to large shareholders in China because they are not merely profit oriented. Under the separation of ownership and control, the managers are reluctant to distribute the cash flows to shareholders, but prone to overinvestment. Over expanding corporate operations or "empire-building" fits the interests of managers at the cost of shareholders. This will be further illustrated in the case study chapter.

[11]The positive relation between firm size and managerial benefits has been tested in many studies (for example, Murphy, 1985; Jensen & Murphy, 1990).

2.6.4.2 Tunnelling

This is a typical Type II agency problem. When having partial control over firm resources, the controlling shareholder or the managers will have vast incentive to take advantage of firm wealth for personal benefits. Corruption is a most direct way of this appropriation behaviour. Nonetheless, there are certain laws and regulations among countries and corporate internal supervisions against corruption, so practically controlling shareholders and managers employ a relatively concealed manner to appropriate, i.e., through the trading of firm resources, which is called tunnelling by Johnson et al (2000).

There are two kinds of tunnelling. The fist kind is self-dealing transactions. For example, the controlling shareholders or managers can use their control power to appropriate outside investor rights by trading their firm resources with a low price to firms with higher cash income allowance, paying the management higher salaries, providing loan guarantee to firms that they have higher stakes, or occupying development opportunities of the firm. The second kind is financial transactions including dilutive share issues, minority freeze-outs, inside trading, creeping acquisitions and other financial transactions to promote the share price.

Tunnelling is not only harmful to shareholder value, but also hinders the development of healthy financial markets. Johnson et al (2000) set forth many cases in their study, e.g., the furious tunnelling behaviours by controlling shareholders during the 1997-1998 Asian Financial Crisis. Bertrand et al (2002) further point out that tunnelling can decrease the transparency of the economy and distort accounting earnings (hence increase information asymmetry); hence the assessment of financial situations becomes more difficult.

In the Chinese setting, Cheng et al (2007) provide evidence that Chinese initial public offerings (IPOs) report better operating performance in the pre-IPO period with artificially boosted revenues and/or profits of their IPO subsidiaries in the pre-IPO period. Then in the post-IPO period, controlling shareholders discontinue this RPT-based earnings manipulation practice and begin to expropriate IPO subsidiaries by obtaining a large percentage of cash loans and hence resulting in worse performance in post-IPO period. Related party transactions (RPTs) with controlling shareholders have significant effects on the long-run performance of IPO firms, especially among state-controlled IPO firms with a highly concentrated ownership structure and a less independent board of directors.

2.6.4.3 Entrenchment

Grossman and Hart (1988) already prove that residual claim corresponds to the control, and thus residual claim without control is unrealisable. Therefore, managers will forcefully resist the dismissal action that deprives their residual claiming power. This kind of resistance toward dismissal might be the most serious agency problem (Jensen & Ruback, 1983). Shleifer and Vishny (1989) consider that unqualified managers try to avoid dismissal by a series of special arrangements in human resource investment, which is called entrenchment, and hence appropriate shareholder rights. La Porta et al (2000) also say that, as a fact of evidence, controlling shareholders (or controlling family) usually emplace their family members that do not own business skills into management team in the firms. There are many other papers discussing the entrenchment behaviour of managers. For example, Harris and Raviv (1988) and Stulz (1988) demonstrate that managers typically maintain firm leverage at a relatively high level in order not to be taken over that would result in dismissal.[12] In the Fluck (1999) model, managers use stock repurchase as a means of entrenchment.

There are also lots of work done on the relationship between entrenchment behaviour of managers and shareholder value. Walkling and Long (1984) find that only when the managers can obtain benefit from takeover activities, such as a stake in the new firm or maintaining their positions, do they not resist them. DeAngelo and Rice (1983) and Jarrell and Poulsen (1988) find that when firm announcement incorporates relevant clauses about takeover resistance, share price of the firm will drop considerably. Johnson et al (1985) carry out an interesting research and find that the share price will rise dramatically when the founder of the firm die from sudden car or plane accidence or commit suicide, hence they conclude that the entrenchment behaviour of firm founders leads to a decrease in firm value.

2.6.4.4 Poison Pills

A poison pill is a tactic that makes the target company less attractive in the event of a successful takeover bid. For example, companies with large amounts of available cash are frequently targeted for takeovers. By buying some other company, they can dispose of some of this cash quickly and reduce their attractiveness as a takeover target. There is no real

[12]Other scholars have put forward different views on how entrenchment motivations affect firm leverage. For example, Jensen (1986) points out that managers always avoid debt financing to avoid supervision from the creditors; while Zwiebel (1996) states that the defence motivation of the managers are exogenously decided so that the leverage level only affects their empire building behaviours. Berger et al (1997) find in their empirical study that defending managers generally choose a lower level of leverage, which proves the free cash flow hypothesis by Jensen (1986). However, they also find that managers sometimes also choose high level of leverage to resist takeover, which is somewhat similar to the Stulz (1988) model.

limitation on the design of the poison pill; it primarily depends on the financial engineering ability and imagination of the management.

The poison pill tactic, however, usually operates by giving the present holders of certain categories of shares the right to purchase a quantity of preferred stock at a cheap price as soon as the acquiring company or bidder has acquired more than a stated minimum percentage of the company stock (trigger level). If the shareholders were to exercise these rights, the bidding company would find that: (1) anticipated profits would be significantly reduced; and (2) the revised capital gearing (leverage) would have reduced the marketable value of the equity so that it could now only be resold at a loss.

Schwert (2000) reports, poison pills and other types of takeover deterrents such as anti-takeover charter amendments and management-friendly state regulations have greatly reduced the frequency of hostile takeovers in recent years. Because the threat of a hostile takeover is usually considered to have some disciplinary effect on management, the absence of these takeovers can be expected to increase agency costs. Consistent with takeover deterrents as an indication of higher agency costs, Malatesta and Walkling (1988) and Ryngaert (1988) report a negative market reaction to the implementation of poison pills and point out that poison pills severely impair shareholder value.

On the other hand, takeover deterrents can benefit shareholders by providing protection for management so that they can invest in long-term projects that may appear unprofitable in the short-run. However, Mallette (1991) finds no relation between corporate investment in long-term projects and the presence of anti-takeover charter amendments. Finally, Lippert and Moore (1995) report in their study that firms with high pay-performance sensitivity are more likely to have poison pills and classified boards. This suggests that inefficient external monitoring can be mitigated, in part, by compensation contracts designed to align manager and shareholder interests.

2.6.5 Agency Costs

Agency costs include the costs of investigating and selecting appropriate agents, gaining information to set performance standards, monitoring agents, bonding payments by the agents, and residual losses. Agency costs arise from the misalignment of interests between the firm's managers and the firm's shareholders. Jensen and Meckling (1976) point out that this conflict of interest between manager and shareholder is caused by the physical presence of excess

cash or cash equivalents. The potential problem here is managers may undertake imprudent decisions such as taking on negative NPV projects and through other means such as perk consumption. More importantly, investors might be more concerned by firms continuing to fund projects whose NPV is negative.

Furthermore, by divesting those assets with negative expected NPV does not fully eliminate the agency problem. Some argue that taking the next step and return the proceeds to shareholders may be more appropriate (Nohel & Tarhan, 1998). In short, the free cash flow hypothesis argues that firms with excess cash and a poor portfolio of investment opportunities will face sizable agency costs if the excess cash is not distributed to shareholders.

There are some important papers identifying agency problems. In 1976 Jensen and Meckling defined agency costs as being the sum of the cost of monitoring management, bonding the agent to the principal and any residual losses incurred to prevent shirking by agents. However, actual measurement of agency costs has lagged behind. Based on their discussion, there are two groups of research in defining agency costs.

The first group use direct measurement of agency costs. Ang, Cole, and Lin (2002) measure agency costs in two ways: first, the difference in dollar expenses between a firm with a certain ownership and management structure and the no-agency-cost base case firm; second, the ratio of annual sales to total assets. Singh and Davidson (2003) extend their work to large publicly traded corporations and focus on selling, general, and administrative expenses of a firm including "managerial salaries, rents, insurance, utilities, supplies, and advertising costs." However, their studies are carried out in US companies. Firth, Fung and Rui (2006) are investigating agency issues in Chinese listed companies without changing the measurement. As in Firth et al (2006), "Operating, general and administration (OGA) expenses are incurred in sales activities, and expenses are incurred in organising and managing the operations and production including expenses incurred by the Board of Directors. Additional expenses under the heading of OGA are incurred due to managerial discretion and these are positively related to agency costs. Therefore, higher agency costs will lead to a higher OGA expenses to sales ratio."

Borokhovich and Brunarski (2004) proxy agency costs with the independence of the firm's board of directors, the percentage of votes held by outside block-holders (shareholders who hold 5% or more of the firm's outstanding votes), and the presence of poison pills in the

firm's charter. Directors who have no business affiliation with the firm are expected to act as efficient agents for shareholders, as these board members have incentives to signal their value as expert decision makers. As such, they define independent boards as those boards in which the number of strict outside directors exceeds the number of inside directors. Strict outside directors include those individuals who are neither managers of the firm nor their relatives (inside directors). Consistent with Weisbach (1988), strict outside directors also exclude directors who have current or potential business ties to the firm, such as bank executives, insurance company executives, accountants, lawyers, and business consultants.

The second group uses firm performance as an inverse indicator of agency costs, including Morch, Shleifer and Vishny (1988), and Agrawal and Knoeber (1996), who use Tobin's Q. Xu, Zhu and Lin (2002) calculate the agency costs as returns on assets, which is defined as the ratio of before-tax profits over the book value of total assets.

Following their work, there are two main measurements of agency costs in China. The first measure for agency costs is returns on assets (ROA), which is defined as the ratio of before-tax profits over the book value of total assets (e.g., Xu et al, 2002). Most Chinese listed firms are transformed from SOEs. In order to protect the value of state assets, fixed assets depreciation rates are centrally determined and often are artificially low, thus leading to an upward bias in fixed asset estimates. Current assets include some stockpiled goods that either cannot be sold at their book value, or cannot be sold at all. Therefore, asset values can be misstated.

An alternative measure of agency costs is the ratio of return on equity (ROE), as a measure of profitability (e.g., Li & Cui, 2003). This indicator measures profitability from a different angle. ROE is clearly a more preferable indicator of profitability, matching the common usage of the market economics (Li & Cui, 2003). Profit is the return to equity holders; therefore, higher return on equity has less agency conflict. A recently study by McKnight and Mira (2003) defines agency costs as an interaction term of growth opportunities and the firm's free cash flow (FCF). Other works use Tobin's Q as an inverse indicator of agency costs. There are two problems here: first, Tobin's Q as used by many authors is ill-defined from its original meaning – firm's market value over replacement cost of the physical assets; second but more importantly, researches are restricted by previous work typically done in the US or UK context and ignore the unique economic and political setting in China.

There are certain studies in the Chinese context about corporate governance mechanisms and agency costs, such as Zhang (1996), Zhang (1997), and Zhou and Wang (2000), although they are more of a descriptive perspective. Obviously, there lacks a uniform and efficient enough definition of agency costs, especially in emerging markets, ever since the conceptual description by Jensen and Meckling in 1976, especially which can be used in the Chinese context. Besides, the corporate governance settings in China are very different from those in developed economies. SOE reforms have resulted in significant degree of insider-control as SOE managers have acquired considerable discretion over the use of state assets (Sun & Tong, 2003).

2.6.6 Main Merits and Criticism

The way scholars today think of corporate governance has been shaped by agency theory. It takes the firm to be a web of voluntary contracts. The major task is to find the most efficient way to align the interests of the managers as the agents to the interests of the stockholders as the principals (Jensen & Meckling, 1976). The market for corporate control is taken to work well, so that this system is self-regulating. There is no reason to assume "contractual failure"; the collective action problems faced by (dispersed) shareholders are overcome by various processes, the most important being unfriendly stock-market takeovers. Agency theory has sparked a huge literature, which has been surveyed very ably and extensively by, e.g., Becht, Bolton, and Roell (2002), Prendergast (1999) Gibbons (1998), and Eisenhardt (1989).

While agency theory is not a unified subject, and different opinions exist, as in any other vigorous discipline, these surveys can adequately represent the state of research. The general adoption of agency theory as the essence of corporate governance has accompanied the success of the US economy that, since 1995, grew significantly more quickly than those in the Europe and in Japan did. Agency theory has not only dominated the academic discipline, but also been accompanied by applications of its major message in business practice. Agency theory's emphasis that managers' interests must be aligned to those of stockholders has arguably been responsible for the widespread effort to introduce performance incentive plans, in particular pay-for-performance. The idea has even spread to areas outside the market and to capitalist economy.

However, the simplest model of agency theory assumes one principle and one agent and a modernist view of the world merely assumes that the addition of more principles and more agents makes for a more complex model without negating any of the assumptions. In the

corporate world, this is problematic as the theory depends upon a relationship between the parties and a shared understanding of the context in which agreements are made. With one principle and one agent, this is not a problem, as the two parties know each other. In the corporate world, however the principles are equated to the shareholders of the company.

Borokhovich and Brunarski (2004) state, in their study, that for any large corporation however those shareholders are an amorphous mass of people who are unknown to the managers of the business. Indeed, there is no requirement, or even expectation, that anyone will remain a shareholder for an extended period. Thus, there can be no relationship between shareholders and managers as the principles are merely those holding the shares – as property being invested in – at a particular point in time. So shareholders do not invest in a company and in the future of that company; rather they invest for capital growth and/or a future dividend stream and shares are just one way of doing this which can be moved into or out of at will.

This problem is worsened, particularly in the UK, by the fact that a significant proportion of shares are actually bought and sold by fund managers of financial institutions acting on behalf of their investors. These fund managers are rewarded according to the growth (or otherwise) of the value of the fund. Thus, shares are bought and sold as commodities rather than as part ownership of a business enterprise. Thus, one of the two parties implicit within agency theory is problematic because there is in reality no principal.

The agent party to the contract is normally considered the managers of the organisation and this too is problematic. The most senior managers of the organisation are the board of directors but their role in the principal-agent relationship is likely to be partly one and partly the other. As agents, their role is to manage the organisation, and receive rewards for their ability in this respect, but they are also likely to be principals as owners of shares in the business. Therefore, there is no divide between principals and agents as far as they are concerned. This situation will almost certainly exist for other managers in the business also as managerial remuneration schemes are based, at least in part, on share option schemes. It is normally assumed that such schemes will successfully align the objects of managers with those of the shareholders but it has been argued (Crowther, 2007) that the effect is to privilege managers objectives over those of the business itself.

Having said that, this study aims to look into the multiple agency relationships in Chinese enterprises and hence mitigate the deficiencies mentioned above.

2.7 Conclusion

This chapter critically reviews the main theories and studies that have been advanced in the literature, i.e. stewardship theory, stakeholder theory, property rights theory, game theory, and agency theory. After reviewing main concepts and their applicability in the Chinese setting, it is concluded that agency theory is to be used for this study.

Stewardship theory has the assumption that behaviours of executive are aligned with the interests of the principals and hence we are less likely to find the installation of a board. This is clearly not the case in China, because managers require closer supervision by the board and the board oversees the actions of the management. In China, there is not only one principal and in fact problems arise when management only represents the largest shareholders. The assumption of stewardship theory is therefore not applicable with Chinese listed companies.

Stakeholder theory considers the relevance of different stakeholders, e.g. shareholders, lenders, directors, employees, customers, suppliers, government and society as a whole. The objectives of all these groups need to be considered by good company managers when making decisions. However, one of the principles of the market economy is that if the owners of businesses attempt to achieve maximum profitability and earnings this will help to increase the wealth of society. As a result, it is usually assumed that a proper objective for private sector organisations is profit maximisation, i.e. the financial manager is concerned with managing the company's funds on behalf of shareholders, and producing information which shows the likely effect of management decisions on shareholder wealth. Considering other stakeholder groups is supplementary in the decision making. During the course, personal incentives come into playing so agency problems arise, especially when the objectives of the stakeholders are often conflicting due to heavy government interference among Chinese listed companies. Hence this theory is not applicable in China either.

Property rights theory has many implications only reasonable when the non-human assets are important or relevant. Another obvious drawback of the property rights approach as aforementioned is that it makes no distinction between ownership and control, while game theory is largely based on agency theory.

Recent research suggests that there is not only a principal-agent problem in transition economies, but also principal-principal problems (e.g., Young et al, 2008). Criticisms on

agency theory neglect the fact that there are two types of agency issues, with Type II being more applicable in the Chinese setting.

The most distinct feature of SOEs in China is that the role of principals is played by the state. Because the owner is far away from the management team, and the manager has no stake in the firm, the agency problem of SOEs on the management side is potentially far more serious than of any capitalist firm where the CEO normally holds a considerable stake and is therefore an inside owner (Zhang, 1996). Moreover, these bureaucrats typically have goals that are different from social welfare, and are dictated by their own political and economic interests. For this reason, many Chinese economists have concluded that the problem of SOEs is mainly that of the principal rather than that of agents (Zhang, 1997). Therefore, agency theory will be used as a theoretical foundation throughout this thesis.

The major trust of agency theory is that it views the modern corporation as a series of contracts between various parties with conflicting economic interests. The agency literature suggests that corporate governance mechanisms can help resolve incentive conflicts between contracting parties in companies and prior study results provide a useful comparative source for this research project, which will be discussed in the following chapter. In the chapter then after, institutional background in the Chinese context will be discussed in detail to illustrate agency issues in listed companies before empirical work.

Chapter 3 Governance Mechanisms

3.1 Introduction

The previous chapter has set out the theoretical framework for the study, justified within the Chinese setting. This chapter is therefore going to analyse relevant corporate governance mechanisms addressing the issues identified, i.e. it will review the corporate governance literature with a focus from an agency perspective (especially Type II agency problem, which is more applicable in China), it will summarise what previous studies have done and whether the methodologies and results apply to Chinese listed companies, and it will then justify why certain mechanisms are chosen for case study and statistic testing.

A central focus in the enormous literature on corporate governance in both finance and in law and economics has been on agency problems between management and shareholders stemming from the separation of ownership and control, and their potential solutions. Different strands address the role of monitoring and supervision by the board, ownership structure and the market for corporate control, and executive compensation in mitigating these agency problems (see, e.g., Jensen, 1993; Shleifer & Vishny, 1997; and Hermalin & Weisbach, 2003). As a general comment, this literature has shed light on potential remedies for the agency problem between management and shareholders.

In theory, agency problems and agency costs can be alleviated by installing various internal and external corporate governance mechanisms (Fama & Jensen, 1983; Jensen, 1986). The internal mechanisms of primary interest are the Board of Directors (BOD) and the equity ownership structure of the firm (Denis & McConnell, 2002). Company Law in China also requires Chinese listed companies to adopt a two-tier board structure, including a BOD and a Supervisory Board (Dahya et al, 2003), which also acts as an internal governance mechanism. Massive research interest has been placed also on dividend payments.

The primary external mechanisms include the market for corporate control, external auditing, and legal protection of investors. These mechanisms will be discussed in the following sections for their applicability in the Chinese context.

3.2 Ownership Structure

A strand of literature the thesis relates to focuses on ownership structure and large shareholder monitoring. In this literature, the shareholder's incentives to intervene in firm management (and thus the degree of monitor independence) are typically linked to the degree of ownership dispersion. Shleifer and Vishny (1988) focus on the ways in which large shareholders bring about value-increasing changes in corporate financial policy through monitoring or takeovers, and show that the free-riding problem associated with a dispersed ownership structure can be mitigated by the presence of a large shareholder.

Burkart, Gromb and Panunzi (1997) highlight a potential drawback of large shareholder intervention. In particular, the authors address the effect of ownership structure on managerial initiative and non-contractible (firm-specific) investments. Their argument is that a reduction of managerial discretion by a large shareholder may be ex post efficient, but lowers the ex ante incentives of managers to undertake firm-specific investments. The authors show that a dispersed ownership structure can serve as a pre-commitment device against excessive monitoring and interference, i.e., it commits shareholders not to exercise excessive control in the choice of investment projects, thus inducing the manager to take initiative.

Many prior studies in China have focused on how difference ownership impacts on firm performance, especially with state ownership and legal person ownership. Therefore in order to compare the results with existing literature, ownership structure will be used as a governance mechanism in this study, which will be discussed further in the next chapter.

3.2.1 Ownership Concentration

An important line of agency costs literature relates to concentrated ownership. Stiglitz (1985) has argued that one of the most important ways of value maximisation by firms is through concentrated ownership of the firm's shares. Shome and Singh (1995) replicate this result and provide evidence that the large shareholder's presence improves accounting performance. Large shareholders thus address the agency problem as that they both have a general interest in profit maximisation, and enough control over the assets of the firm to have their interests respected.

Many scholars argue that outside large shareholders reduce managerial entrenchment (e.g. Denis, 2001; Li & Cui, 2003). However, this does not exclude the possibility of rising

concentration of share ownership to depreciate the market value of the firm (Huddat, 1993; Admati, 1994). The control shareholders often have better access to information, hold more power in selecting management, and involve in key decision-makings. Especially when the manager holds fewer shares and is subordinate to controlling shareholders, control shareholders impinge upon the interests of small shareholders by way of non-division of dividends and diversion of profits (Li & Cui, 2003). The exploitation of small shareholders by controlling shareholders constitutes ex ante an expropriation threat that reduces managerial initiative and non-contractible investments and may come into conflict with performance-based incentive schemes (Burkart, 1997). This specifically relates to Type II agency problems, as explained below.

One of the main characteristic of the Chinese corporate governance is the over concentration of equity structure. Most of the listed firms in China are transformed from SOEs. Ownership structure displays the evidence of the co-existence of control shareholders, who are normally related to the state and many other small and comparatively weak shareholders. State shares are uniquely large.

Statistics show that the state holds shares of most listed firms in great concentration. Of the listed companies, 60% of the equities belong to the state or state-owned corporate persons. By 2005 among the 1395 listed firms on Shenzhen and Shanghai stock markets, the proportion of shares of the number one shareholder reaches 45% and the second largest shareholder makes up 8%. The management level lacks long-term incentive and restraining mechanism. The board of directors is mainly formed by control shareholders. The lack of independent directors makes it difficult to display their regulating and balancing roles. Among all the directors of the listed firms by 2005, 73% have the background of state shares (28%) or shares of state-owned corporate persons (45%). Since the manager holds fewer shares, and is subordinate to controlling shareholders, the agency problem between shareholders of a firm and its manager has turned into the second dimension of the agency problem in a firm, the conflict between the controlling shareholders and small shareholders (data source: Shanghai and Shenzhen Stock Exchange).

3.2.2 Managerial Ownership

Theoretical studies in western economies mainly focus on managerial ownership. Grossman and Hart (1983) argue that for diffusely held firms it might not be the interest of any shareholders to monitor management. This is known as the free-rider problem and it raises the

"agency problem" (Fama & Jensen, 1983). Shleifer and Vishny (1986) suggest that concentration of ownership can avoid this problem, i.e. the presence of a large minority shareholder can increase probability of value-maximising takeover, and thus increase firm value. Stulz (1990) extends their finding, allows for higher-than-majority stakes, and remarks that firm value depends on proportion of votes α controlled by management and increases with small values of α but decreases with large values of α when α increases – firm value attains maximum for an $\alpha>0$ and a minimum when $\alpha>50\%$. A further aspect of structuring the equity ownership of the firm involves the degree to which insiders are also shareholders.

Jensen and Meckling (1976) point out that managerial ownership can play a central role in reducing agency costs of equity, and the divergence of interests may vary inversely with the manager's ownership stake. Morck, Shleifer, and Vishny (1988) find significant non-monotonic association between different levels of directors' ownership and Tobin's Q, suggesting that some levels of board stock ownership have systematic advantages. Demsetz and Lehn (1985), Holderness and Sheehan (1988), McConnell and Servaes (1990), Hermalin and Weisbach (1991), and Dennis and Sarin (1999) find evidence on the relation between corporate performance and the ownership structure of common stocks.

Jensen (1993) suggests that managerial shareholdings help align the interests of shareholders and managers, and as the proportion of managerial equity ownership increases, so does corporate performance. Empirically, the hypothesis by Morck et al (1988) predicts a nonlinear relationship between board ownership and company's performance as measured by Tobin's Q. Morck, Shleifer, and Vishny (1988) use non-linear Ordinary Least Square (OLS) specification of effects of managerial ownership on Tobin's Q measured by firm's market value over replacement cost of the physical assets.[13]

Morck et al (1988) suggest that in fast growing/new firms, managerial holdings play a more important (signalling or compensation) role than in old, large firms, while Demsetz and Lehn (1985) find that managerial ownership is positively related (but at decreasing rates) to monitoring difficulty. McConnell and Servaes (1990) find a significant (initially) positive nonlinear relationship (cubic and quadratic, respectively) between managerial ownership and firm value.

[13]By using a sample of 371 firms from 1980 Fortune 500 list, they find that firm value rises with ownership in 0-5% region, decrease in 5-25% region to attain minimum level, and increase again above 25% ownership but at a decreasing rate. (Morck, Shleifer & Vishny, 1988)

Wruck (1989) looks at 128 large changes of ownership during 1975-1985 on NYSE and AMEX to extend the Morck et al model by considering outsider ownership and reaches a similar result. McConnell and Servaes (1990) clearly distinguish between managerial and non-managerial ownership and use a curvilinear specification with 1173 US companies in 1976 and 1093 in 1986. They use a quadratic regression specification and find that firms reach maximum value for 40-50% range and there is a positive linear link between firm value and institutional ownership. Kole (1995) uses the same sample as Morck et al and suggests that managerial ownership may affect large and small firms differently with respect to value.

Agrawal and Knoeber (1996) examine the use of seven mechanisms to control agency problems between managers and shareholders. The mechanisms are six corporate governance mechanisms (insider ownership, institutional ownership, large shareholder monitoring, outside directors, managerial labour markets, and market for corporate control) and debt. Their sample consists of 400 large US firms. When they use univariate OLS regressions they suggest link between performance and insider ownership, outside directors, debt and market for corporate control; when using a multivariate OLS regression, insider ownership is no longer significant; when using a simultaneous-equations system, debt and market for corporate control stop being significant.

Ang et al (2000) provide evidence on corporate ownership structure and agency costs and conclude that higher managerial ownership significantly and positively influences the corporate asset utilisation efficiency. Singh and Davidson (2003) extend their work to large publicly traded corporations, investigate the role of outside block ownership in terms of their proportion of equity ownership, and make a similar conclusion.[14] Since they measure the agency cost by managerial expense, they focus on a firm's selling, general, and administrative expenses including "managerial salaries, rents, insurance, utilities, supplies, and advertising costs." This becomes somewhat a popular measure in later studies.

Others have argued that managerial entrenchment reduces turnover in cases of higher managerial ownership (e.g., Morck et al, 1988; Dedman, 2003). In Demsetz and Villalonga's (2001) words, managerial holdings "may make management act more like an outside shareholder or more like a manager possessed of an entrenched position." In other words, perhaps "management ownership is related to market-to-book ratios because there are more benefits associated with controlling companies with more intangible assets" (Daniel et al,

[14]Singh and Davidson (2003), "In large publicly traded corporations, managerial ownership significantly alleviates principal-agent conflicts even in the presence of other agency deterrent mechanisms."

1997). Whether the managers of such firms have these amounts to hand is not clear, in contrast to the owner-managers of firms with previous track records of profitable trading who then attain listings for their firms. Further, whether encouraging managers to become owners is good for encouraging the truthful and timely revelation of information is not clear if superior information-motivated insider trading can take place but be largely undetectable.

In China, managerial ownership is extremely low (please refer to the institutional background chapter), which make it a less effective mechanism in governance. According to Fan et al (2007), almost 27% of the CEOs in a sample of 790 newly partially privatised firms in China are former or current government bureaucrats. Moreover, firms led by politically connected CEOs are more likely to appoint other bureaucrats to the board of directors rather than directors with relevant professional backgrounds. Due to the unique characteristics of Chinese companies, managerial ownership might even worsen firm performance because they are representatives of the controlling shareholder, i.e. the state.

3.2.3 Presence of Block-Holders

There are several empirical findings supporting that large shareholders play an active role in corporate governance. Compared to shareholders who hold small amounts of equity, block-holders have incentives to monitor managers, as the benefits of monitoring are more likely to exceed the costs for these shareholders (Shleifer & Vishny, 1988). However, the preferences of block-holders are not clearly defined in the event of a dividend increase. For instance, in addition to their role in controlling agency costs, block-holders can represent shareholders, who, at the margin, prefer dividend income to capital gains. If boards of directors or block-holders prove to be ineffective monitors of management, the market for corporate control can serve as an alternative mechanism to reduce agency costs through disciplinary takeovers. Takeover deterrents can reduce the efficiency of the market for corporate control by increasing the cost of a takeover to the bidder, thus reducing the probability of a takeover. Lippert and Moore (1995) use the presence of poison pills in the firm's charter to proxy for agency costs related to the efficiency of the market for corporate control.

Unlike companies based in other countries, public corporations in the United States have a relative absence of influential shareholders who hold large blocks of a firm's stock over a long period and actively monitor the firm's performance (Bhagat & Jefferis, 2002). While major companies in Japan and Germany have strong bank shareholders, shareholder oversight in the

United States is generally considered weak. There is evidence that firms benefit from monitoring by outside block-holders. Agrawal and Mandelker (1990, 1992) report evidence that is consistent with monitoring by large outside shareholders in their studies of takeover deterrents. They attribute the result to better corporate monitoring at firms with higher levels of institutional ownership. Denis and Serrano (1996) report that firms with more outside block-holding exhibit superior performance relative to firms with fewer outside block-holding. Denis, Denis, and Sarin (1997) suggest that ownership structure has an important influence on internal monitoring efforts. They report that the probability of top executive turnover is positively related to the presence of an outside block-holder. They also note that turnover is more sensitive to performance when the firm has an outside block-holder than when it does not. Bhagat, Black, and Blair (2001) record a significant increase in large-block shareholders from the mid-1980s through the mid-1990s, with sharp increases in holdings by institutional investors. They note that, during the period from 1987 through 1990, firms with large-block shareholders outperform their peers. The results suggest that certain block-holders can identify a successful investment strategy or promote restructuring within the firm to improve performance. Bhagat et al suggest, however, that the strategy is contingent on an active market for hostile takeovers and leveraged restructuring, a situation that was prevalent during the period from 1987 through 1990. They find no evidence of firms with large block-holding exhibit superior performance in an environment with few hostile takeovers or leveraged restructurings.

Outside block-holders are not necessarily homogeneous. Brickley, Lease, and Smith (1988) propose that block-holders who have lines of business with the firm are likely to follow the "Wall Street Rule." The rule holds that block-holders will either vote with management to protect their lines of business or sell the stock rather than opposing management. Therefore, unaffiliated block-holders, defined as outside block-holders having no lines of business with the firm, must be differentiated from affiliated block-holders, defined as outside block-holders having lines of business with the firm. Dividends further complicate the issue. Corporations have tax incentives to hold stocks with high dividend yields. If that incentive is sufficiently strong, it can dominate the incentive to monitor management efficiently even if no lines of business exist.

As China is concerned, there is uncommon presence of block holders other than the state. The major non-state ownership is individual shareholding and independent non-state institutional investors are very rare (Chen, 2004), hence reducing its applicability.

3.3 Board of Directors

There is a growing interest in understanding how board of directors influences corporate performance through monitoring management, especially in earnings manipulation. From this aspect, the corporate governance literature emphasises the role of outside directors in resolving agency problems and reducing agency costs through the design of incentive contracts and the monitoring of management behaviour (Fama & Jensen, 1983).

Thereafter, a considerable body of academic studies addresses the monitoring role and effectiveness of board.[15] For example, Kaplan and Minton (1994) examine the relationship between the corporate performance and outside directorships. Beasley (1996) discovers that firms with boards dominated by outside directors are less likely to engage in accounting fraud. Eisenberg, Sundgren and Wells (1998) deal with the size of board in small firms and they find that as the size increases, agency problems increase. Vafeas (1999) conducts a study on the frequency of board meeting and firm performance and reports an inverse relationship – there are more meetings in bad times. This is, to some extent, consistent with agency theory.

The literature on corporate boards has primarily focused on the degree of independence of the board. Many studies have shown that boards often lack independence from the CEO (Hermalin & Weisbach, 1998). While this conclusion is widely supported, little is known about how board composition comes about. Some exceptions are recent studies that focus on the optimal board composition, particularly in the context of facilitating an optimal information flow between management and board. One conclusion in this literature is that if access to inside information is crucial, the board should be more tilted towards insiders (Raheja, 2003). Similarly, if management is reluctant to disclose information, friendlier, i.e., insider-dominated, boards might be optimal (Adams & Ferreira, 2003). In this way, the board would pre-commit to a lower monitoring intensity in order to encourage information sharing by management.

What these papers show is that the need to access firm-specific information is a crucial determinant of the optimal distance of the board to management. Where firm-specific information is crucial and only insiders can access it, an insider-dominated board is optimal. As will become clear, this insight is consistent with our results in that we will show that highly firm-specific investments require information that is more intimate and dictate

[15]Hermalin and Weisbach (2003) review this literature.

proximity. However, the key trade-off is between the degree of insider control of the board and managerial incentives.

Several other papers have focused on the effectiveness of the board. Fama (1980) and Fama and Jensen (1983) focus on the monitoring role of (outside) directors and emphasise that board members have incentives to build reputations as expert monitors, and thus are "tougher" on managers. While this argument suggests that reputational considerations can mitigate agency problems between outside board members and a firm's shareholders (i.e., outsiders have more incentives to become informed and intervene), we argue that such considerations can also be at the root of incentive distortions. That is, if there is uncertainty with respect to the quality of the board, the board may abstain from intervening in managerial decisions if this could potentially worsen its reputation, technologies that are optimally implemented at a large scale (high productivity impact).

Some other papers discuss the role of the board relative to management. Almazan and Suarez (2003) and Maug (1997) address the impact of board independence on managers' incentives to make firm-specific investments. Almazan and Suarez (2003) conclude that independent directors are optimal if the restructuring potential of the firm's assets is high and the cost of information acquisition is low. This shows that objectivity (distance) becomes more optimal if opportunity costs increase. Maug (1997) focuses on the relative efficiency of independent directors versus shareholders. Hirshleifer and Thakor (1994) focus on the complementarities of monitoring by the board and the market for corporate control.

The literature examining the efficiency of the board of directors provides strong evidence that the capital markets view outside directors as efficient monitors of management. Weisbach (1988) reports a positive relation between the incidence of disciplinary turnover among executives and the proportion of outside directors on the board. In their study of tender offers, Byrd and Hickman (1992) find that the stock-price reaction to takeover bids is positively related to the proportion of outsiders on the board. Borokhovich, Parrino, and Trapani (1996) report that the probability of an outsider being named to a management position increases with the proportion of outside directors on the board and that the stock price reacts positively to the naming of outside replacements.

Other studies examine the correlation between board composition and corporate performance. Bhagat and Black (2001) report a strong correlation between poor firm performance and the

ensuing increase in board independence. They note that poor firm performance, not growth opportunities, determines the change in board independence. However, Bhagat and Black find no evidence that greater board independence leads to improved performance.

The study of corporate governance in China begins with the reform of its SOEs. Many economists have realised that the main reason of SOEs' bad performance is their improper governance. The most distinct feature of SOEs in China is that the state is typically the absolute controlling shareholder. Because the owner is far away from the management team and the manager has no stake in the firm, agency problem of SOEs is potentially far more serious than of most western corporations. Tam (1995) surveys corporate governance in China and concentrates on the board functions.

However, empirical studies of BOD and agency costs in Chinese listed companies are rare. Among the few studies, Firth et al (2003) examine how ownership and board structure affect the informativeness of earnings for companies listed in China. They use the size of the board, the proportion of outside directors on the board, chairperson-CEO duality, and non-executive directors (calculated as the proportion of no-pay directors to the total number of directors on the board) to proxy the effectiveness of BOD in their study. Earnings informativeness is proxied by the earnings-returns relationship and discretionary accruals. Their data are information from 549 listed companies' annual reports and their stock market performances over 1998-2000. They find that firms with more non-executive directors and separated duties of the chairperson and CEO have greater earnings informativeness, which means less significant entrenchment effect and thus less serious agency problem. However, they do not reach any significant conclusion on the impact of board size.

3.3.1 Board Structure

According to agency theory, the company is less likely to suffer loss from the collusion between the managers and the independent directors who come from different external agencies (Fama & Jensen, 1983). According to them, independent directors would be motivated to monitor the management because they have incentives to develop reputations in decision control. Independent directors are encouraged to express the independent opinion of the major events occurred in the company including nomination, appointment, or replacement of directors, appointing and dismissing top executives, remuneration for directors and top executives, and those they consider detrimental to the interests of minority shareholders. Hence, it is reasonable that their presence will improve firm performance and thus alleviate

agency problems and reduce agency costs. On the other hand, insider control could lead to many agency problems such as asset stripping, poor investment decision, de-capitalisation through excessive wage increase, and increases in other private benefits (Wang, 2003). Since the independent director system was introduced in China only from 2001, it is interesting to see how it works in Chinese listed companies.

Within an agency theory framework, because of their independence, non-executive directors (NEDs) are seen as useful because they can monitor and control the actions of opportunistic executive directors (Jensen & Meckling, 1976). As a practical matter, NEDs are potentially effective because they "have incentives to develop reputations as experts in decision control" (Fama & Jensen, 1983). The Hampel Report (1998), combining the agency and resource dependency theories, states that a NED "should have both a strategic and monitoring function," and "may contribute valuable expertise not otherwise available to management." In order to fulfil their various responsibilities, maintain, and enhance their reputations, NEDs have incentives to reduce information asymmetries between themselves and executive directors. In contrast, some evidence suggests that boards dominated by NEDs can result in oppressive strategic actions, excessive monitoring, insufficient business knowledge to be effective, and a lack of real independence (Haniffa & Cooke, 2002).

Another aspect of board structure is whether the roles of chairperson and chief executive are separated (duality). Both theorists and regulators have argued that duality is an important determinant of board effectiveness (Fama & Jensen, 1983; Higgs Report, 2003; Fama, 1980) considers the existence of "panoply of internal and external monitoring devices that evolve to stimulate the ongoing efficiency of the corporate form."

The agency model, assuming managers are opportunistic, argues that the separation of the chief executive and chairperson roles improves shareholders' monitoring effectiveness over management decisions (Fama & Jensen, 1983). If one assumes managers act in the best interest of the firm and shareholders (the stewardship hypothesis), however, the combination of both roles in the same person enables a better understanding of firm's operating environment (Weir, Laing & McKnight, 2002).

3.3.2 Board Size

The size of the board of directors is expected to be associated with less effective board

monitoring,[16] based on the argument that larger boards are less effective and more susceptible to the influence of the CEO (Jensen, 1993). Yermack (1996) reports a statistically significant, negative correlation between the board size and firm value in his empirical study. Li and Cui (2003) carry out an empirical study on agency costs and board size in Chinese listed companies, and reach the same conclusion. As we can see that when board size increases, problems relating to communication, process, decision-making and coordination increase, and the ability of the board to control management decrease, thus leading to agency problems (Eisenberg, Sundgren & Wells, 1998). From the findings of those previous works, we have important implication for corporate governance such that it is possible to improve board effectiveness by restricting board size.

3.3.3 Independent Directors

The presence of non-executive directors (NEDs) on the board is viewed as a governance mechanism that could help in controlling the agency problem. However, whether NEDs indeed promote shareholders interests is open to debate (Berle & Means, 1932; Jensen, 1993). Some authors assert that NEDs are more likely to align themselves with top management rather than the shareholder. This is not only because top managers have a great influence over who is on the board (Mace, 1986; Byrd & Hickman, 1992; Hermalin & Weisbach, 1998), but also because non-management directors typically hold a trivial portion of the firm's stock (Patton & Baker, 1987; Brickley & Coles, 1994; Kosnik, 1987; Rhoades & Rechener, 2000).

However, Fama (1980), Fama and Jensen (1983) and Kaplan and Reishus (1990), for instance, argue that reputation concerns, fear of lawsuits and market for their services motivate NEDs to represent shareholders. Many other studies find that boards dominated by NEDs are more likely to act in shareholders' best interest (Weistbach, 1988; Westphal & Zaiac, 1995; Borokhovich, Parrino & Trapani, 1996; Hermalin & Weisbach, 1988; Byrd & Hickman, 1992; Brickley, Coles & Terry, 1994). Some reform advocates suggest that many directors serve on too many boards. This situation is also known as "busy" director. It is believed that CEOs that serve on too many boards may be disregarding their duties to the firm with which they are most responsible.

On the other hand, additional directorships may be regarded as a proxy for director quality, where higher quality directors should be more closely associated with promoting shareholders

[16] Eisenberg, Sundgren and Wells (1998) argue that as board size increases, increased problems of communication, process, decision making and coordination, and decreased ability of the board to control management thereby leading to agency problems.

interests. Dowen (1995) found that the average number of additional directorships held by board members had a positive impact on firm performance whereas Klein (1998) found a weak relationship with performance. Given the inadequacy of research, the prediction of this relationship remains an empirical question.

3.4 Dividend Policy

Agency costs provide shareholders with the motive to compel managers to act in the shareholders' best interests. Studies examining the agency cost motivation for dividends focus on the relation between the dividend payout ratio and various agency cost and capital structure variables. The thorniest issue in finance has been what Black (1976) termed "the dividend puzzle." Firms have historically paid out about a half of their earnings as dividends. Many of these dividends are received by investors in high tax brackets who, on the margin, pay substantial amounts of taxes on them. In addition, Lintner (1956) demonstrates in a classic study that managers "smooth" dividends in the sense that they are less variable than earnings. This finding is confirmed by Fama and Babiak (1968) and numerous other authors. The results of studies on dividends and agency costs generally suggest that the dividend payout decision is significantly related to the degree of the agency costs within the firm.[17]

In the following sections, difference explanations for dividend policy will be discussed in detail in order to justify the use of it as an internal corporate governance mechanism. In the literature, it is not clear whether it is a cause or a result of agency problem. Consequently, some studies used it as an explanatory variable while others used it as a dependent variable, and prior empirical results are mix. As in the previous chapter, discussions below also include other theoretical aspects for the completeness of a thorough review; however agency theory will again serve as the main supporting theory in the Chinese context.

3.4.1 Bird in Hand Theory

There has been a long discussion about whether dividend can increase firm value until Miller and Modigliani (1961) come up with the MM propositions. In their hypothesis, if the market is perfect (i.e., there are no tax, transactions costs, or any other factors leading to imperfect

[17]For example, Dempsey and Laber (1992) report that the dividend yield is negatively related to the proportion of stock held by insiders and positively related to the number of common shareholders within the firm. Noronha, Shome, and Morgan (1996) examine the relation between agency cost variables and dividend payout ratios, segmented by the level of the firm's growth opportunities. For firms with low growth opportunities, they report a positive relation among the dividend payout ratio, the presence of outside blockholders, and the level of executive incentive compensation.

market), then investors have homogeneous expectations and dividend payment will not influence investment decisions; therefore, whether to pay dividend has no impact on firm value. This is the well known "dividend irrelevance" proposition, the intuition of which is dividend policy insignificance to firm value. However, the assumption of a perfect market and symmetric information seem too ideal and thus people keep this discussion on going. Black (1976) raises the famous "dividend puzzle" and thinks that there is still no standard answer to explain the dividend policy in the real world. Therefore, this puzzle remains one the most important topics for scholars in the corporate finance field.

Graham and Dodd (1951) point out in their book that the investors prefer firms with higher dividend payments and hence their share price goes higher. Then they change this view and think that investors also accept firms that do not pay dividends but have growth opportunities. This change reflects the process that people come to understand the Bird in Hand theory, which analyses the necessity of dividend from the risk perspective. Compared with the MM theory that ignores risk factor, this theory considers that dividend is less risky than return on capital, so that the management can only control the stability of dividend but not share price. Therefore, dividend is the bird in hand while return on capital is the bird in wood. Paying dividend means that the investors' return comes from a less risky part, so it increases firm value.

However, this theory overlooks an important factor – the precondition of MM proposition that paying dividend does not affect investment decisions. As we all know, as long as we fulfil this condition, the total firm wealth is irrelevant from dividend policy and hence the total risk that shareholder bears remains unchanged. In fact, paying dividend even does not affect the return allocation between new and old shareholders, because if paying dividend benefits some shareholders and impairs the interest of the other side, this will be completely reflected in the share price. The MM proposition does not assume a perfect world, instead, a perfect market is assumed. Therefore, the price is a complete reflection of all the changes in an efficient market. For this reason, the Bird in Hand theory is soon to be considered flawed and other theories come into being.

3.4.2 Behavioural Finance Explanations

Behavioural finance explains dividend from the investor irrationality perspective. Thaler and Shefrin (1981) put forward self-control theory, which is the application of agency theory framework into individual decision behaviours. According to them, there are two characters

inside an individual: the principal who considers long-term interest, and the agent who considers present action. In order to realise self-control, the agent has to use will or manipulate opportunities. In this sense, the firm pays dividend to investors to help them realise self-control, i.e., investors use dividend for long-term considerations while return on capital for present consumptions.

Kahneman and Tversky (1979) bring forth choice of uncertainty theory, which has two different explanations itself: the prospect theory and the regret aversion theory. Prospect theory holds that people can make different judgements for two essentially same objects with different appearances. For example, when investors need to make decision under uncertainty, their utility function will vary, and they will treat profit and loss asymmetrically, i.e., the profit utility function is concave while the loss utility function is convex. This is because they are risk-adverse to profit and risk-preference to loss, i.e. being more sensitive to loss than to profit, so that when they make investment decisions there are two patterns – combining profit and loss, or separating them. When it comes to profit, combining different sources of profits will increase total utility because the function is concave; and when it comes to loss, separating different sources of profits will increase total utility because the function is convex.

In the real world, this can be explained with share price changes. When share price rises, investors will combine dividend claim and return on capital so that they feel like obtaining extra profit. When share price drops but still gives a positive profit together with dividend, investors still combine the profits again. When share price drops and gives a loss even with dividend, investors will separate dividend claim and return on capital so that they feel like being compensated with dividend claim. The regret aversion theory is more straightforward. Investors can raise cash and fulfil present consumption in two ways – the dividend and sale of the stock – but they will feel regretful if they sell their stocks, so in order to avoid the regret, they need dividend.

However, behavioural finance provides these explanations mainly from laboratory experiments and lacks empirical support. Scholars for efficient market remark that even if individual investors are irrational, the market can still be efficient. There are two required conditions to link irrational investor behaviour with market inefficiency: investor sentiment (investors decision have systematic error and cannot cancel out each other), and no arbitrage. When these problems are not supported by empirical evidence, we cannot explain market behaviour with behavioural finance.

3.4.3 Signalling Theory

In the MM postulation, outside investors have the same information as internal management team about current earnings and future growth. However, in the real business world, the managers obviously have more information than shareholders do. This asymmetric information assumption is the base of signalling theory. Bhattacharya (1979) is the first to investigate the signalling function of dividend through theoretical models. Ross (1977), Bhattacharya (1980), and Miller and Rock (1985) then further improve the model in analysing how dividend works as signal. Miller and Rock (1985) build a by-period signalling model to explain the way in which dividend passes information to the market. Their model suggests that earning announcements as well as dividend announcements bring the same impact on share price changes. Empirical studies on signalling purpose of dividend lie in two aspects. The first group examines the informativeness of dividend announcements. Both Aharony and Swary (1980) and Asquish and Mullins (1983) find that when the firms begin paying dividend or increase it, their share price will rise; when the firms stop paying dividend or reduce it, their share price will fall. The other group studies how current dividend change forecasts future earnings change. Healy and Palepu (1988) investigate those firms that begin to pay or stop paying dividend and find that they result in earnings increase and decrease, respectively. DeAngelo, DeAngelo and Skinner (1992) do their research with 167 firms listed on NYSE, which experience loss during 1980 to 1985, and find that the termination or reduction of dividend payment is significantly related to future loss. Their study shows that dividend change does work as a signal for future earnings. However, recent studies have produced inconsistent results.

3.4.4 Agency Theory

Another important theory to explain the necessity of dividend payment is the agency theory. Easterbrook (1984) and Jensen (1986) both point out that if a firm has extra cash flow and does not pay shareholders dividend out of it, then inside managers will invest it on projects that have negative NPV or fulfil their own interests. For this reason, outside investors expect dividend payment rather than retained profit.

There are two main differences between agency theory and the MM propositions. First, the MM theorem concludes that investment decisions will not be affected by dividend payment, while agency theory considers the agency problem between outside investors and management so that managers may invest on projects with negative NPV out of self-interest

and therefore dividend payment can reduce this probability. Second, MM theorem holds that it makes no difference whether to allocate profit through dividend or return on capital because it finally goes to investors.

However, agency theory holds that as there is agency problem between outside investors and inside managers, i.e. Type II agency problems, retained profits might be used for personal purposes to transfer via related party transactions. Hence, dividend payment will still affect shareholder wealth. La Porta et al (1998), however, comment that the studies by Easterbrook (1984) and Jensen (1986) both ignore an important factor that dividend payment from inside management to reduce agency costs will not take place spontaneously unless there is adequate supervision. They state that law is the key factor for management to pay dividend and reduce agency costs by raising two hypotheses: the outcome model and the substitute model. The outcome model suggests that dividend payment is a legal protection for investors, so that countries with better legal protections for investors will have higher level of dividend payment. The substitute model suggests that dividend payment is a complement to insufficient legal protection for investors, so that inside management pays dividend to build up reputation for future considerations on raising fund. According to the substitute model, countries with better legal protections will have lower level of dividend payment because the management will not have to build up reputation. Through a cross sectional study with more than 4000 firms in 33 countries, La Porta et al (1998) find evidence to support this model.

3.5 External Auditing

Agency theory hypothesises an inherent moral hazard problem in management-control relations that gives rise to agency costs. The demand for auditing is assumed the efficient resolution of agency problem because audited annual reports are widely viewed as a means of mitigating agency costs (Defond, 1992). Also as agency costs increase, there is a demand for high quality auditing, either voluntarily undertaken by managers as a bonding mechanism or externally imposed as a monitoring mechanism by shareholders and creditors (Watts & Zimmerman, 1986). As in Watts and Zimmerman (1986), the financial statement audit is a monitoring mechanism that helps reduce information asymmetry and protect the interests of the principals, specifically, stockholders and potential stockholders, by providing reasonable assurance that management's financial statements are free from material misstatements.

External auditors can potentially provide assurance of the quality of publicly reported accounting information, which in turn limits the manager's ability to manipulate accounting

Second, financial analysts can play an important monitoring role because they influence managers' opportunities to expropriate wealth from investors (Jensen & Meckling, 1976). As managers' decisions are closely monitored and, together with estimations of their impact on firm value, conveyed to the financial markets very quickly, financial analysts help investors to discipline managers. Barron et al (2002), Barth et al (2001), and Wyatt and Wong (2002) address the relationship between financial analysts' following and intangible assets.

3.5.1 Audit Firm Size

As in DeAngelo (1981), large audit firms have incentives to supply a higher level of audit quality and auditor size is a proxy for unobservable audit quality to some extent. This is because large audit firms have more clients and if they lack independence or provide a low-quality audit, they are likely to lose them. From this perspective, large audit firms are likely to conduct a true and fair check on the firm's financial statements and management behaviours, and thus provide the company shareholders with high-quality audit reports. Carcello and Nagy (2003) also find in their study that firms are more likely to hire Big Four auditors when their ownership structure indicates agency conflicts, i.e., when their ultimate owners possess high degrees of control and a large divergence between the control and ownership rights.

Further tests reveal that the relation between auditor choice and ownership structure exists among small and high-risk firms whose threat of expropriation is higher, but not among large and low-risk firms whose threat of expropriation is lower. Their results also show that Big Four auditors charge a higher fee and set a lower audit qualification threshold to auditees with larger agency problems, while non-Big Four auditors do not. More specifically, Big Four audit firms charge a fee premium for clients with high control concentration and large control-ownership divergence. In addition, they document that poor earnings can more likely trigger a qualified opinion for Big Four clients with large agency problems. Taken together, the evidence suggests that Big Four auditors do have monitoring and bonding effects as predicted by the agency theory. (Carcello & Nagy, 2003)

On the other hand, McKeown et al. (1991) find that larger clients are less likely to receive a going-concern opinion, even after controlling for the effect of client size on the probability of business failure. Nelson et al. (2002) find that auditors are more likely to waive proposed audit adjustments for larger clients. We expect that auditors are more likely to agree to the

information and hence his/her ability to extract wealth from outside shareholders.[18] It is generally believed that an audit will reduce agency costs only if the auditors have a level of independence. Therefore, researches are conducted on the importance of audit independence and audit quality (for example, see DeAngelo, 1981; Watts & Zimmerman, 1983; and Simunic, 1984). DeAngelo (1981) defines audit quality as the joint probability of detecting and reporting material financial statement errors and concludes that large audit firms have incentives to supply a higher level of audit quality. Consequently, he argues that an ordering of auditor size can be used to proxy audit quality. Accordingly, in most auditing markets, the Big Four audit firms are trusted to be able to produce high-quality audits.

Nevertheless, in China most previous studies merely concentrate on auditor independence and disclosure (for example, see Xiao, 1999; Wong, Defond & Li, 2000; Lin, Tang & Xiao, 2003), which all come to the conclusion that auditor independence is severely impaired by two factors – government influence and economic dependence on the auditee (Xiao, Zhang & Xie, 2000).

There are two specific reasons why we require external auditing. First, auditing can provide credibility to the information exchange process between the company and its investors. Auditing costs are a component of the monitoring and bonding costs that investors bear (Jensen & Meckling, 1976). Alongside board structure, auditing is one of the less expensive monitoring and bonding devices but auditing is not perceived to be of uniform quality, when larger auditors, ceteris paribus, viewed as providing a higher quality audit than smaller audit firms (DeAngelo, 1981). In an industry where information is highly asymmetric, firms may select auditors who are deemed of higher quality by investors in order to add credibility to financial statements and reduce perceived investor risk. Research has found that the use of large auditors reduces earnings management in firms with large investment opportunity sets; also, that companies with more investment opportunities are more likely to hire Big Four auditors (Lai, 2002). This suggests that the use of large auditors is a successful bonding mechanism in firms with high ex-ante agency costs. In Australia, where R&D can be capitalised, the use of higher quality auditors has been found to display a positive association with the value of firms' R&D assets (Krishnan, Percy & Tutticci, 2002). In the US, Pittman and Fortin (2004) find that young firms can lower their borrowing costs by engaging a Big Four auditor. This relation does not hold over time, consistent with information asymmetry between firms and providers of capital reducing in firm age.

[18]The governance role of external audit has been discussed in numerous publications by regulators and practitioners. Recent academic research has also documented that earnings management activities are negatively associated with board independence (Klein, 2002; Peasnell et al, 2000) and the choice of Big Four auditors (Becker et al, 1998).

attempts of larger clients to employ aggressive accounting treatments, and that these aggressive accounting treatments will sometimes degenerate into fraudulent financial reporting. This aggressive accounting may progress from being within the confines of general accepted accounting practice (GAAP) to being outside GAAP boundaries (Young, 2000), sometimes without the auditor even realising this progression until the financial statements are materially misstated (Bazerman et al, 2002). In addition, larger clients are more likely to operate in multiple lines of business. It is unlikely that any audit firm would be an expert in every line of business in which a complex firm operates (Carcello & Nagy, 2003).

3.5.2 Audit Firm Tenure

Presently, mandatory auditor rotation is being considered as a possible solution to the auditor independence problem; its proponents argue that imposing limits on auditor tenure is expected to improve audit quality by reducing client influence over auditors (Brody & Moscove, 1998). An opposing viewpoint is that problem audits occur more frequently for newer clients because auditors have less information about these firms (AICPA, 1992). For instance, audit problems are especially severe for new clients with complex accounting issues such as forward sales contracts, long-term leases, joint ventures, and off-balance sheet financing arrangements. As the auditor-client relationship lengthens, firm-specific expertise allows auditors to rely less on managerial estimates and become more independent of management (Solomon et al, 1999).

The heart of the debate rests on how auditor tenure affects auditor independence. Proponents of mandatory auditor rotation claim that lengthy auditor tenure erodes independence, while others argue that independence increases with tenure because of auditor expertise. Since independence is not observable, regulators, practitioners, and academics often rely on the appearance dimension to define auditor independence (Dopuch et al, 2003). Recent studies such as Myers et al (2003), Johnson et al (2002), and Davis et al (2002) provide valuable insights into the debate surrounding tenure, independence, and audit quality using accounting accruals as a proxy for audit quality.

A perception that auditors' work is more objective and independent inspires greater confidence in audit opinions, which increases the perceived reliability or the quality of reported accounting numbers (Ryan et al, 2001; Elliott & Jacobson, 1998). Independent auditors are likely to increase the reliability of financial statements because (1) they are more likely to prevent or detect and correct material misstatements/omissions, and (2) they ensure that financial statements comply with generally accepted accounting principles (Carmichael,

1999; Teoh & Wong, 1993). To the extent that capital market participants perceive auditor tenure as improving independence, and thus, enhancing audit quality, reported financial statements are expected to be more useful for investment and credit decisions. Therefore, reported earnings are considered as more informative about future economic earnings if audit quality is perceived as high (Teoh & Wong, 1993).

A large number of researches have been done on testing how auditor tenure affects earnings management and thus agency problems (for example, Chang & Monroe, 1994; Davis, Soo & Trompeter, 2000; Ghosh & Moon, 2003; Barton, 2004; Carcello & Nagy, 2004; and Mansi, Maxwell & Miller, 2004). In these studies, it is hypothesised that long-term auditor tenure impairs auditor independence and enables management to gain greater reporting flexibility. Evidence is also found consistent with the hypothesis.

The implication is that constraining tenure could act to strengthen auditor independence and enhance the extent to which audits serve as a check on manager performance. As in Davis, Soo and Trompeter (2000), over time auditors begin to identify with and act as advocates for management, who might manipulate financial figures and pursue personal profit rather than company welfare and thus render agency costs. They also find that over time auditors become "stale" and fail to notice and incorporate into their judgments new evidence or changes in the client's situation. This behaviour could result in auditors failing to provide an efficient audit and thus worsens agency problem.

However, using earnings multiples from returns-earnings regressions as a proxy for investor perceptions of earnings quality (Teoh & Wong 1993), Ghosh and Moon (2003) find evidence that investors perceive earnings quality as increasing with auditor tenure. They also find that auditor tenure positively affects S&P stock rankings and debt ratings. Further, the influence of earnings on rankings/ratings is stronger for client firms with long auditor tenure. Thus, consistent with the auditor expertise hypothesis, investors and information intermediaries view audited financial statements to be more reliable when auditors remain longer with client firms.

3.6 Debt Monitoring

Another strand of the agency literature has focused on the role of debt as a means of disciplining managers. Grosseman and Hart (1982) are the first to argue that managers could pre-commit to work hard by using debt rather than equity. Similarly, Jensen's (1986) free cash

flow theory considers additional debt benefit since the firm attempts to improve the productivity of its assets because of additional debt acquired. Debt not only reduces free cash flow but also provides discipline to management through the debt market. Debt monitoring hypothesis is formalised by Harris and Raviv (1990) and Stulz (1990) and empirically demonstrated by Maloney et al (1993). Shleifer and Vishny (1997) provide extensive survey about the role of debt in reducing the conflict of interests between managers and shareholders.

On the other hand, increased leverage also has costs. As leverage increases, the usual agency costs of debt rise, including bankruptcy cost (Jenson, 1986). Myers (1977) points to the debt overhang problem where firms may forego good projects if they have significant debt outstanding. The reason is that for a firm facing financial distress, a large part of the returns to a good project goes to bondholders. Therefore, in choosing their debt-equity level, firms should trade off between the agency costs of debt and the agency costs of equity. By appropriately allocating refinance between equity and debt, capital structure can balance the conflicts between investors and management as well as that between management and creditors.

Finally, two previous studies most closely related to this study are Ang et al (1999) and Singh (2002). In the first case, Ang et al provide evidence on corporate ownership structure and agency costs measured in terms of asset utilisation and operating expenses. Ang used data on small business in America to examine how agency costs vary with a firm's ownership structure. They find agency costs 1) are higher when an outsider rather than an insider manages the firm; 2) are inversely related to the manager's ownership share; 3) increase with the number of non-manager shareholders, and 4) to a lesser extent, are lower with greater monitoring by banks.

In the second study, Singh and Davidson (2003, 2004) extend the work of Ang's analysis of relationship between corporate ownership structure and agency costs to large publicly traded corporations. Using slightly different measures of agency costs, they analyse multi-period data for the years 1992 and 1994, and not only study inside ownership structure as a determinant of agency costs, but also the role of outside large equity holders in disciplining the management. They find outside large shareholders' ownership may only have a limited effect on reducing agency costs and board size is negatively related to asset turnover, and unrelated to discretionary expenditures.

As China is concerned, the central goal of corporation, including public listing, is to establish "a modern enterprise system" in China, featuring the corporate governance structure that separates the government from enterprises. Another objective is to raise capital for SOEs and reduce their high level of debt to asset ratio by increasing direct finance through selling equity to the public. The vast majority of China's listed firms are formerly state owned or state controlled firms, mostly large and better performing firms. Before initial public offering, they do their best to dispose of the debt. Therefore, the debt to asset ratio of listed firms is lower during the first couple of years after initial public offering.

According to capital structure theory, the way to refinance is determined by the cost of capital. In developed capital market, top managers are restrained by shareholders and creditors, facing the pressure of paying dividend and debt. Empirical results show that listed firms obtain capital first from internal sources, then from debt, and last from equity. Capital cost influences the style of financing. In China, due to the special ownership structure of listed firms, state share is absolutely the largest among total shares and the representatives of state shares are usually absent. This reduces the restriction to management, and the managers would over pursue the control right of cash flow. The consequence is that re-financing of listed firms would have partiality for equity rather than debt. Additionally, there is not much pressure of dividend from shareholders, so refinancing of listed firms in China usually place the order of debt after additional or right shares.

The optimal debt-to-equity ratio is the point at which firm value is maximised, the point where the marginal costs of debt just offset the marginal benefits. The over low level of debt to asset ratio reflected the poor management of corporate financial gear of Chinese listed companies. Refinancing through equity is not the optimal strategy to reduce their capital cost. It is not a common phenomenon for a modern corporate to rely almost totally on its own capital, using none or merely little debt. One of the most important reasons that Chinese listed companies do not bother to use debt is the fact that they generally can obtain "free capital" easily from the equity market. In order to limit the "equity financing thirst", China Security Regulatory Commission (CSRC) requires that the debt to asset ratio of listed firms who want to add shares on stock market must have higher debt to asset ratio than the average level of the same industry. Listed firms have paid more attention to their capital structure since then, and it helps to improve the capital structure of listed firms.

3.7 Conclusion

The governance mechanisms discussed in the chapter include four perspectives.

First, ownership structure: this includes the shareholding structures of the listed companies, and actual control relationships, cross shareholding, or indirect shareholding. Additional information includes operation of large shareholders and state of their shares, for example in China, the tradability. Since these mechanisms are broadly examined in the Chinese context but generating mix results, they will be used in this study as well for a comparison with prior studies. Main ownerships in discussion are the state, legal person, management, and foreign shareholdings, as will be discussed in the next chapter.

Second, shareholder rights: in order to protect shareholder rights, large and small shareholders need to be treated fairly in getting relevant company information in time; also the harm of insider control need to be prevented effectively. Therefore, ownership concentration is also used as a governance control mechanism. Additionally, the study will deal with conflicts between large and small shareholders known as large shareholder expropriation, i.e. Type II agency problems for further illustration of how this impacts on firm performance and agency costs.

Third, information disclosure: there should be a timely, true, and complete disclosure of company information. This deals with information asymmetry. The independence of audit units is another aspect to focus on in affecting the quality of information disclosure and firm performance. In this sense, external auditing is selected as representing external governance mechanism rather than immature manager's market and market for M&A.

Fourth, internal governance: this includes the structure and operation of board of directors and supervisory board. Investigation lies in how the two boards function in supervising and maintaining a reasonable balance between stakeholders. Size of the board, frequency of board meetings, and presence of independent directors will be discussed in the subsequent chapters. These are tested in many prior studies, however by dividing the test period before and after introduction of independent directors system in China, we can carry out an assessment of the results and see whether this mechanism is effective in Chinese listed companies. Additionally the size of the supervisory board is incorporated into the econometric modelling, which is among the very first attempts. Dividend policy will also be discussed and cash dividend

payment will be used as another internal governance mechanism proxy. The definition of the variables and model set up will be discussed in chapter 6 in detail.

In summary, company value and financial performance depends largely on whether the company has a sound mechanism on decision-making and practising, while the mechanism depends largely on a reasonable ownership structure, which consequently determines the structure and operation of the BOD and the co-operation between the board and management team. In China, there are also studies reaching the same conclusion. For example, He (1998), Sun and Huang (1999), and Chen and Jiang (2000) examine the relationship between ownership structure and company value and state that the quality of corporate governance practise is closely related to company value.

The establishment and evolution of corporate governance structure and mechanisms depend significantly on the historical, cultural, political, regulatory, and institutional environments of a country. In China, the listed companies develop from Confucian school thinking and the planned economy background. Therefore, the ownership structures, human resource arrangements, and other financial activities all reveal such uniqueness. For example, the planned economy system results in dominant state shareholdings; the Confucian philosophy and Guanxi (inter-personal relationships) result in interlocking shareholders and related party transactions. Imperfect laws and regulations in the transition period make the Chinese corporate governance pattern different from either the single-tier system in UK and US or the two-tier system in German and Japan. Consequently, the corporate governance mechanisms chosen in China take into account the unique governance environment that Chinese listed companies face and emphasise on the internal mechanisms. Further institutional background will be investigated in the next chapter.

Chapter 4 Institutional Background

4.1 Introduction

The previous chapters have laid out a theoretical framework for the study, and discussed the effectiveness of corporate governance systems and the role of various governance mechanisms in the wider corporate governance literature. In this chapter, focus will be directed to the Chinese listed companies in relation to the agency theory framework and corporate governance practice. Specifically, the chapter explores the unique history of the Chinese capital market as well as corporate governance developments in order to reveal the institutional foundation for the case study and econometric analysis in the next two chapters. By analysis of the development of capital market and corporate governance practice in China, appropriate mechanisms can therefore be selected.

Thirty years of reform and opening in China have marked success in its transition process from a plan economy system to a market economy. One chief component of this enormous restructuring practice is the reform of SOEs, which started from 1979. Through the scheme, those small and medium sized SOEs have been merged, joint ventured or sold. Many SOEs are losing money and they continue to be a significant burden on the economy as a whole. According to Qi, Wu and Zhang (2000), the problems they must cope with to become effective corporations involve bad performance, poor productivity, and increasing debt. Problems faced by SOEs often stem from their history as pure state enterprises within a centrally planned economy, heightened by their slowness in adapting the new corporatisation regime (Cheung, 1996). Therefore, if the enterprises want to become competitive, corporate governance issues have to be addressed straight away.

An important motivation for the Chinese authorities to implement the reform was to resolve the problem of a lack of incentives in manufacturing production. This problem has taxed practitioners and theorists not only in centrally planned economies, but also in the West (Alchian & Demsetz, 1972). The problem is understandably more severe in centrally planned economies, in that there are no clearly defined ultimate owners who can monitor the performance of the firms, nor are there competitive capital and commodity markets to punish poor performers through bankruptcy or takeover. The economic performance of the SOEs was improved during early 1980s by the introduction of the bonus system (Xu & Zhuang, 1998).

This was based on the belief that the poor performance was caused by the lack of an appropriate incentive mechanism for individual employees, including top management. Soon the authorities found that the bonus system produced a ratchet effect – all decisions to increase the bonus were welcomed, but to punish firms or individual workers for poor performance by reducing or removing bonuses was simply not politically possible.

Aoki and Kim (1995) argue that two sets of factors need considering in analysing corporate governance in transitional economies. One is the special designs of governance systems based on specific conditions during the process of transition. The other is that the governance mechanisms in developed economies may not be applicable and effective in the transitional social contexts. Therefore, the unique characteristics of Chinese companies and the institutional background upon which the uniqueness are formed will be examined in detail in the subsequent sections.

The rest of the chapter is organised as followed. Section 2 discusses the development of corporate governance structure with SOE reform process. Section 3 introduces the development of capital market in China. Section 4 describes the distinctive characteristics of Chinese listed companies that cause corporate governance problems. Section 5 examines the causation of agency problems and research possibilities. Section 6 is about the development of corporate governance mechanisms in controlling agency problem in China. Section 7 summarises the chapter.

4.2 Reform of SOEs and Corporate Governance Structure

Contract responsibility systems were introduced in most large and medium-sized State industrial enterprises during 1986-1997. The system was officially intended to place (governmental) ownership at arm's length to enterprise management, so allowing more decision-making space to the latter (Child, 1994). In the contract, the firm hands over an agreed amount of annual profit and tax for which they have contracted. It was permitted to retain a proportion of any surplus it achieved above the contracted level. In addition, the firm guaranteed to invest to increase asset values and to develop technology by an agreed amount, using retained profits during the period of the contract. However, substantial collusion soon emerged between the directors of the companies, and the heads of the supervising government departments, leading to widespread corruption (Hay et al, 1994). The directors found that it was easier and quicker to reward themselves by simply transferring the firms' assets to their own firms. The lesson was that it is not feasible for the authorities simply to relinquish control

to the firms' managers in an attempt to improve performance. Rather a new relationship between the State, as owner, and the firm needed to be developed.

It is evident that the policy-makers and theorists in China gradually understood that a clear-cut system of property rights was required as a prerequisite for providing incentives for investment, to adequately restrain and monitor management, and to widen the finance channels and permit the introduction of non-State capital into the SOEs. This, in turn, required the new institutional arrangement of a joint-stock system, as well as a sound corporate system by which suppliers of finance to corporations could assure themselves of getting a proper return on their investment (Shleifer & Vishny, 1997).

4.2.1 The Reform of SOEs

The main topic of the reform centres on the relationship of the government, the corporations, and the market. There are five main stages of the reform.

Stage 1: During 1978-1984, the reform lies mainly in "Fangquanrangli" (power allocation and profit retention) in order to enhance large SOEs authority to handle their affairs by themselves. According to Liu and Gao (1999), instead of centralizing all production and capital allocation decisions as under the plan economy system, a pilot reform program on the expansion of enterprise autonomy was started in late 1978 and SOEs were allowed to retain 3% of their profits so that there were incentives to improve productivity and efficiency. The year of 1984 is a breakthrough in separating the government ownership from control in SOEs.

Stage 2: From 1984 to 1986, the reform is about "Ligaishui" (profit replaced by tax) and "Bogaidai" (government allocation replaced by bank loans), making the profits to be turned in to the government as tax, while the funding for SOEs capital investments to come through bank loans instead of being allocated directly from government financial reserves (Sun & Tong, 2003). In the first step, large and medium sized SOEs have to pay a tax 55% of their profits to the state; in the second, the state defines eleven kinds of taxations. However, this did not help a lot since SOEs through financial manipulation used their money to pay the bank interest instead of government taxes. As the Chinese saying goes, where there are policies from higher level, there are countermeasures from lower level.

Stage 3: From 1986 to 1992, the reform focuses on the implementation of "Chengbaozhi" (contractual management system). The regulation mechanisms of listed companies were

developed during this period. Independent legal person's status of SOEs was defined in 1988 and this allowed the managers to act as legal representatives and make decisions about operations through establishment of contracts. The year 1988 was also the year when the first version of Industrial Company Law was established. However, this still cannot get rid of the short-term behaviour of SOE managers. Everybody wants the assets, and nobody wants the liabilities. With the unclear assignment of property rights, there is an asymmetry in the allocation of rights and obligations for good and bad assets. In effect, while assets are "privatised", liabilities are socialized.

Further, in 1992, the organizational pattern of modern corporations was restricted, whilst detailed regulations for the establishment and operation of those corporations were set. In the same year, CSRC was founded and it published a series of regulatory provisions as governance mechanisms for listed companies. During this period, the function of board of directors, supervisory board and the rights and obligations of managers were defined explicitly; also external governance mechanisms, such as information disclosure of listed company, were put on the table. At the end of this period, two national stock exchanges were set up in the cities Shanghai and Shenzhen, which formed the prototype of a capital market in China.

Stage 4: From 1993 to 2002, the reform lies on establishing a modern corporation system around the theme "Zhuadafangxiao" (protect the large, release the small) as well as corporatisation. In 1993, the Decision on Establishment of Market Economy by the Central Government explicitly required SOEs to renovate operational mechanisms to adapt to market economy and the modern corporation system.

A new Company Law was established on July 1 1994. In the same year, the State Council selected 100 companies to apply modern corporation mechanisms. In 1998, the State Council sent audit agents to big companies to supervise state asset. In December 1999, the Company Law was amended and the function of Supervisory Board was defined. In August 2000, the State Council sent supervisory board to big companies instead of audit agent. In August 2001, CSRC required all domestic listed companies to revise their operational rules and employ independent directors to include at least one professional accountant. In 2002, the Corporate Governance Regulations of Listed Companies was launched for modern corporatisation. The new Company Law proved in 1994 legally defined corporate governance structures.

Stage 5: From 2003 to date, the reform has put the emphasis on state asset management, and has made a great progress with dynamic development of the securities market. The central government sets up laws and regulations, while local governments represent shareholders and unite the liabilities; rights, obligations and responsibilities in managing asset, personnel, and operation of the corporations. More specifically, the central and local governments set up State Asset Supervision & Administration institutes and authorize them with the related powers as shareholders. The next stage of the reform will be directed at improving the state asset management systems and corporate governance mechanisms, standardizing shareholder meetings, board of directors, and supervisory boards according to modern corporations requirements, adjusting recruitment strategies and developing manager market, and protecting the legal rights or employees, etc.

4.2.2 The Development of Corporate Governance

The initiation and development of corporate governance structure in China are very different from those in developed countries. Firstly, it is a component of the reform of macroeconomic system, that is to say, it pushes traditional firms under plan economy to convert into modern business entities under market competition. Hence, its initiation and development have to be influenced and restricted by the systematic environment and the plan mechanisms. Secondly, it is a revolutionary process dominated by human designation and interference, instead of spontaneous evolution of modern corporations as in western countries. Apparently, in China the concept of corporation is introduced during the reform of the entire national economy. Most listed companies are transformed or restructured from previous SOEs (Sun, Tong & Tong, 2002). Therefore, the establishment of corporate governance structure is largely prejudiced by the disadvantages of SOEs.

Since they set up their governance structure together with the reconstruction, they have all kinds of connections and ties with the SOEs, so that they sometimes ignore new manoeuvre criterion and just follow traditional way of operations. This results in the lack of efficient relationship and mechanisms between shareholders, board of directors, supervisory board, and top executives in the listed companies. Various kinds of related party transactions after listing have severely infringed small shareholders rights, which become the most serious problem among listed companies.

The corporate governance pattern in China was initially developed during late 1970s. Before the reform and opening, the SOEs were controlled totally and perfectly by the government

and lacked vitality. The executives were appointed or dismissed by the government, they enjoyed the same political and economic treatment as government officials, and their achievements were not evaluated by the enterprises' financial performance, and instead by satisfying plans made by central government (Chen & Chen, 2004). Since property and managerial rights were not separated, the agency problem of managerial theft was restricted, for management had little autonomy over the allocation of funds (Zhang, 1996).

From 1993 backwards, the SOEs experienced five stages of corporate governance structure. (1) From 1950 it was called Factory Management Committee, which was lead directly by authorities and was the only management organisation in a company. It consisted of the factory director (FD), chief engineer, other in-charges, and some employee representatives. (2) From 1950 to 1955, SOEs adopted the Sole Factory Director system from Russia, i.e. the FD was appointed by the state and was in charge of everything in a company. Although a committee was founded to participate in the management, some FDs overstressed their personal power. (3) From 1956 to 1985 (except for the Cultural Revolution), a party committee (PC) was established in companies in order to restrict the power of FD. The PC was the core power organization in a company and the FD was in charge of daily operations. The existence of PC in fact mixed up the political and economic functions of a company because it separated the power and responsibility of the FD. (4) From 1980 to 1985 some companies set up employee representatives to participate in company decisions, while the FD managed daily operations and the PC took up supervision rights. (5) From 1985 to 1993 an improved Factory Director System was implemented, especially when the Industrial Company Law was released in 1988. The FD was the legal representative of a company and was responsible for everyday operations and management issues. A management committee was set up to assist the FD solving important issues and making decisions. Employee representatives held regular meetings and organised labour union to assess important decisions, supervise management, and protect employee rights. The PC supervised how the company complied with laws and regulations.

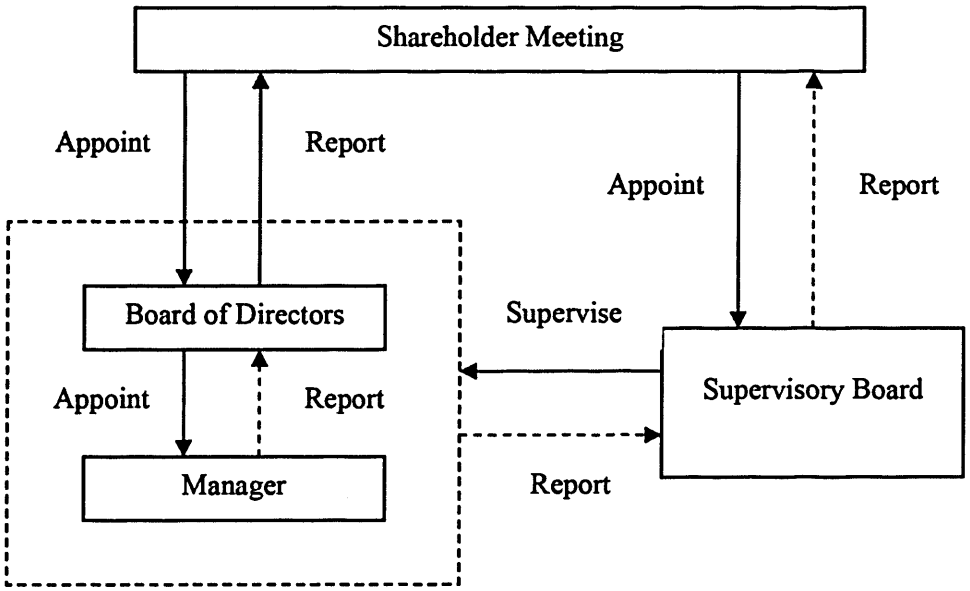
From 1990s, China has formed a capital market that based mainly upon the two stock markets in the two cities Shanghai and Shenzhen. The stock markets witness a fast development and, up to date, there are more than 1200 companies listed on the Shenzhen and Shanghai stock exchanges, when most of them have been transformed from SOEs. Since state shareholding is still dominant in these listed companies, they inherit the tradition governance mechanisms. For that reason, the improvement of corporate governance has been put forth as an essential

issue in further reform. Generally, scholars in China divide the establishment and development of corporate governance structure into two major periods. The new Company Law was established in 1994, when it represented a new stage of corporate governance. Some of the SOEs were required to restructure and transform into limited liability companies (LLC), lay down operational rules, and set up shareholder meeting, board of directors, supervisory board, and professional managers. However, with few exceptions, sector bureaus and ministries, as well as large enterprises, have been transformed into new entities, and the corporate structure remains un-modernised.

In March 1999, China Securities Regulatory Commission (CSRC) and China Economy and Trade Committee (CETC) jointly announced that listed companies should appoint independent directors, which was an essential step toward superior internal governance mechanism. In January 2002, CSRC put its emphasis on standardising the reliability and responsibility of directors, supervisors, and managers. This represents a milestone in the corporate governance development.

Shareholder meeting, board of directors, supervisory board, and manager are clearly defined, while incentive mechanism, supervision mechanism, and decision-making mechanism are developed at the same time. The shareholder meeting is the power unit, the supervisory board is the supervision unit, the board of directors is the decision unit, and the manager is the executive unit. The relationship can be illustrated in the following Figure 4.1 below:

Figure 4.1 Relationship between shareholder, BOD, and supervisory board



In such an arrangement, the ownership structure plays an important role, because it determines the composition of shareholders, board of directors, supervisory board, and managers. Prior research indicates that corporate governance has a significant impact on firm performance. Evidence suggests that improving performance and creating value can be achieved by paying greater attention to ownership structure and concentration (Jensen & Meckling, 1976). In this context, the effect of ownership structure on firm performance and valuation has been the focus of widespread analysis in the literature. Modern corporations have realized a separation of ownership and control and thus generated agency relationship (Berle & Means, 1932). Under different shareholding structures, the supervision intension and ability of the principals or their representatives are different, because they tolerate different levels of risk and gain different payoffs. Problem arises because there is discrepancy between the interest of the principal and the agent.

The situation in China is unique and worse. It is not the market, nor the motivation to obtain private benefits, that determines the presence of block holders. Ownership structures are typically determined by the government. At listing, a large proportion of shares are transferred to state-owned investment trusts and asset management companies (legal persons) as well as a significant proportion held back by government (Sun & Tong, 2003). The untradability of state shares hinders the formation of a real capital market and thus results in a deficiency of corporate governance of listed companies. Since most listed companies in China are transformed from SOEs, the dominant state-shareholding is unavoidable and hence leads to a deficiency of control and supervision system for block holders and inside management. Although the publicly listed shares are dispersed and most principals of the listed companies are small shareholders, the state remains in control of most listed companies. In this situation, the listed companies are not stock companies of real sense. In China, the representative of the state actually controls the companies and thus takes charge of the personnel, such as appointment of board chairperson and chief executive officer (CEO). Consequently, individual shareholders are absent from board of directors: they do not have the right in making operation decisions, and they have little legal protection. Under this environment, there are lasting and intense discussion on how to protect minority shareholders and impetus SOE reform.

Some measurements have also been carried out for improvement, although the process is slow and gradual. For example on 12 June 2001, the State Council announced an arrangement to reduce state shares and on 26 January 2002, CSRC published a report about its achievements.

the stock market. Table 4.1 below gives the number of listed companies on the stock exchanges since their setup.

Table 4.1 Number of Listed Companies (1990-2005)

Year	SHSE	SZSE	Total
1990	8	2	10
1991	8	6	14
1992	29	24	53
1993	106	77	183
1994	171	120	291
1995	188	135	323
1996	293	237	530
1997	383	362	745
1998	438	413	851
1999	484	465	949
2000	572	516	1088
2001	646	514	1160
2002	715	509	1224
2003	780	507	1287
2004	837	540	1377
2005	834	547	1381

Source: China Statistics Press (http://www.stats.gov.cn)

From the beginning, these two markets have their own distinctive properties. In Shanghai, the listed companies are mainly large SOEs; the market performance of Shanghai is therefore sometimes regarded as an indicator of Chinese domestic economy. The Shenzhen exchange is by contrast populated by manufacture and export companies doing business with Hong Kong, so it is sometimes thought to be a sign of health in that sector. Stocks in both SHSE and SZHE are classified into A Shares and B Shares: A Shares are designated for the purchase and trading by local Chinese investors; B Shares for the purchase and trading by offshore investors. On February 19, 2001, CSRC announced the opening of B Share market to local Chinese individual investors.

By December 2004, there had been 837 firms listed in SHSE and 540 firms in SZSE, and the combined capitalisation of the markets reached RMB ¥3705.56 Billion (Internet: China Stock Exchanges). From Table 4.1, we can see that the expansion of Chinese capital market moved

SOEs had to sell their state shares equalling 10% of the capital to be raised before issuing new shares to public investors. Even so, this arrangement encountered many obstructions due to historical problems remained with the system. After five months of implication, on 22 October 2001, CSRC declared a closure of the regulation. This put an end to the challenge of state shareholding. Chen (2001) makes a conclusion that the reduction of state ownership is not the only way to improve corporate governance of the listed companies and to protect individual investors. Instead, it might be a more feasible choice to transform the ownership structure from sole controlling shareholder to multiple controlling shareholders.

In summary, there are two basic patterns of corporate governance structures with listed companies, i.e. sole shareholder control and insider control patterns, which are complicatedly overlapping in listed companies. In the former structure, when the sole shareholder is individual or private entity, we normally regard it as family control; when the sole shareholder is the state, ownership and control cannot be separated clearly and the state perform direct intervention and political control in the listed companies, which usually contradicts firm value maximisation. Some scholars in China combine these two patterns and describe it as key person structure. The key person normally is the top executive or representative of sole shareholder, who assumes arbitrary power in almost everything, such as control, execution, supervision, and sometimes appointment.

4.3 The Chinese Capital Market

The development of securities markets in China can be traced back to 1990 when the first stock exchange was established in Shanghai. Unable to wait for the national securities laws to be enacted, the local authorities of Shanghai and Shenzhen developed their own respective local company and securities laws, and on 19 December 1990, the Shanghai Stock Exchange (SHSE) officially opened as a non-profit organisation. The Shenzhen Stock Exchange (SZSE) followed suit on 3 July 1991. Its organisation and structure closely resemble those of its Shanghai counterpart. The two markets are comparable in both market capitalisation and trading value (Internet: Virtual China Stock Market Guide).

The trading system covers all large- and medium-sized cities with 2,412 retail branches all over the country. There is a distinct difference between Chinese listed companies and those in developed countries. The long-term liabilities of Chinese corporations are much less than companies in other countries. This is partly due to the limited size and underdevelopment of Chinese bond market. The other reason is that Chinese corporations prefer raising capital in

and listing of so-called "public" securities, which normally would be included in the securities law. In the absence of a securities law, the Company Law has been a major step forward for securities market regulation. It does not replace or abrogate previous regulations, and must be incorporated as a new layer into the existing legal framework.

Until 1992, the Financial Administration Department supervised all securities-related matters. Then on 17 December 1992, the State Council issued a document to spell out details for a new, national regulation for developing securities markets. At the national level, the first arm of the new regulatory structure is the SCSC, which is responsible for macro policy issues relating to the securities markets including approval for the establishment of new stock exchanges and approval of new securities legislation and regulations. It is also responsible for setting the level of securities issues over a given period for both bonds and shares at the national and provincial levels.

The second tier of the regulatory framework is the executive body of the SCSC, namely, CSRC, which is an independent legal entity. It has taken over most of the functions previously performed by the Financial Administration Department, and it gives approval for all listings pursuant to both the Company Law and the Interim Securities Regulations issued. The Company Law also names the CSRC as the authority to suspend a listing if the company fails to meet the conditions for listing. This responsibility requires a substantial amount of time on the part of the CSRC. The CSRC is responsible for supervising commodities futures trading as well. At the regional level, prior to November 1992, regulation was carried out by the provincial governments. The PBC was also closely involved at the regional-level regulations through its branch offices. Local securities regulatory bodies, namely the Shanghai Securities Commission and the Shenzhen Securities Commission, were established in Shanghai and Shenzhen by the local municipal governments.

4.4 Characteristics of Chinese Listed Companies

There are two main specifications about listed companies in China. On the one hand, their emergence is not the consequence of developed classic corporation systems. Instead, it is grafted on firms during the economic reform and works as a tool for the reform itself. Public ownership is unshakable, so behind all the state shares, legal person shares, and public shares, the state share is absolutely dominating. With this specification, not only the conflicts between shareholders and management but also those between dominant and minority shareholders become key issues in corporate governance. On the other hand, China is in a transition period

very quickly, especially during the first several years. However, tradable shares remained a stable percentage of total shares, either in terms of number or in terms of value, of nearly 30%. Table 4.2 below presents statistics of total and tradable shares.

Table 4.2 Statistics of Total and Tradable Shares (1992-2005) (Billion)

Year	Number of Total Shares	Number of Tradable Shares	% of Tradable Shares	Value of Total Shares	Value of Tradable Shares	% of Tradable Shares
1992	6.937	2.118	30.53	104.813	--	--
1993	38.773	10.788	27.82	353.101	86.162	24.40
1994	68.454	22.604	33.02	369.061	96.889	26.25
1995	84.842	30.146	35.53	347.428	93.822	27.00
1996	121.954	42.985	35.25	984.238	286.703	29.13
1997	194.267	67.144	34.56	1752.924	520.442	29.69
1998	252.679	86.194	34.11	1950.564	574.559	29.46
1999	308.674	107.965	34.98	2647.117	821.397	31.03
2000	379.169	135.426	35.72	4809.094	1608.752	33.45
2001	521.803	181.317	34.75	4352.220	1446.317	33.23
2002	587.544	203.690	34.67	3832.912	1248.455	32.57
2003	642.845	226.992	35.31	4245.772	1317.852	31.04
2004	714.941	257.718	36.05	3705.557	1168.864	31.54
2005	762.951	291.477	38.20	3243.028	1063.051	32.78

Source: China Statistics Press (http://www.stats.gov.cn)

The basic framework of Chinese securities market regulation is a two-tier structure that is split between the national and regional level. In 1993, the first set of national securities regulations were enacted by the State Council Securities Committee (SCSC) and China CSRC. The SCSC is the highest regulatory body in the PRC and the CSRC is the executive arm of the SCSC. Early securities regulations were promulgated in 1987 and were supplemented with a State Council circular and People's Bank of China (PBC) circular in 1989. The first national regulations on securities issuing and trading, known as the Interim Regulations on Share Issuing and Trading, were issued in May 1993 by the SCSC. This set of more than 20 regulations forms the framework within which the present regulators of the securities markets, namely the SCSC and the CSRC, operate. Meanwhile, the new national Company Law came into effect on 1 July 1994. The Law contains several provisions regarding the issuing, trading,

and therefore lacks a mature legal system to supervise. Managers in listed companies can seek advantage of a power vacuum created through the disintegration of previous plan economy and performs strong control of the firms. In this sense, they become actual owner of the firms and generate the "insider control" phenomenon.

4.4.1 Types of Ownership

Based on the classification of shareholding entities, shares are classified as state shares, legal person shares, foreign shares, employee shares, and individual shares (A shares). The latter two types of shares are too diffuse and/or too insignificant to have any collective effect on firm value, while state, institutional, and foreign shares are relatively more concentrated. These shareholders have different interests in the firm and hence their incentive and ability to monitor the management differ. Definitions of different shares are referenced by the CSRC website and information from both stock exchanges.

(1) State Shares are either shares retained by the state or shares issued to the state through debt-equity swap when privatising a SOE. They are held by various government departments or their delegated bodies. Theoretically, these shares are owned by all residents of China and the state acts as an agent to look after the people's best interest. These shares are not publicly tradable, but may be transferred to domestic institutional upon the approval of the Ministry of Finance and CSRC (China Securities Law). The inefficiency of state shareholdings mainly arises from government intervention that does not usually allow management autonomy and incentive contracts (Wang, 2003). In firms with high state ownership, insiders gain control either through direct government appointments or indirect political influence, despite owning few or no cash flow rights. Moreover, the government lacks transferable residual claims, prefers social and political policy goals over profit maximisation, and employs staff based on political connections rather than ability to perform, or encounters greater information asymmetries and higher transaction costs (Sun & Tong, 2003). Politicians have incentives to control and subsidise SOEs to achieve economically inefficient objectives for political purposes. In particular, they may require an SOE to hire more workers than needed to increase employment, or to maintain excess employment even when a firm's performance declines.

(2) Legal-Person Shares are shares owned by Chinese domestic legal entities and corporate investors, including SOEs, financial institutions (other than commercial banks), and other companies. Many of these legal entities are themselves fully, or partially, owned by different levels of government (central or local). Legal persons are typically business agencies or

enterprises of local governments that help set up listed company by giving permission to operate some business or by allowing public resources to be used for the set-up. Domestic institutions such as industrial enterprises, securities companies, trust and investment companies, foundations and funds, banks, construction and real estate development companies, transportation and power companies, and technology and research institutes hold legal person shares. These institutions are further classified according to their ownership structure as SOEs, state-owned non-profit organisations, collectively owned enterprises, private enterprises, joint stock companies, and foreign-funded companies. These shares are not publicly tradable either, but may be sold to other domestic institutions by negotiation outside the stock exchanges upon approval. Sales of institutional shared to foreign investors were suspended in May 1996 to avoid foreign investors dominating domestic companies.

(3) Employee Shares are offered to employees of a listed company, usually at a substantial discount within a limited quantity. However, not all listed companies issue employee shares. As in Sun and Tong (2003), employee shares account for less than 2% of the total shares and act purely as an incentive scheme rather than providing ownership control of any kind. In this sense, the presence of employee shares does not have significant impact on the firm performance, and therefore this type of shareholding will not be discussed in the following analysis. These shares are initially prohibited from trading for one year after allocation, and may thereafter become tradable A-Shares upon approval from CSRC. Shares held by senior management of listed companies may not be sold during their term of office (China Companies Law).

(4) A-Shares are held mainly by private individuals and some securities investment funds, and can be publicly traded in the Shanghai and Shenzhen stock exchanges. The state shares and legal person shares are neither transferable nor tradable, which account for about 64% of total shares; public investor shares, which are the only tradable shares, account for about 36%. The A-shares are dispersedly held by individual investors and they can hardly be major shareholders in most listed companies. Normally the top ten largest shareholders are either the state or legal persons, as in most empirical studies in China.

(5) Foreign Shares are shares owned by investors with non-mainland Chinese residency, including foreign investors and residents of Hong Kong, Macau, and Taiwan. Currently, foreign shares include foreign legal person shares, B shares, and H shares. Prior to February 2001, B shares could be subscribed to and traded only by foreign investors and residents of

Hong Kong, Macau, and Taiwan. Transactions are made in U.S. dollars for B shares listed in Shanghai and in Hong Kong dollars for those listed in Shenzhen. It is open to domestic individuals afterwards. However, since China has a strict currency regulation, domestic investors can only use their small quantity of existing dollars to trade with B-shares; so the B-share market remains inactive.

H shares are shares issued by Chinese firms and traded on the Hong Kong (H-Shares), New York (N-Shares), and Singapore (S-Shares) stock exchanges. Foreign listing should increase shareholder values because of a better external governance regime compared to that in emerging markets and commitment to a higher level of disclosure. In China, the groups with foreign joint ventures may perform better because the information regarding technological improvement obtained from overseas partners may improve the productivity and performance. Table 4.3 below lists the types of shares among Chinese listed companies through the years.

Table 4.3 Types of Shares among Chinese Listed Companies (1992-2005) (Billion)

Year	State	Legal Person	Employee	A Shares	B Shares	H Shares	Others	Sum
1992	2.900	1.834	0.085	1.093	1.025	0.000	0.000	6.937
1993	19.022	8.012	0.932	6.134	2.470	2.184	0.019	38.773
1994	29.647	15.421	0.672	14.376	4.146	4.082	0.110	68.454
1995	32.867	20.895	0.307	17.994	5.652	6.500	0.627	84.842
1996	43.201	33.144	1.464	26.732	7.865	8.388	1.160	121.954
1997	61.228	59.646	3.962	44.268	11.731	11.145	2.287	194.267
1998	86.551	71.617	5.170	60.803	13.396	11.995	3.147	252.679
1999	111.607	82.112	3.671	81.318	14.192	12.454	3.541	308.674
2000	147.513	90.294	2.429	107.816	15.156	12.454	3.509	379.169
2001	241.061	95.422	2.375	131.813	16.310	33.194	1.626	521.803
2002	277.343	101.747	1.562	150.922	16.761	36.007	3.203	587.544
2003	304.653	106.889	1.097	171.473	17.535	37.762	3.437	642.845
2004	334.420	117.264	0.894	199.253	19.701	38.764	4.647	714.941
2005	347.067	161.977	0.453	226.449	17.927	41.306	3.626	762.951

Source: China Statistics Press (http://www.stats.gov.cn)

From the above we can see that the ownership structure of Chinese listed companies is complicated with far too many types of shares. A shares, B shares and H shares are traded with separated prices and currencies in isolated markets, and their holders have different

rights; this contradicts the modern corporation philosophy and the company law. For most listed companies the state is the largest shareholder, whose objective may be conflict from small shareholders. The government may not consider firm value maximisation; instead, it might be social welfare maximisation or other political pursuits, which gives rise to so-called political costs in the listed companies as many scholars argue.

4.4.2 Characteristics of Ownership Structure

In most of the listed companies, the state has absolutely shareholding; therefore, the corporate governance appears a "super strong" control pattern, which means the state dominates other shareholders in arranging governance mechanisms in the listed firms. Potential benefits of concentrated ownership creating superior performance and higher firm value has been identified by Shleifer and Vishny (1986). However, this also seems inapplicable in China.

Chinese SOEs before economic reform were controlled by politicians, who had almost all the noticeable authority as well as most of the actual power over business and personnel decisions in the firms. In the listed companies, ownership is concentrated in the control of the state, which stands for an average of virtually 50% of the shares of the firm and far exceeds that held by the second largest shareholder (Zhou & Cheung, 2003). On the other hand, the state is not involved into daily management of the controlled companies; instead, it delegates its power to the representatives, whose qualification is in doubt though (Tong, 2003). This is because they are often offered with a fixed salary, which in turn have less incentive to align their interest with profit and firm value maximisation and thus occurring higher agency costs. Since all categories of shareholders are entitled to equal voting right, those who control the state shares can influence decision making of board of directors easily.

Government departments and agencies exercise the roles of both shareholder and administrator. As a result, the function of board of directors and supervisory board, and the arrangement of managers are also severely interfered by the government in that it can appoint its own delegate to perform as the chairperson of the board and decide how the board works and how the management level is chosen. Alternatively, the state shares are not tradable or transferable, so that there also appears a "super weak" control pattern. The state asset is entrusted to asset management agencies and then to the listed companies. Since the asset is regarded as public goods, the agents do not have any incentive to manage the capital or supervise the board of directors etc. With the co-existence of both "super strong" and "super weak" control patterns, sole shareholders and the inside managers tend to plot together and

expropriate small shareholders. This is because the state has absolute dominant shareholdings and thus it has the right to play an influential role in appointing the managers.

Moreover, the external market for managers and the Chinese capital market are somewhat too underdeveloped to form a bonding mechanism for the managers. Consequently, managers enjoy more autonomy than is officially sanctioned. Without proper checks and balances, they are able to engage in opportunistic behaviour. Since SOE managers, as agents of the state, are not given shares or stock options to pay off their efforts, they have a strong incentive to use the power in their own self-interest and pursue superficial profitability in the short-term, even through profit transfer and state asset stripping.[19] Then again, politicians still maintain official authority over key personnel, asset consumption, and investment decisions. This is a universal phenomenon in Chinese listed companies, particularly when initial public offering (IPO) and performance evaluation are undertaken.

In addition, there is no effective method to evaluate managerial discretion (Qian, 1996), which has made the agency costs difficult to measure in Chinese listed companies. This will be discussed more detailed in the next part of this chapter.

4.5 Agency Problem and the Origin

As we all know, agency problem commonly exists in modern corporations. A large number of studies have been conducted on this topic ever since Jensen and Meckling (1976). The problem arises because there are various shareholders who entrust their right to the board of directors via voting and thus form the ownership agency relationship. Then the board of directors gives the executive power to managers via contracts to form the executive agency relationship. China has revealed Type II agency issues, which are different from most of the western economies.

After discussing the historical background about the reform process of SOEs, agency problem of Chinese listed companies seems clear. The reform of SOEs begins with thinking that proper governance mechanisms are needed to improve their performance and overcome the political costs problem. However, the well-investigated agency problem remains serious in Chinese listed companies and reveals a different weight. There is some obvious evidence revealing serious agency problems in listed companies as follows.

[19]Asset stripping includes any transfer, at below fair market prices, of state assets to non-state entities, like individuals, collectives, and joint ventures (Qian, 1996).

However, short-term managers might instead pursue self-interest and sacrifice shareholder interest. Other personal desires might be further inconsistent. In China, SOEs are owned by the whole people, and the state performs as a representative. The hugeness, complexness, and dispersions of whole people property make it difficult to manage in a direct way. Therefore, the state further seeks representative to enter the board of directors and execute, which makes agency problem worse.

The reasons are twofold. First, there are multiple layers of agency relationships and high agency costs. Compared with the firms with individual shareholders, SOEs have indirect, multi-layer, and complicated agency relationships. The state, as ultimate owner, cannot exercise direct supervision on the SOEs and has to employ agents to do the job. The agents probably need to employ other agents for the same reason. Through all the layers, aims and interests of supervision may vary and become inconsistent, and thus result in high agency costs.

Second, the choice of agents is not market oriented. In a system of private corporations, agency relationships are formed by free market choices and based on individual shareholder's rational expectation of profit maximisation pursuit. Their private stocks are liquid and they can assess the performance of the agent according to operation performance. In this way, the agency relationships are formed under market contracts and stay in a dynamic state of adjustments and optimisations. In the public property system, the agents are the representatives of the state so that they do not really have the incentive of profit maximisation, nor do they have the right to transfer capitals. Therefore, it is obvious the appointment of the agents is more like political or administrative technique. In some of the SOEs, the directors and managers are often appointed by nomination and thus the shareholders do not have many options to bind management. The consequence of the discrepancy between them and their agents is high agency costs.

From the development of corporate governance structure in listed companies, we can see that many listed companies are restructured from previous SOEs. They are hence dependent on the SOEs from which they are disassociated or restructured. Not all the allocations of business scale, capital, employees or costs are excellent and independent because of the complex characteristics of SOEs. Sometimes the listed companies are funded by the capital formerly planned to put into the original enterprises, hence they cannot be totally independent from the shareholding enterprises and have to face large number of related party transactions,

First, by setting up private accounts or asset transfer, the agent changes the usage of publicly raised funds and even expropriates company assets. For example, ST Jindi lent ¥80 million at a monthly interest of 1.8% to Guangfa Securities Companies and earned a total interest of ¥6,857 thousand, without the approval of shareholder meetings or board meetings in 1996. Moreover, this change of the fund usage was not disclosed. Corporate loans hence become a common means of large shareholders expropriating medium and small shareholders.

Second, the agent accepts kickback and harms company interest in pricing, sales, purchasing of raw materials and equipments, choosing providers and retailers, and investing and financing. Sometimes the agent even takes bribe and sells the economic and technical secrets of the company, as evidenced by the capital market scandals in China.

Third, the agent fakes financial statements, conceals loss, and deceives investors. For example, ST Hongguang had a loss of ¥65 million by June 1997 but it claimed a profit of ¥17 million in the midterm report. Its total loss in 1997 was ¥230 million but in the annual report, it disclosed it as ¥198 million. Manipulation of accounting data will be better scrutinised by external auditors as per many research as discussed earlier. However, this has not been common practice among Chinese listed companies.

Fourth, the agent uses company wealth for excess personal expenses. It is common that the agent uses the money for social events like banquets and drinks, overseas travelling, or even purchase of expensive cars for personal use, as showed in the case company.

Fifth, the agent pursues short-term interest and prefers risky investment decisions. Besides, the agent intends to neglect long-term developments and expropriate profit for rises in salaries and bonuses, etc. Vast prior research has been taken to investigate the causation of the problems arising within these agency relationships, among which interest conflict and information asymmetry are the most accepted ones.

4.5.1 Interest Conflict

The owner of the firms aims at capital gaining and thus pursues profit maximisation, while the agent has multiple desires, such as economic profits, social reputation, power of resource allocation, and self-evaluation awareness. The economic desire is closely related to firm performance and thus in the long run may be the same as shareholders.

sometimes even competition from the same trade or business. All the above foreshadows insider control after listing and makes it possible for large shareholder to expropriate small shareholders, which becomes a major agency problem in Chinese listed companies, namely the secondly type as discussed in previous chapters.

As per Zou et al (2008), controlling-minority shareholder incentive conflicts are acute in China for two reasons. First, the split share structure means that large non-tradable shareholder often have different interest from those of minority investors. This is because non-tradable shareholders interests are not directly affected by changes in market stock prices because of the non-tradability of their shares. More importantly, the concentrated ownership structure has given non-tradable shareholders tremendous potential to dominate company decisions and benefit themselves at the expense of minority interests.

Second, most listed firms in China are spin-offs from SOEs with the parent groups serving as their largest shareholders. The process, by which a profitable arm of an SOE is carved out, packaged financially and floated creates inherent business and personnel connections between the listed firm and the unlisted parent firm and thus further compounds the expropriation problems between the controlling and minority shareholders. In many cases, the listed firm is expected to channel funds back to support the parent firm's unprofitable units (Aharony et al, 2010). Zou et al (2008) further point out that many controlling shareholders therefore treat the listed firm as a vehicle of fund raising from minority shareholders and resource tunnelling.

4.5.2 Information Asymmetry

In the meanwhile, shareholders keep abreast of far less information than executives do, so that they cannot achieve full supervision on the agents about whether they really make greatest effort or not in pursuing shareholder profits. This kind of information asymmetry gives origin to "free rider" problem and harms shareholder interest. The reason behind is that under information asymmetry, insiders in listed companies have the incentive to perform rent seeking through various actions. Since it is costly for small shareholder to collect information, and since individuals bear supervising costs while the result of supervision is public goods, small shareholder will be motivated to free ride. Under such circumstances, i.e. state ownership is intangible and small shareholders being opportunistic, insider control grows to be spread in listed companies in China. For that reason the problem of inside management expropriate small shareholders exists. This is consistent with Pratt and Zeckhauser (1985) in that information asymmetry favours the agent.

More exhaustive, there is some behaviour that makes agency problem worse in China as widely reported in national medium. One, managers use information asymmetry to lie to principals. Sometimes they will make fake report about business operations and environments to achieve low expectations from the principal and thus less pressure in management. In such a way, they can gain more resources with lower prices by the support from government. Two, managers impair shareholder interest by not adopting proper measurements to prevent loss, or increasing unnecessary costs for self-enjoying luxuries, or manipulating the retained profit by paying less dividend to state shares. This also causes the problem of asset stripping. During restructure and reform before listing, state asset can be transformed into collective or private assets in the name of various transactions, such as setting up a joint operation with non-state economies. This is known as related party transactions.

4.5.3 Related Party Transactions

A related party transaction (RPT) is defined as a transfer of resources or liabilities between a listed company or nay of its subsidiaries and a connected party (Cheung et al, 2005). Related parties can be legal entities or individuals including management, board members, principal owners, or members of the immediate families of any of these groups (Aharony et al, 2010). RPT with subsidiaries and the firm's largest creditors are also considered a connected. RPT of a total value greater than RMB one million or 0.5% of net asset, whichever is higher, must be reported to the exchange within two working days following the signing of the contract, and must be disclosed in the company's annual report. Transaction over RMB ten million or 5% of net assets, whichever is higher, must get shareholder approval in general meetings where related persons with interests in the transaction cannot vote.

As mentioned above, many listed companies have all kinds of connections with the SOEs from which they have been restructured. They remain closely tied with the SOEs in many aspects, e.g. buying and selling, asset reorganising, capital collecting, ensuring, and leasing, etc. There are many forms of such related party transactions. For example, the sole shareholder can use its dominant power to exploit the listed company by asset transposition, or plot together with connected enterprises on earnings management to make up good performance, or transfer profit via connected transaction to avoid taxation. Sometimes listed companies use related party transactions simply to make news in the security markets.

This is a very common phenomenon in China, as recently many scholars have cast great attention on the research of such Chinese "Guanxi" (interpersonal relationships), such as Chen

2) In order to obtain qualification for right issues. After the companies are listed, they tend to issue right shares as a matter of fact. There are strict rules about right issues in China, e.g. listed companies to issue right shares must have annual net profit over 10% in recent three years. The listed companies will then use RPT to manipulate their profit figures. It is common that in the annual financial statement of most listed companies, the net profit tends to lie between 10%-11%, while almost none between 9%-10%.

3) In order to protect the "shell" company. According the company law, listed companies that have an operational loss for three consecutive years will stop issuing shares, which is known as special treatment. Therefore, companies will provide profit or buy off loss from the shell company so that it will not be ST.

4) In order to cover up the profit. In many listed companies, during years with good performance, they tend to use RPT to transfer profit into parent company or large shareholder, i.e. to cover up the profit, so that in later years with poor performance they can transfer the profit back to avoid negative impacts.

5) In order to evade tax. This is similar in the western countries. The tax rate for Chinese listed companies is 15%, and for regular companies the tax rate is 33%. This is a big different. Therefore, in some companies, they tend to transfer the profit into listed companies so that they can pay less tax. Besides, the tax rates for different regions are not the same either. For companies that own different subsidiaries in different regions, they will hence use RPT to transfer profit into companies with lower tax rate.

6) In order to provide guarantee and meet the loan restrictions of banks. Listed companies usually have higher credits, so it is easier for them to get loans from banks. Some companies thus use listed companies as guarantee to apply for loans or raise funds from banks. In China, many related parties provide guarantee to each other.

7) In order to meet the needs of parent company. Sometimes parent companies tend to transfer or displace assets with listed companies. In this way, they can change the business and capital structure of listed companies and thus obtain the advantages of being listed indirectly. A result of such RPT is that the listed companies will lose independence and competing ability.

and Chen (2004), and Jing, Zhou and Tse (2004). This kind of connection lies in every business aspect, with not only related enterprises but also powerful officials. It is like a cobweb connecting the listed companies and their parent company and shareholding corporations. Through related party transactions, they can earn private profit and exchange money or power, however in the expense of small shareholder interests.

Cheung et al (2005) examine a direct channel through which political connections may affect firm value by analyzing connected transactions between Chinese publicly listed firms and their SOEs shareholder. They find that although a handful of firms may benefit from connected transactions with SOEs, the majority of their sample is more likely to be subject to expropriation by the SOEs.

4.5.3.1 Motivations for RPT

In general, the view that RPTs represent a conflict of interest is consistent with agency issues similar to those considered by Berle and Means (1932), and Jensen and Meckling (1976). Jensen and Meckling (1976, 313) portray the agency conflict between a manager and outside shareholders as the manager's tendency to appropriate the firm's resources for personal consumption, like perquisites. As such, RPTs present the potential for the expropriation of the firm's resources. To control potential agency costs, companies can use various corporate governance mechanisms to better align the interests of managers and owners, including CEO compensation and board structure. If RPTs are conflicts of interest that arise because of the lack of alignment of managers' (or boards') incentives with shareholders, or because of limited internal monitoring, we expect that weaker governance structures will be positively associated with RPTs. Some specific motivations are listed below.

1) In order to be listed. There is restricting regulations for companies to issue new shares and raise fund in the capital market. Before March 2001, there was quota system for companies to issue shares, i.e. number of shares was allocated to provinces according to industries and geographic distributions. The quota system was rather defected because companies that wanted to raise fund in the capital market would thus compete to obtain "shell" companies.[20] In order to fulfil the requirements of CSRC, companies carried out a series of RPT, such asset dispatch, displacement, or rent, to prepare the shell companies for raising more funds in the capital market.

[20]The term "shell" company in China refers to those listed companies that are financially poorly performing and therefore disqualify themselves in raising additional financing from the stock market (Chi & Ma, 2000).

4.5.3.2 Negative Results of RPT

Through RPTs large shareholders tunnel resources from listed firms to related parties or prop up listed firm. Expropriating RPTs can divert free cash flow of listed firms to related parties, or expose listed firms to high risk of paying back bank loans for related parties. There are some empirical evidences as listed below.

1) The act of tax evasion makes a loss to the state and investors of listed companies. Companies use RPT to transfer profit into low tax rate firms so that their taxable profits become less. In this way, the state incurs a loss in tax income. On the other hand, the decrease in taxable profits results in the decrease of allocable profits and hence the decrease of dividends to shareholders.

2) The made-up profits through RPT impair the interest of small investors. Since CSRC has strong regulation on how listed companies make rights issue or remain listed, some of them make up profit figures through RPT. For example, when some listed companies are approaching bankruptcy, their parent companies will transfer funds into them and make a nice fake performance, which then misleads small investors. Moreover, when listed companies have the funding they qualify for rights issue and can raise money from security market. Once the faked performance drops, the ultimate victims are small investors.

3) The existence of unregulated RPT distorts the function of the capital market, and forms mistaken investment philosophy among investors. The basic function of the capital market is to better distribute resources, i.e., to raise efficiency of resources usage by transferring them into well-performed, promising companies through listing. However, unregulated RPT make fake prospectus about listed companies and hence alter the distribution. At the same time, the share prices of such companies often get to a high place, make bubbles in the security market, and thus prevent healthy development of the capital market.

4) Too many RPTs will lower the competitiveness and independence of listed companies. RPT via buying and selling result in fake performance, and thus have detrimental impacts on listed companies, which increase the dependency on parents companies. Some listed companies rely their material purchasing and product selling merely on the parent company and lack competitiveness in the market and lose ability to resist risk. Once the parent company stops the responsibility, the listed company will die out in the market.

Lo et al (2010) find that firms with a relatively more independent board, or have financial experts on their audit committees, are less likely to engage in transfer pricing manipulations through RPTs. Overall, our research findings reveal that the quality of corporate governance is important in deterring the use of manipulated transfer prices in related-party sales transactions. Kohlbeck and Mayhew (2010) also find that firms with RPTs have significantly lower valuations and returns than those without. This can be further demonstrated in the case study.

4.5.4 Tunnelling

In literature, the term "tunnelling" refers to the observed expropriation of minority shareholders by the controlling shareholders, through the transferring of assets and profits out of the controlled firm for the benefit of the controlling shareholders (Johnson et al, 2000). As Johnson et al (2000) state, such transfers can take various forms such as advantageous transfer pricing to parties related to the controlling shareholder, excessive executive compensation, loan guarantees, expropriation of corporation opportunities, manipulation of dividend payout rates, and so on. In these cases, the controlling shareholder often diverts economic resources from the firm to the detriment of minority shareholders (Jiang et al, 2005). As Jiang et al (2005) remark, China offers a particularly interesting setting for studying the tunnelling phenomenon. This is because most of the Chinese listed companies are restructured from existing SOEs (Aharony et al, 2000), in which the original SOE retains a large proportion of the total outstanding shares.

In fact, a highly concentrated ownership structure is general among Chinese listed companies, which produces the environment for tunnelling. The Jiang et al (2005) study strongly supports the existence of tunnelling among Chinese listed firms and indicates that this form of tunnelling is pervasive throughout the Chinese listed sector and carries serious economic consequences for the firms involved. Lee and Xiao (2004) find that state-dominated firms in China have high propensity to pay cash dividends, indicating that cash dividends might be used as a vehicle for tunnelling in state-dominated firms. Claessens et al (2000) conclude that tunnelling may be one explicit form of expropriation of minority shareholders.

4.6 Governance Mechanisms

Theoretically, governance mechanisms are developed to overcome the agency problems. These mechanisms are divided into such two categories as internal and external ones in literature. Internal corporate governance mechanisms emphasise on constructing a seasoned

power structure within the companies and forming an appropriate system of inspiration, self-discipline, and management, so that the companies will abide by the law and realize shareholder profit maximisation (Dahya, Karbhari & Xiao, 2003).

The primary external mechanisms include the market for corporate control, external auditing, and legal protection of investors, while external markets for corporate control refer to product market, capital market, and managerial labour market (Denis & McConnell, 2002). The competitions of product prices, mergers and acquisitions, and labour market employments will boost and restrict the companies with their operations. As for relevant laws and regulations, the government enacts a series of rules to protect investors and ensure the companies to comply with law as well as moral standards. The rules identify the responsibilities of directors, accounting standards, and information disclosure, etc. In China, there are potentially various problems with corporate governance mechanisms, including systematic defects, imperfect market developments, and less empowered regulations.

4.6.1 Ownership Structure

State shares and institutional shares are similar in that they may be owned directly or indirectly by different levels of government, and there are inherent agency problems associated with both types of shares. However, there is one important distinction in terms of their primary interest in the firm. The state's primary interest may be more political than monetary, such as maintaining employment levels or control over certain strategic industries. Institutional shareholders are more profit-oriented and may have more incentives to monitor the firm. Given these two opposing forces, the effect of institutional shares on firm value remains an empirical question.

Another problem is that the state shares are not tradable in order to maintain the dominant control of state ownership, which means the interest of state shares are combined with the listed company despite its performance. In this perspective, the government may have conservative attitude toward outsider monitoring, such as an independent audit, to protect large listed SOEs from being delisted. This can be seen from the fact that smaller and modern industrial companies are concentrated with legal person and employee shares and A-shares and are more widely held. Large and traditional industrial companies are heavily concentrated with state shares. Besides, smaller, growing, high-tech companies have a greater reduction of state control whereas larger, strategically important companies remain majority state control.

Many studies suggest that companies with high level of legal person shares perform better (e.g. Qi, Wu & Zhang, 1996; Xu & Wang, 1999). Since those who have legal person shares do not have the dominant voting right, it is not easy for them to expropriate minority shareholders interest through related party transactions (Jing, Zhou & Tse, 2004). On the other hand, legal person shares are not tradable, thus the holders cannot speculate in the market to get short-term return as some public investors do. Return of holding legal shares only comes from dividend. In this sense, holders of legal person shares have a keen incentive to monitor company development and to maximise shareholder benefits, and thus reduce the agency costs caused by conflict between management and control.

4.6.2 Board of Directors

Numerous studies have proved that this is the mechanism, through which governance is realised and some of the solutions to agency problems can be sought. Xu and Wang (1999) argue that both the state and institutional investors rely heavily on the board acting in a prudent and responsible manner. However, as stated in above parts most listed companies are transformed from SOEs, they are rather short of independence and thus parent companies take control of the boards in listed companies, i.e., the board in Chinese listed companies is often dominated by large shareholder representatives and/or internal executive directors (e.g., He, 1998; Li & Deng, 1999; Xu & Wang, 1999).

The executive directors appointed are occasionally recommended by company staff and primarily by the government. As in Lu (2004), a board of directors should consist of 5 to 19 directors according to the Company Law, and a survey by World Bank shows that two-thirds of all directors are executive directors while only 3.1% have some degree of independence.

Furthermore, about half of the executive directors take senior management position and only 5.4% of the listed companies have established sub-committees such as finance committee, audit committee, and strategy committee. As in many studies with Chinese listed companies, public servants from government divisions are not permitted to become board members in listed companies and banks are not allowed to become shareholders, when directors from these institutions do exist. To some extent, this is a reflection of weak regulations by relevant authorities.

The notion of independent directors is new to most listed companies in China. The independent directors are generally recruited by the companies. They tend to be former

advisors to the companies and they are usually elected because of their reputations and professional expertise. According to the World Bank survey cited by Lu (2004), about half of executive directors take senior management positions. Comparatively fewer directors hold professional positions such as chief engineers, advisers, and economists. Non-executive and independent directors tend to be more highly educated than executive directors appointed by shareholders are. About half of all executive directors, two-thirds of non-executive directors, and almost all independent directors hold degrees in management-related subjects or finance and accounting. An insignificant number of directors have studied law.

In terms of background, most directors have worked in the fields of engineering, marketing, and sales. Independent directors have more experience in technological research, education, and organisational work for the government. Therefore, they are expected to be of good faith and diligence towards listed companies and all the shareholders.

Nevertheless, most executive and non-executive directors are former SOE employees, while independent directors are drawn mostly from government departments, research institutions, and universities. In fact, they can be independent actually by no means due to their various relationships with the listed companies. This accounts for the description of listed companies as "old wine in new bottles," that is, on the surface a new corporate governance framework appears to be in place, while in reality companies still operate essentially similar to old SOEs.

Long (2001) also points out some other reasons that the independent director system lack efficiency in China at this stage: (1) lack of legal backing for the role of independent directors; (2) low accommodations and lack of incentives; (3) drawbacks in the independent directors own credentials and abilities; and (4) impact of the social and cultural environment. The first three points are consistent with empirical studies about board of directors in Chinese listed companies and the last point perfectly explains "Guanxi" – interpersonal relationship that is treasured to maintain harmony with the listed companies and therefore prevents independent directors in honouring their obligations.

Besides, Chinese corporations still lack nominating committees for directors and other sub-committees. The procedure of nominating directors in listed companies is not disclosed publicly and most listed companies do not have a system ready for establishing board committees. The main reasons for this are (a) the boards of directors' relative lack of independence, (b) the prevalence of insider control, and (c) the lack of independent directors

who are familiar with the legal aspects of business operations (Zhang, 2001). Some special committees cannot function meaningfully in the absence of independent directors.

4.6.3 Supervisory Board

At the same time, company law in China requires all the listed companies to set up supervisory board, consisting of representatives of shareholders and employees. As conceived of in China, the board of supervisors is unique: a mixture of the German-style supervisory committee and China's traditional concept of employees as masters of enterprises. Dahya, Karbhari & Xiao (2003) review studies on the supervisory board in China and outline the distinct characteristic of the two-tier board structure in China, that is, the supervisors are not empowered to appoint and dismiss directors and executives, which make them better characterized as unitary board. They also conclude that the supervisory board in Chinese listed companies lack legal power and responsibilities, independence, technical competence, or decent status. The supervisors are not empowered to appoint and dismiss directors and executives while they are supposed to. The Dahya et al. (2003) study also observes that supervisors generally meet less often than boards of directors and their meetings are less well attended. Supervisory boards are more "decorative" than functional. As with some other studies with supervisory boards in listed companies, the supervisors hardly challenge decisions made by the board of directors or executives. The dependence, technical incompetence and less professional experience of supervisors have led to their incapability to supervise directors and managers in reality.

Moreover, their main source of information comes from the participation of board meetings without voting rights, in addition to the reports of the board chairperson and general manager. Besides, Company Law does not stipulate that board of directors and managers have to report regularly to supervisory board, and supervisors are not involved in the selection of directors and managers, not to say efficiently disciplining them. This is consistent with Li and Deng (1999) in that as shareholder and employee representatives tend not to be independent of board directors and management, they frequently fail to discharge their duties in an independent and objective manner.

4.6.4 External Auditing

Before the economic reforms in the 1980s, businesses in China were operated and strictly controlled by governmental agencies (state or ministry levels). Operations of SOEs were

conducted according to state plans. The government and its agencies retained all investment and operating decisions. The managers of these entities had little incentive and managerial authority to enhance the efficiency of SOEs. SOE was not regarded as a mere commercial organization in the sense that its objective was to maximise profit. It was also considered as a quasi-government agent that was required to pursue the broad social, political, and economic objectives of the government.

In such a planned economy and financial reporting environment, the main objective of financial reporting was to provide financial information for the government to formulate and enforce state economic plans and to control economic activities. In addition to direct supervision exercised by the governmental unit directly superior to the particular enterprise, the Ministry/Department of Finance performed annual "financial examination" of SOEs.

Regular audit was not considered necessary under the planned economy. In the case of central government-controlled SOEs, the Ministry of Finance (MOF) was responsible for such an examination (usually performed annually). For local SOEs, the Department of Finance of a local governmental office is responsible (Lau & Yang, 1990). The financial examination by MOF served as a means of direct control and management of the SOE. This was appropriate, as the cash flows of SOEs were part of the overall cash flows of public finance of the state.

There was an overwhelming focus on compliance with certain economic and financial rules and profit/tax submission rather than a verification of financial statements. As the SOEs were under direct control of the government, there was no need for an independent audit of financial statements by a third party who provides an independent view as to whether the financial statements are true and fair. Therefore, prior to 1980, independent audit did not exist.

It has been generally agreed that the government's direct control and management of SOEs, together with other factors such as an over-centralized national economy, result in poor performance of SOEs (e.g., Tang et al., 1996). In the early 1980s, the government began reforming the SOEs. The objective of the SOEs reform was to rejuvenate the SOEs by giving more and more autonomy in making economic decisions and providing financial incentives to managers and employees of SOEs.

Two major reforms have been adopted for SOEs. They are the contract responsibility system (CRS) and corporatisation. Under CRS, while the government retains the ownership, the SOE

is subcontracted to selected individuals (managers) to run the firm independently. The managers are rewarded if the operating targets set in the contract are achieved. The financial incentives for managers include sharing of the profits in excess of the targeted amount. Unfortunately, the CRS has not been successful in improving the economic efficiency of SOEs. Liu and Zhang (1996) discuss several factors contributing to the inefficient and unprofitable operations.

Consequently, the government intends to replace CRS by corporatisation, which refers to converting SOEs into companies with limited liabilities. Although the abovementioned reforms have improved efficiency of SOEs (Chang, 1997), new problems have emerged. One of the problems is the self-serving management. Xiang (1998) states that "as a result of these profound changes, China's large SOEs, either corporatised or still under the CRS, now significantly resemble modern corporations in the West in that the SOEs are characterised by a high degree of managerial authority and a separation of ownership from control. As a consequence, potential agency problems have emerged".

The agency problem is more serious among the SOEs managers as the incentive system is short-term oriented. Their primary financial reward system is linked to the profit performance. As these managers are not allowed to own shares in the SOEs they managed, there is no long-term incentive. After restructuring, without direct control and without involvement in day-to-day management, the government has to rely on the SOEs' financial statements to make decisions.

However, there are growing incentives for the manager to manipulate the financial information. The manager may inflate the profits to their benefit or provide false financial statements to conceal embezzlement and other irregular behaviour. The financial statements provided do not represent the true and fair state of SOEs. As a result, relying on this misleading or false financial information may lead to serious consequences, such as the loss of state funds, the wrong assessment of managers, and the formulation of incorrect economic decisions and policies.

As DeFond et al (2000) and other studies conclude, a direct threat to the supply of independent audits in China is the widespread government ownership of both client sand their auditors. Most of listed company auditors are affiliated with state agencies and the controlling shareholders in virtually all listed companies are government entities. What's more, the

administrative responsibility of the CICPA is authorised by the MOF by law. Such direct monitoring from the government and affiliation with the auditees both make external auditing in listed companies inefficient to some extent.

Moreover, as discussed in previous sections, interpersonal relationships are very important among businesses. Thus over time auditors begin to sympathise with and serve as advocates for management, who might in fact manipulate financial figures and pursue personal profit rather than company welfare and thus render agency problem. It is also found that over time auditors become 'stale' and fail to notice and incorporate into their judgments new evidence or changes in the client's situation. This behaviour could result in auditors failing to provide an efficient audit and thus worsens agency problem (Davis, Soo & Trompeter, 2000).

Theory suggests that some monitoring and bonding mechanisms may develop to mitigate the agency problem and hence reducing the financing costs (Jensen & Meckling, 1976). One such method is for the controlling owner of a firm to hire an independent external auditor to testify the accuracy of its financial statements. East Asian auditors potentially have a stronger governance role because the conventional corporate control systems are weak in protecting outside investors.[21]

As in DeAngelo (1981), large audit firms have incentives to supply a higher level of audit quality and to some extent; auditor size is a proxy for unobservable audit quality. This is because large audit firms have more clients and if they lack independence or provide a low-quality audit, they are likely to lose them. From this perspective, large audit firms are likely to conduct a true and fair check on the firm's financial statements and management behaviours, and thus provide the company shareholders with high-quality audit reports.

DeAngelo (1981) argues that audits conducted by Big Four firms were more likely to discover the presence of material errors in financial statements compared to smaller firms, as they possess technological advantages over their competitors. According to his study, in a situation where an auditor discovers a misstatement in the client's accounts and the client tries to influence the auditor not to report the misstatement, the auditor's incentive to "cheat" is measured by the loss of the present value of client specific quasi-rents if the engagement is discontinued.

[21] With the presence of Big Four accounting firms and other international firms across East Asia, the international market for external auditors are much more established than the market for credible independent directors. Neither is there a viable market for corporate control in this region, mainly a result of the concentrated ownership. Hostile takeovers are extremely rare. (Fan & Wong, 2001)

Alternatively, the countervailing disincentive to cheat is the present value of quasi-rents specific to the auditor's other current clients. If the auditor "fails to report" the misstatement and the "failure to report" is discovered, the auditor is in danger of losing these other clients and/or reduced fees from the clients that continue to retain the auditor. Therefore, it follows that auditors with a larger client base have more to lose, i.e. greater disincentive to cheat than smaller auditors. Shockley (1981) reported that Big Four audit partners', loan officers' and financial analysts' perceptions of independence were significantly influenced by audit firm size. The risk of independence becoming impaired was more likely for small auditors.

Among Chinese listed companies, Big Four accounting firms only audit a very small portion of Chinese listed companies in terms of number of companies, which is far different from the situations in western countries. However, when it comes to market value, this percentage increases significantly although at an overall level of less than 40% market capitalisation, which is more similar to the pattern in developed economies in a sense that big companies are inclined to hire Big Four as external auditors to ensure investor confidence. Details are shown in Table 4.4 below.

Table 4.4 External Auditor for Chinese Listed Companies (2005)

Auditor	PWC	E&Y	Deloitte	KPMG	Big 4	Others	Total
Number	31	29	20	11	91	1239	1330
Percentage	2.3%	2.2%	1.5%	0.8%	6.8%	93.2%	100%
Market Value	8.4%	7.3%	3.5%	16.9%	36.2%	63.8%	100%

Source: Centre of China Economic Research Services (CCER)

Besides, the low efficiency of corporate governance is also related to the weak credit system and legal system in China's new market economy. Credit is the soul of market economy, which maintains the cooperation and transaction of market participants, and safeguards the market contracts and rules. In the meanwhile, effective governance mechanisms need a regulation backup to protect small shareholder rights and maintain fair transactions.

However, in China, no matter the supervision on securities market by government authorities or supervision on listed companies by business administration, taxation and credit departments are both inadequate. Improvement of the governance effect requires more vigorous implementation of relative laws and regulations.

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Looking back to history, the Certified Public Accountants (CPA) profession was established in 1918 and four CPA firms were founded in the 1920s. However, there were no authoritative or unified auditing standards. Shortly after the revolution in 1949 the role of auditing in diminished significantly and finally abolished after the economy was fully nationalised in 1962 (DeFond et al., 2000). Economic reforms in 1979 brought back a demand for external audits for tax collection purposes and the concept of professional auditing did not emerge until 1980 when China allowed foreign companies to set up joint venture firms (Haw, et al., 2003). Hence, the MOF created the Chinese Institute of Certified Public Accountants (CICPA) in November 1988 to administer the CPA examination, which took place for the first time in 1991. Additionally, the government granted permission to a select set of accounting firms to audit public companies after the establishment of Shanghai and Shenzhen stock exchanges (DeFond et al., 2000).

As Haw et al. (2003) state, although the CPA designation is granted by the CICPA, the CSRC impose its own licensing requirement for CPAs and CPA firms to audit listed firms to ensure the quality of the audit in 1996. However, due to lack of capital, the new CPA firms affiliated themselves with existing institutions and therefore three types of auditing firms emerged: government-affiliated audit firms, university-affiliated audit firms, and joint ventured audit firms with an international CPA firm. Among the three types of auditing firms, the government-affiliated firms are by far the dominant group in the audit market due to the government's desire to maintain control of the economy.

On the other hand, when international audit scandals occurred, such as Enron, and Sarbanes-Oxley Act was announced, the MOF decided to draw back most the CICPA power in formulating, developing, and implementing codes of CPA in January 2003. Therefore, the MOF becomes a main administrator of the CPA industry.

Due to the narrow focus of the financial examination by MOF, these management problems could not be discovered or resolved. Largely, audits by MOF tended to be concerned with uncovering taxes, profits, and charges that should be submitted to the government but retained in the enterprise. In addition, there was a lack of independence. The MOF might have financed the SOE and have been involved directly or indirectly in making business decisions. They have to consider their interest when performing the financial examination. Consequently, the examination might be biased as the examiner has a strong and direct interest in the revenue outcome of the audit. There are anecdotal stories that some departments of finance

would not correct accounts as long as they achieve the budgeted revenue collections for the current year, leaving the (uncorrected) detected errors as a hedge for attaining future years' collection targets.

In responding to these changes resulting from SOE restructuring and particularly in recognising the need for a more independent auditing organisation, the Chinese Constitution was amended to create state auditing offices, and to charge it with this responsibility. Auditing by the state audit office involves the evaluation of the fiscal plans implemented, reviews of the revenue and expenditures, and assurance of compliance with the state's financial and economic guidelines, regulations, rules, and disciplines (Huang, 1987).

In practice, while the objective is explicitly stated in the Auditing Law, its implementation is hampered by the lack of specific criteria for measuring effectiveness and efficiency. It is also difficult for the state audit office as a government agent to make judgment about SOE business decisions and activities in terms of effectiveness and efficiency.

4.6.5 Legal Environment

The legal environment is the most important external influence over corporate governance, and provides the framework to the formation of companies, corporatisation, the IPO, and subsequently the raising of finance, investment, and information disclosure. These laws, and the quality of their enforcement by the regulators and courts, are essential elements of corporate governance and finance (La Porta et al, 2002).

Currently, there are two major Laws, passed by the National People's Congress of China, which set the legal framework in line with the needs of the socialist market economy.

The first major law, the Company Law 93, was promulgated in 1994, setting out general requirements on company incorporation and providing the foundation for the establishment of companies.

The Law specifies two types of companies. The first is the limited liability companies (LLC), which is established with the capital of a limited number of shareholders and where equity cannot be transferred. This type of companies is allowed to have up to 50 shareholders and their equity capital cannot be divided into equal shares. The second is the joint stock company, which is allowed to raise capital from the public and to be listed on the stock exchanges. This

type of companies can be incorporated through a combination of subscriptions and IPO. The Law also mandates a corporate governance structure for companies incorporated in China.

The second major law, the Securities Law 98, was promulgated in 1999, and its objective is to regulate the trading of securities in both primary and secondary financial markets. It dictates the procedures for share issuance, share transactions, information disclosure requirements of public companies, and the rules of corporate takeover.

The two major Laws are supplemented by various regulations and notices issued by the authorities. Those regulations cover issues such as accounting standards, information disclosure, State asset management in listed companies, and the conditions for seasoned equity offerings. For instance, in 1997, the CSRC issued a regulation on 'Guidelines on Articles of Association for Listed Companies', whose purpose was to improve the accountability of management to the shareholders, and to ensure a fair, open, lawful relationship between the shareholders, the BOD, and the company.

A sound legal system is important for the healthy development and functioning of corporate governance and capital markets, yet it is not enough on its own. Effective legal protection involves both the content of the laws, and the quality of their enforcement. The willingness of all parties to observe laws is crucial for their successful implementation, and this requires a compatible, harmonised, social, cultural, and broader legal system.[22]

4.6.6 Other External Mechanisms

The market for corporate control through merger and acquisitions (M&A) plays an active role in reducing agency costs in the US.[23] However, it is simply emerging and is not active in China. Due to ownership concentration in the Chinese capital market and the fact that the state is the dominating shareholder, it is very hard for takeovers to succeed in China.

Fan et al. (2002) argue that the market for corporate control is at its most primitive stage, as most M&As are policy-driven and managed by state. In practice, many local authorities require healthy SOEs to merge with as many as loss-making ones as possible to make their

[22]La Porta et al (1998) point out that the extent of legal protection of outside investors differs enormously across countries.

[23]There is evidence that takeovers increase the combined value of the target and acquiring firm (Jensen, 1983) and that takeover targets are often poorly performing firm (Morck, Shleifer & Vishny, 1988). Therefore, takeovers can act a corporate governance mechanism (in the US) to lessen managerial discretion and thus agency costs.

unbalanced because 'insiders' and the agent of large shareholders control the board and take less responsibility.

(2) Ineffectiveness of external market of corporate governance: active market for mergers and acquisitions is severely distorted and it hardly influences the governance of listed companies; there are few highly qualified agencies with excellent reputations; the managerial labour market is underdeveloped, especially in selecting company management.

(3) Relevant laws and regulations for corporate governance are yet to improve: there still lacks a legal principle or standard on corporate governance, while most of the current rules are impractical and formalistic; the enforcement of current regulations is not rigorous and there are interference of government and politicians.

Modern corporation theories remark that large shareholder losses the advantage of disperse investments and will therefore have strong incentive to supervise management in the companies to improvement firm performance. In previous studies, sole shareholder and concentrated ownership are considered the solution of vacuum supervision.

Conversely, situation in China is very different from those in developed economies. Corporate governance settings in China are relatively unusual. Many of the listed companies in China are state owned and SOE reforms have resulted in significant degree of insider control as SOE managers have acquired considerable discretion over the use of state assets (Sun & Tong, 2003). The state is the absolute controlling shareholder while being unable to management the firms on a daily basis and hence there forms a sort of absent owner. Such an ownership structure leads to a lack of managerial initiatives on the one hand, and misinformed business decisions on the other. This renders the Type II agency problem as previously mentioned, i.e. conflicts between large and minority shareholders.

The state has incentives to finance the SOEs in achieving economically inefficient objectives other than profit maximisation, which other minority shareholders pursue. Minority rights are limited in the sense that they can seldom vote for crucial events or appointment or dismissal of directors. Because the management is only a political representative of the state, agency problem of Chinese SOEs is potentially far more serious than of most western companies. Chinese listed companies operate in a unique environment, which provides an interesting setting to carry out empirical tests of hypothesis.

Through the discussions in this chapter, several governance mechanisms are identified from the literature based on their applicability in the Chinese settings. They are ownership structure, BOD, supervisory board, dividend payment, as well as external auditing. These choices are further confirmed in the following case study chapter and tested in the econometric modelling chapter afterwards.

types of agency problems and in China, especially listed companies, the problem with large and small shareholders are more serious given the history and nature of Chinese capital market. In order to develop testable hypotheses, a pilot study was carried out in SDG group to discuss relevant corporate governance mechanisms. To further obtain knowledge practically about how large shareholders can interfere with company operations and hence generating agency issues, a second round of field work was performed within the same group. More details will be presented in the coming sections.

Specifically, section 2 describes case study methodology and provides a summary of interviewees included in the data collection procedure of qualitative research. Section 3 gives the background information of the parent company SDG and the listed subsidiaries. Section 4 reviews corporate governance mechanisms and financial performances in the group before the modernisation reform, i.e. the debt into equity transformation process carried out by the Shenzhen government in 2005. Section 5 discusses agency issues and agency costs both theoretically and practically. Section 6 is about the corporate governance mechanisms after modernisation reform. In such an arrangement, the whole dataset will be analysed in their specific background. The last section concludes the chapter.

5.2 Research Method

Bimberg et al (1990) define field research in relation to its natural settings that are not created for the sole or primary purpose of conducting research. Ferreira and Merchant (1992) require that field research rely on interviews and direct observations as the primary data source through direct and in-depth contact with members of the organisation. In addition, Ahrens and Chapman (2005) point out that interview certainly offers potential to add to our understanding. Yin (2003) views that field studies are essential to developing hypotheses and building theory. While many researchers advocate quantitative methodology, they also realise that such "hard" methods can only be applied limitedly to human beings. The predetermined answers constrain the respondents for the sake of replication and analysis and therefore hinder the possibility of discovering sensitive information of the real world. Hence, some "soft" methods can work as effective complements.

Through qualitative research, theoretical relationships between governance mechanisms and agency costs can be outlined in the form of hypotheses and further explained with statistical tests and econometric models, as will be presented in the next chapter. A series of interviews and analysis will be conducted among the specific case companies in two stages. Stage one

Chapter 5 Case Study

5.1 Introduction

The objectives of the case study are four-fold.

The first objective is to crystallise agency issues and relationship between agency costs and corporate governance mechanisms. Apart from the various theoretical suggestions given in the previous chapters, this chapter will focus on a specific case which serves as a typical example amongst Chinese listed companies and their largest shareholders in illustrating agency issues in the real business world.

The second objective is to identify additional proxies for agency costs which may be more appropriate in the Chinese context. Many prior studies do not reach significant results or generate mix results due to applying variable proxies defined in the literature, which mainly come from empirical evidence in developed economies. By deriving new proxies that are more relevant to the Chinese setting, the models and results will be more meaningful.

The third objective is to explore characteristics of Type II agency issues, because this is more severe with Chinese listed companies as well as other large entities in general.

Finally, the case study seeks to justify corporate culture as a new governance mechanism, which may be of interest to future research in this field.

The previous two chapters explore the literature on corporate governance mechanisms around the world and in China. As can be seen, the results are mix when investigating the impact of various governance mechanisms on dealing with agency problems, especially in the Chinese context, due to the reasons discussed above. In order to establish an appropriate model for the purpose of this study, i.e. exploring agency issues and finding agency cost proxies, a case study is designed to help understand real issues and construct empirical models.

In this chapter, the group company Shenzhen Development Group Ltd (SDG) and its subsidiaries will be investigated to explore real agency issues and how corporate governance mechanisms affect agency costs and curtail agency problems. As mentioned, there are two

includes pilot study, i.e. preliminary questions and interviews, which will help set up hypothesis and econometric models to be presented in the next chapter. In addition, the stage two results are used to facilitate hypothesis testing and econometric analysis in the next chapter. More specifically, some of the issues identified which cannot be substantiated or explained in the econometric models will be discussed using case study results, as detailed in the next chapter.

Qualitative methodology allows participants make their own interpretations on what happens upon them, attach their individual point of view, often quite different, to the researchers' actions, and adjust their participation in the research process. Based on the discussions, this research project combines qualitative with quantitative empirical data and analysis, which is widely known as "triangulation". Quantitative analysis allows powerful statistical testing of hypotheses using a particular data set while qualitative analysis facilitates a great insight into contextual issues such as why certain corporate governance mechanisms are effective and why others are not.

As Merriam (1998) states, case study is used to give intensive descriptions and analyses of a single unit or bounded system such as an individual, program, event, group, intervention or community. It is well suited to studying areas where reliable datasets are largely unavailable (Mar & Young, 2001), or when a phenomenon is not well understood. Case study is particularly useful for exploring of "how" and "why" issues (Yin 1994). Given the background of SDG, this chapter provides insights into the current practice of corporate governance among large SOEs and their subsidiaries including listed companies. Following the research rationale, both explorative and confirmative questions are asked hoping that the answers will provide more perspectives of the problem, and extended answers are encouraged for further discussions.

Data is collected through interviews and information from financial statements, including financial performances ratios and corporate governance structures. There are two stages of interviews in this case study. The first round was used as a pilot study, which took place in February to March 2006. Interviews were carried out on members of the parent company SDG as well as its listed subsidiaries, including general manager, directors, board secretary, accountants, and other management personnel. The purpose of the pilot study interviews was twofold. Firstly, general questions about corporate governance in the companies would help understand the background; secondly, unexpected information from the answers would guide

the construction of questions for the second-stage and further interviews, and thus creating sophistication in the data. In fact, the early interviews also permitted preliminary testing of the hypotheses and it lead to constructing more meaningful variables in the main project, for example Administration Costs as similarly used by Singh and Davidson (2003), as well as Other Receivables (ORC). The second round interviews were carried out in January to March 2007, this time on members of the group company and its subsidiaries, as well as government officials and representatives of large shareholders. The complete list of interviewees with their background information is given in Table 5.1 below, together with a description of whether they are contacted in stage 1 or stage 2 interviews.

Table 5.1 Information about Interviewees

Interviewee	Organisation	Department	Qualification	Tenure	Stage
A1	SASAC	SOE Reform	PhD	6 Years	2
A2	SASAC	Legitimacy & Regulation	MA	4 Years	2
B	IHC	Vice President	College	8 Years	2
C1	SDG	General Manager	BSc	5 Years	2
C2	SDG	Vice General Manager	College	15 Years	1 & 2
C3	SDG	Vice General Manager	College	8 Years	1
C4	SDG	Vice General Manager, Director	BA	7 Years	2
C5	SDG	Secretary, Board of Directors	BSc	9 Years	1 & 2
C6	SDG	Human Resource	MSc	1 Year	1
C7	SDG	Administration, General Office	MSc	5 Years	2
C8	SDG	Chief Financial Officer, Director	BSc, CPA	8 Years	2
C9	SDG	Investment & Development	PhD	5 Years	2
C10	SDG	Audit & Supervision	MSc	2 Years	1
C11	SDG	Director, Discipline Committee	College	9 Years	1
D	SDGI	Chair, Board of Directors	MSc	5 Years	1
E1	Tellus	Chair, Board of Directors	MSc	5 Years	2
E2	Tellus	Chair, Supervisory Board	PhD	5 Years	2

State Asset Supervision & Administration Commission (SASAC) is directly controlled by the State Council, and it operates in many major cities throughout the country. Previously in Shenzhen (1995-2003), state assets were managed through three tiers: SASAC, asset

management companies, and SOEs. In May 2003, the State Council announced a new regulation regarding the management structure of state assets, which was a two-tier model: SASAC-SOEs. Therefore, in 2004, the Shenzhen government merged its three asset management companies into one – the Shenzhen Investment Holding Corporation (IHC). State assets are allocated to both SASAC and IHC, while the former mainly controls crucial industries including energy and food, and the latter other non-crucial ones. In this way, the management structure was simplified and clarified.

Interviewee A1 was from SASAC Shenzhen office, who worked as director of the SOE Reform Department. He was very familiar with the developments of SDG and the city of Shenzhen. Interviewee A2 also worked for SASAC Shenzhen office and she was based in Legitimacy and Regulation Department. She dealt with most paperwork outgoing to companies. Interviewee B was the Vice President from IHC, the direct superior of SDG. Interviews C1 to C11 were employees in SDG from different functions and departments. Interview D was the chair of board at SDGI, who had much experience in large SOEs. Interviewees E1 and E2 were from Tellus, representing directors and supervisors. Interviewee C2 was the main contact in the company, and after several discussions of my research questions and objectives, I had identified suitable people within the group for interviews as listed in the Table. Only interviewees C2 and C5 were interviewed twice due to their availability and more importantly their good knowledge about the group.

The objective of this study was to investigate agency issues and evaluate the effectiveness of corporate governance mechanisms on affecting agency costs. Therefore, the questions fell into two themes: (1) agency issues and agency costs, and (2) corporate governance mechanisms. There were two sub categories of questions in Theme One. Category (a) was a series of questions on exploring evidence of agency problems and conflicts between government and managers, between shareholders and debt-holders, between large and small shareholders, and between shareholders and managers. There were also questions regarding why these issues arose. Category (b) was about the ways in which these agency problems manifested, including how they arose and what the consequences were. In the end, the interviewees could give their opinions on this theme in case any vital questions were missing. Theme Two was about what corporate governance mechanisms actually existed in the case company and its subsidiaries; how many external and internal mechanisms were there; and how they affected agency problem and agency costs. A list of interview questions is attached in the appendix.

The interview questions were sent to the interviewees beforehand so that they understood the basic procedures and could make sure they were willing to undertake the conversations. Consent would be obtained before any voices were recorded, and the venue would be in the interviewees' offices. Each interview lasted for about two hours, based on how much detail they wanted to go over answering the questions.

After the interviews, their answers were translated for further analysis, as given in the following parts. Generally, the interviewees preferred their comments being taken as notes rather than recordings, so only the interviews with A1 and C9 were recorded. However, other interviews did not last as long as these two (these interviews lasted for about two hours each while other interviews lasted about one hour or one hour and a half). Notes were taken during the process and were showed to the interviewees for approval. Translation was done on a word by word and sentence by sentence basis, and original notes and voice records were retained for references.

5.3 Background Information of SDG

This case company is chosen because it is one of the oldest and biggest companies in the region and it has listed subsidiaries that float on the Shenzhen Stock Exchange in very early years when it came into existence. It has all typical SOE characteristics and agency issues, as will be discussed in the following sections.

The company was established by the Guangdong provincial government in 1981, when Shenzhen was named Special Economic Zone, and designated to attract foreign investments. It is among the earliest and biggest state-owned group companies in Shenzhen and has a profound political background. When the company was initially set up, it carried out both the functions of government and enterprise, currently owning 37 secondary enterprises and 6,000 employees. Through development in these decades, it now becomes a gigantic financial and commercial group involving car industry, electronic information industry, commerce and trading, real estate, tourism, and finance etc. fields.

During the period from 1981 to 1994, the company was in its first-stage plan of developments. SDG established the first China-Japan joint venture enterprise in China, the first joint venture enterprise in Shenzhen, and the first listed subsidiaries on SZSE among many other initiative activities. By the end of 1993, the company had 289 subsidiaries spreading industrial, commercial, real estate, tourism, and financial sectors. The total revenue of the group rose

from ¥5.4 million in 1981 to ¥4.6 billion in 1993, and sales profit rose from ¥5.2 million to ¥0.5 billion. To achieve the economic targets of the Shenzhen government, it attracted $880 million foreign investments, completed $2.07 billion import and export transactions, and realised a profit of $4.45 billion at the end of 1995. However, since its early years, the company mainly represented individual desires that had actually no professional perception, i.e. the governor had little knowledge about the industry. For example, one of its listed subsidiaries SDGI set its main business as high technology but in fact only because it sounded fancy at that period and had nothing to do with the company's real business. This situation resulted in that some of the subsidiaries could not achieve factual success in operation and had poor performances in the securities market or their industries.

From 1995 to 2005, the company experienced its second-stage plan of developments, including a major reform called debt-into-share (DIS) scheme. The company reported a ¥10 billion of total asset at the end of 1995, but then faced a significant crash during the 1997 Asian Financial Crisis and experienced severe losses. In 2000, the company negotiated with three asset management companies, Changcheng, Dongfang and Xinda, for an asset reconstruction. After more than five years reconciliation, it finally completed its reform process and turned into the new Ltd. Company. ¥900 million of debt being turned into shareholding and ¥2 billion bad assets being cancelled off, the previous SDG had been reformed after the DIS mechanism. March 31, 2005 was the last day that the state helped badly performed SOEs change their debt into shareholding. This was the date SDG completed its reform and registration and thus made itself the last DIS company.

The new company had turned from government-owned mono shareholding company into a Ltd. Company with three new shareholding companies totalling in four. Changcheng (28.87%), Dongfang (26.03%), and Xinda (1.80%) asset management companies purchased and shared the ¥900 million debts into shareholding, and successfully took over control of the new SDG, while the remaining 43.30% of shareholding continued to be in the hands of the Shenzhen government.

After the reform, there were nine people on the board, eight of whom had been nominated and appointed by each shareholder and one from employee representative. Besides the board of directors, there was also a supervisory board of five people, a strategy committee, an audit committee, and a remuneration committee. The directors voted for top managements.

SDG also controlled three listed companies, which are Shenzhen Tellus Holding Co. & Ltd. (Tellus), Shenzhen SDG Information Co. & Ltd. (SDGI), and Shenzhen International Enterprise Co. & Ltd. (SDGE),[25] the first two concentrating on high-tech products and the last being a biggest chain department store in Shenzhen. Like many other Chinese SOEs, SDG was losing money and it continued to be a significant burden on the economy as a whole. The problems they faced included bad performance, poor productivity, and increasing debt. These problems often stemmed from their history as pure state enterprises within a centrally planned economy, heightened by their slowness in adapting to the new corporatisation regime. SDG was of no exception, and therefore it made a good case in point with high representativeness.

On the other hand, SDG also had some unique characteristics worth exploring, e.g. local government control, foreign investments, and structure transition, which would be discussed in the coming sections. Going back to the agency problem of controlling shareholders expropriating minority shareholders, the SDG group and its listed subsidiaries are a good example. As Zou et al (2008) state, controlling shareholders in China can use two primary vehicles to expropriate minority investors. The first is false information disclosure by listed companies in relation to equity issues in order to meet CSRC's profitability requirements and secure the right to issue shares (see also Yu et al, 2006). The second vehicle for expropriation is through tunnelling RPTs (e.g., Aharony et al, 2010; Cheung et al, 2006) including controlling shareholders obtaining soft loans from the listed companies (there are many documented abuses on the CSRC web site), using listed companies as guarantors for bank loans, and buying and selling goods, services, and assets at unfair prices. These will be looked at in detail in the case companies.

5.4 Corporate Governance in the Business

5.4.1 Ownership Structure

According to Jensen and Meckling (1976), ownership structure refers to the relative amounts of ownership claims held by insiders (management) and outsiders (investors with no direct role in the management). It is an important source of incentive for management, boards of directors and outside shareholders (Milgrom & Roberts, 1992) and therefore is often

[25]Strictly speaking, SDGE was an associate rather than subsidiary. SDG used to have significant influence over SDGE in terms of its business operations. However, after the DIS scheme, SDG lessened its shareholding in the associate so that it had less influence. This was the reason no interviewee from SDGE was picked for the case study. The discussion only included SDGE for the sake of completeness.

recognised as one of the most important internal governance mechanisms. The pattern of ownership structure can influence managerial behaviour and corporate performance in many ways, as discussed in the literature review chapter. The relationship between ownership and performance has been the subject of an ongoing question in the literature. SDG has different stakes in the three listed companies, i.e., it is the biggest and dominant shareholder in Tellus, one of the biggest shareholders in SDGI, and a considerably large shareholder in SDGE. The ownership structure of SDG was discussed in the previous section, and the ownership structure of these three listed companies will therefore be looked at below in order to see how ownership structure affects corporate performance.

Tellus was the earliest listed company of SDG, which obtained listing on Shenzhen Stock Exchange (SZSE) and entered the capital market in 1993. It covered all hot industries at that time, such as export, import, and real estate. However, only after two years, Tellus began losing money. In year 2000, since the shareholder value was under registration capital (i.e., net asset value per share below stock face value), the company was listed as "special treatment" (ST)[26] and remained unchanged until 2006. In 2001, it reported a ¥5.14 million profit by related party transactions (RPT) to escape from delisting, and then in 2002 it went back to a ¥40.98 million loss. These dramatic ups and downs were rather not market driven due to the characteristic of its ownership structure.

This company had been restructured for several times. The total assets of the company maintained a decreasing trend from 1996. Then in 2001, its assets almost doubled due to SDG's capital injection for parenthood protection, followed by another decreasing movement. In July 2001, SDG helped Tellus by swapping the assets.[27] This was later referred to as reverse tunnelling by one of the interviewees, and as a typical Type II agency issues within the group.

During this asset transformation, selling, testing and repairing cars became Tellus's main business. SDG Huari Car Company was the first in China to repair Toyota cars and sell Toyota Vios cars. In a city like Shenzhen, where average income and expense level ranked

[26]According to the Shanghai and Shenzhen "Stock Exchange Listing Rules", when a listed company experiences abnormal or other unusual circumstances, the stock exchange will give the company's stock a special treatment and the stock will be renamed with an ST initial. This is to warn investors that there are signs of risk, which may result in the termination of the listing and/or jeopardy of prospect investment interests. For a full list of circumstances, please refer to the stock exchange web sites.

[27]SDG took over Tellus's bad assets in its four loss-making subsidiaries. At the same time, SDG paid its borrowing from Tellus with quality assets of SDG's well-performed company, Shenzhen Car Industry and Commerce, and transferred parts of shareholdings of companies SDG Huari Car, Shenzhen Huatong Car, and Shenzhen Hongtian Industrial to Tellus.

number one in the country, car sales and services brought many opportunities to Tellus. However, in 2002, surprisingly the realised car sales revenue was ¥1.1 billion while net profit only ¥40 million; car repair services revenue was ¥13.25 million while net profit only ¥100,000. In 2002, Tellus announced a total loss of ¥40 million after its restructuring, major costs lying in administrative expenses. More shockingly, on March 8, 2002, less than half a year after the changing of large shareholders, Tellus transferred 70% the shareholding of Huatong Car Company (which had a net asset of ¥79 million) to a private enterprise with ¥30 million registered capital – Shenzhen Pingtai Investment and Development Co & Ltd. This turned out to be a poor management decision imposed by biggest shareholder when Tellus then terminated and resulted in a lawsuit later on. This case revealed severe agency problem within the corporation, i.e. sacrifice of minority shareholder wealth to reach unsound management decisions forced by large shareholder. Similarly later in 2003 and 2004, many public firms were in financial distress because large sum of free cash flow had been tunnelled to the controlling owners for use of other purposes.

When the ownership concentration is high, board of directors is usually too weak to constrain controlling shareholders from expropriating minority shareholders. Fan and Wong (2002) find that over 50% of the directors of SOEs are appointed by controlling shareholders, and that no director is representative of minority shareholders. Therefore, they would not be able to scrutinise management behaviour as to whether it maximised firm value. Table 5.2 below shows the top ten shareholders in Tellus with their respective percentage and type of shares.

Table 5.2 Tellus: Top Ten Shareholders (as at 31/12/2007)

Number	Shareholder Name	Number of Shares	Percentage of Shares (%)	Type of Shares
1	SDG	145,870,560	66.22	State Shares
2	KGI Asia Ltd.	1,439,149	0.65	B Shares
3	BOCI Securities Ltd.	1,101,292	0.50	B Shares
4	YU Aijun	850,000	0.39	A Shares
5	WANG Cuixia	541,200	0.25	A Shares
6	LIANG Jingqin	473,400	0.21	A Shares
7	First Shanghai Securities Ltd.	454,200	0.21	B Shares
8	ZHANG Zibin	444,839	0.20	A Shares
9	YE Ying	440,000	0.20	A Shares
10	CHEN Weijian	434,300	0.20	B Shares

The ownership structure of Tellus was very typical among listed companies in China. As in Table 5.2, the state owned 66.22% of total shareholdings (the figure was 72.45% before the DIS scheme), which was a high concentration. The percentage of tradable shares was thus relatively low and accounted for 33.78%, among which tradable A shares accounted for 21.80% and tradable B shares accounted for 11.98%. The number of individual shareholders was relatively high and the individual investors were segmented with their shareholding extremely low, no more than 0.4% individually.

The first largest shareholder was SDG, which held 66.22% of total shareholding of the company (it used to hold 72.45% before the DIS scheme). As a result, the control of the company lay merely in the hands of dominant shareholder, i.e. the state. The second until tenth largest shareholders were entities and majorly individual investors, with the holding of shares ranging from 0.65% to 0.18%. Their shareholdings were in the type of tradable A shares or B shares, totalled in 2.81%.

As per Table 5.3 below, top ten tradable shareholdings added up to less than 3%. The disperse shareholdings made them less willing or capable to participate in the supervision of management of the company, and thus worsened the problem of free ride. As per above, the companies assets are managed by the state, i.e., government officials (politicians), given state ownership is concentrated. The state lacks a clear, accountable representative to enforce its will (Qian, 1996), and hence the positive effect of concentrated state ownership is limited (Mar & Young, 2001).

Table 5.3 Tellus: Top Ten Tradable Shareholdings (as at 31/12/2007)

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7	ZHANG Zibin	444,839	0.20	A Shares
8	YE Ying	440,000	0.20	A Shares
9	CHEN Weijian	434,300	0.20	B Shares
10	XU Ailan	400,000	0.18	B Shares

As a result, the state does not exercise effective control over their companies (Tam, 2002). Moreover, as pointed out by Zou & Adams (2004), the politicians have little incentive for monitoring managers to ensure they run the firms efficiently, because the control/voting and cash flow rights associated with state shareholdings are segregated in China, which accrue to the Ministry of Finance (MOF). This situation can lead to severe agency problems (Berkman et al., 2002) as quoted above.

SDGE was listed in SZSE in 1996 within the commercial category. Although its new Closer Economic Partnership Agreement (CEPA)[28] concept for the department stores helped improve sales, SDGE remained close to meagre or negative profit. This listed company, which had created many top rankings (e.g. the first and only retail business to seek listing; the first and only retail business to issue both A and B shares; the first retail chain to attract foreign investment and apply CEPA concept, etc.) in the Chinese commercial history, encountered a loss per share of ¥0.12 in 2002. This will be discussed further in the financial performance section later. Table 5.4 lists its top ten shareholders with their respective percentage and type of shareholdings.

Table 5.4 SDGE: Top Ten Shareholders (as at 31/12/2007)

Number	Shareholder Name	Number of Shares	Percentage of Shares (%)	Type of Shares
1	Foh Chong & Sons SDN. BHD.	30,264,192	13.70	Foreign Shares
2	SDG	23,560,184	10.67	State Shares
3	Shenzhen Taitian Industrial Development Co. & Ltd.	8,802,825	3.98	Legal Person Shares
4	F.C. (Asia) Holdings SDN. BHD.	8,684,194	3.93	Foreign Shares
5	Credit Suisse Singapore	3,323,173	1.50	Foreign Shares
6	Daibou Wochung Chemical Industry Co. & Ltd.	2,880,000	1.30	Legal Person Shares
7	BOCI Securities Ltd.	2,581,396	1.17	Foreign Shares
8	Hong Kong Wosing International Trading Company	2,170,200	0.98	Foreign Shares
9	Letscon Holdings SDN. BHD.	1,497,172	0.68	Foreign Shares
10	YANG Jun	1,400,100	0.63	A Shares

[28]This is an agreement signed between Hong Kong and mainland China to boost business cooperation. Under the agreement, the products imported from Hong Kong can be sold in SDGE stores without charging extra tariff ("tax free") and hence have competitive advantage.

In terms of ownership structure as in Table 5.4 above, SDGE had a very different pattern as compared with Tellus. The control was quite dispersed because SDG only owned 10.67% by the end of 2007 and became the second largest shareholder of SDGE (SDG used to hold 19.03% of SDGE's total shares until the end of 2005 and then disposed some of its shareholdings in early 2006). Top three shareholders held 28.35% of total shareholdings, top five shareholders held 33.78%, and top ten shareholders held 38.54%, so ownership was much less concentrated than Tellus. The first largest shareholder of SDGE, Foh Chong & Sons, held 13.70% of its foreign shares and exceeded 13.05% (untradeable and tradable combined, as shown in Tables 5.4 and 5.5) held by SDG.

Table 5.5 SDGE: Top Ten Tradable Shareholdings (as at 31/12/2007)

Number	Shareholder Name	Number of Shares	Percentage of Shares (%)	Type of Shares
1	Foh Chong & Sons SDN. BHD.	30,264,192	13.70	B Shares
2	F.C. (Asia) Holdings SDN. BHD.	8,684,194	3.93	B Shares
3	Shenzhen Taitian Industrial Development Co. & Ltd.	7,403,913	3.35	A Shares
4	SDG	5,266,291	2.38	A Shares
5	Credit Suisse Singapore	3,323,173	1.50	B Shares
6	Daibou Wochung Chemical Industry Co. & Ltd.	2,880,000	1.30	A Shares
7	BOCI Securities Ltd.	2,581,396	1.17	B Shares
8	Hong Kong Wosing International Trading Company	2,170,200	0.98	B Shares
9	Letscon Holdings SDN. BHD.	1,497,172	0.68	B Shares
10	YANG Jun	1,400,100	0.63	A Shares

The portion of top ten tradable shareholdings was totalled to 29.62% as in Table 5.5 above. Total untradable shares of SDGE represented 20.41%. The percentage of tradable shares was very high and accounted for 79.59% (this figure increased to 90.94% in 2008), among which tradable A shares account for 33.55% and tradable B shares for 46.03%.

Furthermore, SDGE also had a subsidiary joint venture corporation, the Shenzhen International Commercial Property Management Co. & Ltd. As discussed in the literature and background chapter, foreign shareholders expected to be a better mechanism in regulating management and performance. As far as RPT was concerned, this seemed right and SDGE

was not involved in any type of RPT with SDG or its other subsidiaries. The number of individual shareholders was high and individual investors retained extremely small shareholding.

Listed in 2000, SDGI was the newest listed subsidiary of SDG. The ownership structure of SDGI was similar to that of Tellus. The state owed 53.37% of total shareholdings and legal persons shares were 8.01%, which made total untradable shares of 61.38% and was a high concentration (this figure was 72% before the DIS scheme), as in Table 5.6 below.

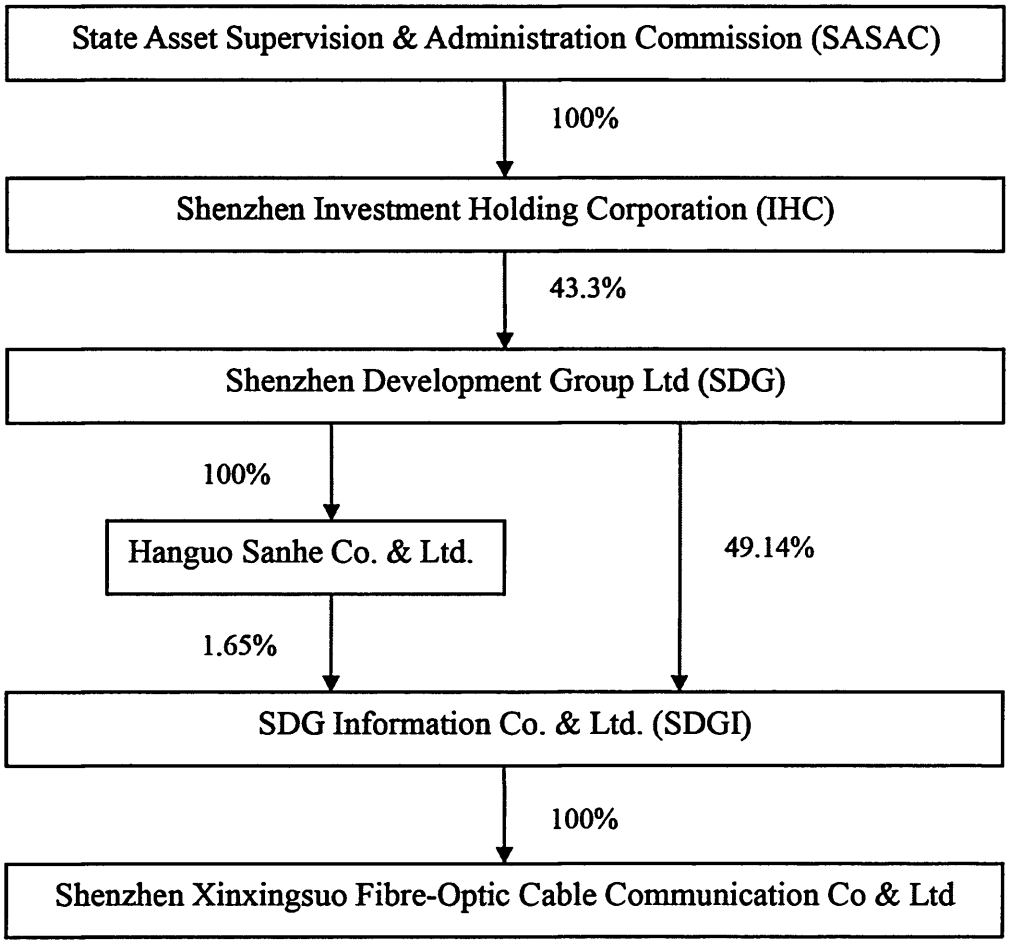
Table 5.6 SDGI: Top Ten Shareholders (as at 31/12/2007)

Number	Shareholder Name	Number of Shares	Percentage of Shares (%)	Type of Shares
1	SDG	122,841,186	49.14	State Shares
2	Qirong Trading Co. & Ltd.	15,859,344	6.34	Legal Person Shares
3	China Minmetal Corporation	7,929,757	3.17	State Shares
4	Hanguo Sanhe Co. & Ltd.	4,126,460	1.65	Foreign Shares
5	Beijing Jinshizhuangyuan Heating Centre	2,977,794	1.19	Legal Person Shares
6	China Tongguang Electronics Company	2,300,000	0.92	State Shares
7	Shenzhen Wanxingda Trading Co. & Ltd.	1,410,200	0.56	Legal Person Shares
8	Beijing Wanjia High Tech Trading Development Ltd.	839,300	0.34	Legal Person Shares
9	CAI Kangfeng	592,246	0.24	A Shares
10	HE Zhongming	585,081	0.23	A Shares

The percentage of tradable shares was relatively low and accounted for 38.62%, which were all tradable A shares. The first largest shareholder was SDG (state shares), which held 49.14% of total shares of the company. Given SDG also 100% owned Hanguo Sanhe Co. & Ltd., and other second until tenth largest shareholders owned very low percentage of shares, SDG essentially had control (50.79%) over SDGI and hence the agency issues in this subsidiary were very obvious and severe (discussed in the next section). Top three shareholders held 58.65% of total shareholdings, top five shareholders held 61.49%, and top ten shareholders

held 63.78%, so ownership was quite concentrated (this figure was 72.30% before the DIS scheme). The structure of the group can be shown in a simple illustration as below:

Figure 5.1 Shareholding Structure of SDG Group



SDGI had a co-partnership with a French company Alcatel and established a joint venture corporation in Shenzhen, which made a profit of ¥20 million and another ¥4 million rent in 2001. However, SDGI did not make the number one fibre-optic cable producer in the industry it operated. In 2002, its profit per share dropped from ¥0.17 to ¥0.01 and its share price in the secondary market kept dropping that it decreased 75% within the first year being listed. At the end of 2003, with the request of CSRC, SDGI disclosed how large shareholders occupied the capital. The two largest shareholders used a huge amount of SDGI's capital, totalling in over ¥100 million, without any approval or relevant procedures. This was referred to by some of the interviewees as serious agency issue (i.e. tunnelling), which was typical among Chinese listed companies.

On the other hand, after SDGI being listed for less than half a year, SDG sold 75% of its shareholdings of Shenzhen Xinxingsuo Fibre-Optic Cable Communication Co. & Ltd. for ¥63.87 million to the listed company. In August 2003, SDGI purchased 25% of the

shareholdings of Xinxingsuo Fibre-Optic Cable Communication Co. & Ltd. for ¥20.64 million from Hanguo Sanhe Co. & Ltd., another subsidiary company of SDG. Through these transactions, the listed company reclaimed some of its pending retrievable accounts, but remained poor control over cash flows. In the third quarterly financial report of SDGI in 2003, the administrative and financial expenses reached over ¥60 million, due to large shareholder inhabitation. Among the three listed companies, SDG manoeuvred the capital of SDGI most.

From Table 5.7 below we can see that top ten tradable shareholders all had very little stake in the company, with shareholding representing 0.095% – 0.038% of total shares of SDGI. Total percentage of top ten tradable shareholdings was only 0.577% of total shares of the company, which was smallest number among the three listed companies of SDG, and therefore generating more serious free-rider issues and agency problems.

Table 5.7 SDGI: Top Ten Tradable Shareholdings (as at 31/12/2007)

Number	Shareholder Name	Number of Shares	Percentage of Shares (%)	Type of Shares
1	Qirong Trading Co. & Ltd.	12,500,000	0.095	A Shares
2	China Minmetal Corporation	7,929,757	0.092	A Shares
3	Hanguo Sanhe Co. & Ltd.	4,126,460	0.062	A Shares
4	Beijing Jinshizhuangyuan Heating Centre	2,977,794	0.060	A Shares
5	China Tongguang Electronics Company	2,300,000	0.058	A Shares
6	Shenzhen Wanxingda Trading Co. & Ltd.	1,410,200	0.055	A Shares
7	Beijing Wanjia High Tech Trading Development Ltd.	839,300	0.040	A Shares
8	CAI Kangfeng	592,246	0.039	A Shares
9	HE Zhongming	585,081	0.038	A Shares
10	GAO Zhe	550,000	0.038	A Shares

As a summary of this section, the relationship between SDG and its subsidiaries shows a typical ownership arrangement among Chinese listed companies, i.e. dominant state shareholding, over concentration of largest shareholdings, and minor foreign and management ownership. More specific with SDG, the ultimate owner of the business is still the state, i.e. the government itself; hence we reasonably expect political influence to some extent. This is explored in detail in the governance mechanisms section to follow.

Regarding tradability, state shares can only be transferred to other institutions via private negotiations, and legal person shares can be semi-public auctioned depending CSRC permissions. State shares exist in China to designate holdings in the SOEs by the central government, local government, and solely government-owned enterprises (Sun & Tong, 2003). Legal person shares are held by domestic institutions, e.g., industrial enterprises, financial institutions, foundations, funds, and research institutes, which are either directly state owned or controlled by the public sector. Therefore, the state is directly (through state shares) or indirectly (through legal person shares held by SOEs) in control of listed companies in most cases (Tenev et al., 2002). The non-tradability of the shares in Chinese listed companies implies that there is limited potential pressure that capital markets could exert on the corporate governance of listed companies, and thus makes agency problem worse.

5.4.2 Board of Directors and Supervisory Board

By the end of 2007, there were nine members on the board of directors at Tellus, among which three were independent directors. Three of the directors (1/3) were from SDG and two others used to work for SDG. One of the independent directors had overseas research experiences in business laws, finance, and management, and was directors of other unrelated companies as well. Another independent director had professional qualifications in accounting, auditing, and asset evaluations and liquidations, while the last one had experience in many of SDG's subsidiaries before and was independent director of other unrelated companies. Their appointments were from 2006 and due in 2009.

The chairperson of the board was previously senior management in SDG and chairperson of board in two subsidiaries, one associate, and one joint venture of Tellus. There were five members on the supervisory board, three of them (3/5) came from the parent company specialising in finance and investment, and two of them were representatives of employees. There was a remuneration committee and an audit committee under the board of directors. SDG had major control over the operations and could easily manipulate the board decisions of Tellus. This was classic in Chinese listed companies in that parent SOEs still had significant influences over the listed subsidiaries and hence the Chinese capital market could vaguely fine tune the corporate governance of the enterprises. This was also reflected in the following table (Table 5.8), i.e., only the largest shareholder attended shareholder meetings, and made all the decisions without voting because they had dominant control. The board apparently lack independence from management as, often, there is overlap between chairperson of the board and top management.

Table 5.8 Tellus: Information about board of directors and supervisory board

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Shareholder Meeting	2	1	2	2	2	2	2	3	2	2
Attending Number	3	2	3	2	2	2	2	2	1	1
Board Meeting	5	4	2	10	7	8	9	10	8	14
Board Size	7	7	7	7	9	9	8	9	9	9
Independent Directors	0	0	0	0	2	3	3	3	3	3
Directors with Salary	2	5	3	4	5	3	2	3	3	3
Supervisor Meeting	3	3	5	6	8	7	7	4	5	5
Supervisor Number	5	5	5	5	5	4	5	5	5	5
Supervisors with Salary	2	2	3	2	3	1	2	3	3	3

Compared with practices in other markets, boards in Chinese listed companies have relatively little decision-making power within existing legislative framework, while government ministries and regulatory authorities do. Major strategic decisions are agreed upon beforehand by controlling shareholder or among key shareholders (typically the state), often outside the formal shareholders' meeting or boardroom, resulting in shareholder meeting being a formality.

There were eight directors on the SDGE board by the end of 2007, among which three were independent directors. Details of the number of directors, board meetings etc. information for SDGE is presented in Table 5.9 below.

Table 5.9 SDGE: Information about board of directors and supervisory board

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Shareholder Meeting	2	2	1	3	2	2	1	2	2	1
Attending Number	35	39	11	15	8	6	5	12	12	11
Board Meeting	4	4	2	7	8	6	9	5	9	12
Board Size	5	5	5	7	7	8	7	7	7	8
Independent Directors	0	0	0	2	2	3	3	3	3	3
Directors with Salary	0	1	1	7	7	1	1	1	1	1
Supervisor Meeting	2	3	1	3	3	3	2	2	2	4
Supervisor Number	3	3	3	3	3	3	3	3	3	3
Supervisors with Salary	0	3	3	3	3	2	2	2	2	2

One of the directors came from parent company SDG. Two of the independent directors had overseas research experiences in accounting and consultancy, and were managers of other companies as well, while the other had professional qualifications in architecture. The

chairperson of the board was not the general manager of the company. There were three supervisors on the supervisory board and none of them came from parent company. Two of them had relative experiences and the other had political status. As we can see from Table 5.9, the number of attendees to the shareholder meeting was obviously more than that of Tellus, due to the disperse shareholdings. Shareholders individually had relatively similar power of influences over the operation of the company so they were more interested in voicing their opinions and voting for crucial business decisions. This in some level reduced agency problems in SDGE.

There were eleven directors on the board of SDGI by 2007, among which four were independent directors, as per Table 5.10 below. Two of the directors came from parent company and three from other related parties. All of the independent directors had academic experiences in universities, two from professional practices, one from academia, and the other retired from IHC. The chairperson of the board was previously senior management in the parent company. There were three supervisors on the supervisory board, two of them came from the parent company, and none of them had other employments.

Table 5.10 SDGI: Information about board of directors and supervisory board

Year	2000	2001	2002	2003	2004	2005	2006	2007
Shareholder Meeting	2	1	1	1	2	2	1	3
Attending Number	7	8	7	7	7	7	4	2
Board Meeting	4	3	7	7	7	5	5	10
Board Size	11	13	10	10	10	10	10	11
Independent Directors	0	0	2	4	4	4	4	4
Directors with Salary	6	7	4	2	2	2	2	2
Supervisor Meeting	2	3	3	4	2	2	3	3
Supervisor Number	3	3	3	3	3	3	3	3
Supervisors with Salary	0	1	1	1	1	1	1	1

It is necessary to mention about the chairperson in SDGI's board of directors – interviewee D, who had been working for the group for more than ten years. He had been the chairperson of the Board at SDGI since 2003 and had overseen the development of SDGI including IPO during all these years. During its first years, SDGI had many weaknesses as many other SOEs in China and lacked competitiveness. As Interviewee D said, "only by combining the company strategy and capital market performance can we improve the whole image of SDGI and realise shareholder value maximisation." This is theoretically consistent with the

Interviewee E1 talked about the history of how Tellus developed. In 1997, Tellus experienced severe financial distress and was acquired by the SDG group. The parent company had many times supported Tellus for its growth during the years. However, as Tellus had continuously heavy debt burdens and there were conflicts among management members exercising their power of influences, resulting in conflicting decisions, it showed consecutive losses over time. Tellus was designated as an ST firm due to its financial abnormalities, e.g. net loss for two consecutive years in 1999 and 2000. Further net losses would cause it to be de-listed, which would then lead to the loss of a valuable "shell" resource (Bai et al, 2004). Therefore, local governments or entities under their control, i.e. SDG in this case, bailed out the firm, or "re-tunnel" assets back into them.

In 2003, SDG actually reassigned management members in Tellus to solve operation difficulties. Moreover, SDG injected high quality assets into Tellus since then and focused on car industry for stable revenue so that the company performance was greatly improved. Particularly, the board members in Tellus were changed by SDG and other members were promoted through competitions considering experience and qualification. Consequently, the new management team formed committees for specific projects, asset-debt coordination, budget control, and audit supervision.

As a result, the effective work by the committees reduced administration costs by ¥16 million in 2003 and a further ¥10 million in 2004, as in Table 5.11. This was also the outcome of an improved corporate governance structure. In 2004, many comprehensive rules and regulations were launched for the board and management team. For example, post expense (certain amount of expense limit allocated to higher management positions) could only be claimed by individuals with an application in advance and complete receipts. The constant profit from 2003 to 2005 helped Tellus bring to an end the ST title in the stock market.

As seen in Table 5.12 below, SDGE was generally doing better than Tellus. Administration cost was not a significant part out of sales income, being 8% in average before 2004. We can see from Table 5.12 that in 2004 admin costs took up 83% due to massive bad debt provision and inventory impairment provision considering obsolete stock. Then in 2006 and 2007, there was a significant falling trend in total revenue due to the downturn of real estate market, and hence resulting in admin expenses taking up a larger portion of sales revenue. Due to the nature of the business, fixed costs are normally very high; hence operating expense seems higher in terms of its portion out of sales revenue if we compare with Tellus.

literature describing capital market as an external governance mechanism on firm performance. Nevertheless, related party issues and agency problems in SDGI were more significant than in other subsidiaries of SDG due to concentrated control, which will be discussed in the next section.

5.4.3 Financial Performance

The financial performance of SDG has always been bad. As mentioned before, it had huge debt and hence heavy burden of finance costs. Due to it being one of the government entities that bear more than commercial goals, the debt was essentially written off during the DIS process to alleviate its financial distress. In its financial statement before the reform, its short term loan amounted ¥ 1 billion and long term loan ¥ 144 million. Also its other payable creditor, mainly to group entities, was ¥ 466 million. As follows the performances of the listed subsidiaries will be discussed in order to provide evidence of agency issues within the companies. The financial performance of Tellus had been poor through the years. Its total asset displayed a decreasing trend, except that in 2001 the parent company injected capital to avoid delisting. Administration cost remained a large part out of sales income, the highest percentage being 41% in 2000. Net profits of the company had been terribly small, given a ¥-105m in 1999, ¥-118m in 2000, and ¥-41m in 2002 as shown in Table 5.11 below.[29]

Table 5.11 Tellus: Information of Financial Performance (¥ 000)

Year	Sales	Admin Expense	Operating Expense	Profit	Total Asset	ROE%	ROA%
1997	377,730	66,769	10,435	27,748	971,103	8.34	2.86
1998	305,066	71,688	11,237	22,138	952,071	6.76	2.33
1999	308,646	75,599	17,102	(104,589)	864,550	-49.53	-12.10
2000	152,616	61,912	10,744	(118,383)	766,479	-123.90	-15.45
2001	703,245	52,919	24,354	5,144	1,368,433	1.93	0.38
2002	1,289,321	78,094	41,690	(40,981)	1,232,230	-20.14	-3.33
2003	1,436,383	62,416	52,861	5,175	1,274,705	2.45	0.41
2004	1,124,746	52,440	50,954	4,320	1,063,459	2.00	0.41
2005	1,043,811	49,259	48,617	5,676	859,359	2.51	0.66
2006	1,133,692	52,679	48,776	(92,149)	830,866	-45.72	-11.09
2007	991,037	51,732	40,257	6,626	835,575	3.23	0.79

[29]The profit figure for 2006 was ¥-92,149 thousand as in Table 5.5. However, this was due to a lawsuit charge amounting to ¥87,569 thousand and a redundancy cost amounting to ¥9,064 thousand. These were regarded as one-off items, so should be excluded from general expenses. If we recalculate the profit figure in 2006 excluding these two costs, the result would be ¥4,484.

Table 5.12 SDGE: Information of financial performance (¥ 000)

Year	Sales	Admin Expense	Operating Expense	Profit	Total Asset	ROE%	ROA%
1997	214,125	17,401	27,626	40,972	898,438	10.04	4.56
1998	332,390	27,188	46,739	2,370	1,050,130	0.60	0.23
1999	314,704	17,815	51,129	30,221	1,190,510	7.78	2.54
2000	469,863	14,673	45,085	36,123	1,263,188	9.59	2.86
2001	301,450	30,952	47,047	19,706	1,188,322	5.29	1.66
2002	187,833	24,191	33,080	(25,707)	1,095,417	-7.72	-2.35
2003	114,629	5,762	25,372	1,255	1,070,624	0.38	0.12
2004	86,671	71,892	25,939	(73,687)	937,464	-41.53	-7.86
2005	188,947	24,112	33,716	7,002	728,665	3.48	0.96
2006	71,031	36,396	34,269	(11,480)	740,555	-6.97	-1.55
2007	42,587	20,822	22,819	51,761	1,035,266	26.08	5.00

SDGI performed well among the three listed companies. The amount of total asset showed a stable level, and administration cost was around 8% every year except that in 2005 due to a one-off event[30]. Net profit also presented a positive figure throughout the years (again except that in 2005), which could be seen from Table 5.13 below.

Table 5.13 SDGI: Information of financial performance (¥ 000)

Year	Sales	Admin Expense	Operating Expense	Profit	Total Asset	ROE%	ROA%
1999	487,963	34,606	44,476	52,387	730,377	20.14	7.17
2000	570,810	55,203	47,992	55,880	1,363,439	7.21	4.10
2001	659,158	62,986	49,877	41,918	1,348,565	5.41	3.11
2002	493,246	52,784	42,632	1,925	1,271,548	0.25	0.15
2003	466,068	49,584	40,216	5,005	1,264,782	0.64	0.40
2004	501,176	45,140	37,024	4,861	1,254,057	0.63	0.39
2005	403,609	133,037	33,218	(168,552)	1,005,388	-22.03	-16.76
2006	505,623	34,063	27,161	2,917	1,007,528	0.47	0.29
2007	535,321	35,044	28,369	11,511	973,556	1.78	1.18

5.5 Agency Issues and Agency Costs

This section is to discuss the agency issues in the SDG group, mainly between SDG and its two subsidiaries. As in the literature chapter, there are two types of agency problems, i.e. those between shareholder and management (aka Type I), and those between large and small shareholders (aka Type II). Within the SDG group, main agency problems are of the second

[30]This is disclosed in the annual report to the shareholders.

type, as the largest shareholder, i.e. the state, appoints management to manage the company; and in the same way, the parent company has strong say in the subsidiaries through appointing directors and supervisors. As can be seen from the previous section, shareholders other than SDG normally have very few holdings in the companies. Agency problems exist because the state needs to consider social and political factors in making operating decisions rather than pure economic desire, as widely discussed in the literature. Additionally, government appointed management may also pursue personal welfare in sacrifice of total shareholder wealth, which is termed expropriation of small shareholders.

A series of questions were asked on exploring evidence of agency problems and conflicts between government and managers, between large and small shareholders, and between shareholders and managers, while the focus of this study is on the conflicts between large and small shareholders. As mentioned in the literature review and institutional background chapters, there are two types of agency problems and the second type, i.e. controlling shareholder expropriating small shareholders, seems to manifest in emerging markets (Dharwadkar et al, 2000; Yoshikawa et al, 2005; Su et al, 2008; Young et al, 2008). As per the studies, this is referred to as principal-principal problem.

5.5.1 Agency Problems

5.5.1.1 Government Interference

In most SOEs, government interference is regarded as the most serious governance issue. It is regarded as Type II agency problem as the government represents largest shareholder, especially in large SOEs. China is a transitional economy still tightly controlled by government (Xiao et al., 2004). The State emphasises on macroeconomic functions including social welfare, regulation, and policymaking, as well as microeconomic activities, hence resulting in inherently conflicting roles. The macroeconomic role looks after overall economic performance of all enterprises, while the microeconomic role looks at the performance of an individual enterprise. It is essential to break such an integration of conflicting roles, as the government's dual roles can lead to conflicting goals in dealing with Chinese firms, which in turn weakens the effectiveness of both of its roles (Allen et al., 2005).

In particular, large SOEs have right relationship with central or local government. Their performances are included in government reports and are considered part of political achievement for some government officers. SDG is one of such SOEs. Cheung et al (2005)

have provided direct evidence showing that political connections may prove detrimental to the firms' public shareholders by examining a direct channel through which political connections may affect firm value. This is consistent with the "grabbing hand" model of government (Shleifer & Vishny, 1998).

Before April 2005, SDG was 100% state-owned. There was no any supervisory board. The board chairperson, the management, and the general manager were responsible to report to shareholders according to the allocated portion of funds. The government appointed the chairperson of the board, who was actually also the chief executive in the firm. There was no general manager as nobody was willing to take responsibility for operating losses. The government appointed vice general managers as well. The board and vice general managers appointed other senior management and decided their salaries and bonuses, representing government's control. Major decisions were finalised between individual discussions because the management had only to communicate with some certain officials from the government. Interviewee C5 actually said, "The corporate governance structure was quite weak back then." Moreover, interviewee C7 said, "The salary is quite rewarding in this company, compared to other state-owned enterprises. The level of managerial compensation provides a sufficient motivation for top managers to stay in." Comparing with the poor performance, such high compensation was recognised as one agency issue – management entrenchment.

When the management is appointed by the largest shareholder, i.e. the government, this is clearly the type-two agency problem – large shareholder expropriating minority shareholders. As Johnson et al (2000) point out, such controlling shareholders are in a position to exert a great deal of influence on the way the companies they own are operated, and thus to obtain private benefits of control at the expense of minority shareholders. These private benefits of control can take many forms. If the controlling shareholder is also a manager of the company, minority shareholders can be exploited by paying a high salary to the controlling shareholder.

Although after the DIS reform, SDG had diversified its shareholdings, the core of control still had not changed. The four asset management companies were set up by the state and therefore controlled by the state. In 1997, the Ministry of Finance allocated ¥300 billion to the four national banks to set up asset management companies. Industrial and Commercial Bank of China took ¥100 billion and set up Huarong, Bank of China set up Changcheng, Agricultural Bank of China set up Dongfang, and China Construction Bank set up Xinda. The asset management companies bought off the banks' bad debt and provided the banks with cash

before they went on listing, so fundamentally SDG was still stated owned and not operating under marketisation.

The operation of the firm was actually in the hands of some certain persons, because as Interviewee A1 pointed out, "The top management had only to report to the government, and in fact some officials representing the government." Therefore, decisions were made rather by individuals and lacked proper evaluation and control. Some top managers lacked the incentive or courage to take initiative in terms of strategic management or investment management, because they were reluctant to be faced or threatened with pressure and risk. Therefore, they only accepted project decisions set by the government, no matter profitable or not.

For instance, Water Paradise Theme Park and Xiaomeisha Resort are two failure projects with a total loss of ¥200 million. Water Paradise is a theme park with adventurous activities built over the water including rollercoaster and cannons. Xiaomeisha Resort has a chain of hotels and country cabins near the beach for people enjoying an ocean-view room for short breaks. Those projects were initiated in early years, so they mainly represented the preferences of certain people. In the first a few years of their operations, the profit was ok, but soon started dropping, especially Xiaomeisha because it mainly accommodated government officials and large SOE executives for their conferences and training programmes, both from Shenzhen or other neighbouring cities. Xiaomeisha began to make a loss in very early years, and then SDG built the Ocean World Theme Park next to it to attract tourists and families. Again, this was the idea of senior management because they thought the Ocean Park in Hong Kong was making profit so they wanted to build a similar Aquarium to put on shark shows etc. to increase income and to promote the resort to the public. The new Park brought about some profit but things returned to the same soon after, again because there was weak project management and feasibility studies, according to some of the interviewees.

Furthermore, managers in SOEs have undifferentiated salaries and stock-based incentives are weak as managerial ownership is inconsequential (as can be seen from the empirical results). Additionally, an active market for corporate control does not exist, as stated in previous chapters, so managers tend more to entrench themselves at the expense of firm performance (Tam, 2002). The aforementioned projects are good examples of on-the-job perquisites, i.e., they can enjoy entertainment, free trips and accommodations, and client social activities, while bearing no risks, political or financial.

Since the company invested in many areas, many projects needed approval by related government department, which was the reason why SDG maintained a tight relationship with the authorities, not just in Shenzhen. Here was an example given by Interviewee C2: "There was an irrigation work some years ago that our listed company SDGI wanted to invest in. Since it was a huge project, the Shenzhen government could not approve the investment so we had to contact director of the State Planning Committee to apply for approval. It was a complicated procedure, but with our political background, we managed to convince the state department, and it granted us the opportunity." In this way, many large investment projects were initiated by individuals rather than executive census, just because they had connection with government parties in charge of appraisal and approval. This subsequently would result in loss making projects being approved, which was consistent with the hypothesis that government interference will negatively affect firm performance and increase agency problems.

This reflects the study by Fan and Tong (2004) in that accounting performance of the firm run by a politically connected CEO deteriorates more than an otherwise similar firm. This is because the board structure lacks governance function – almost no director represents public investors. Their study also clearly shows that having a politically connected CEO is associated with low professionalism. Therefore, unsound investment decisions are made because the board has more political background than professional background. The directors are on average older in age and less likely to be females, and they tend to divert substantial resources of SOEs for social or political objectives, which are often inconsistent with firm value maximisation.

There are a number of surveys regarding government interference and political connections in the Chinese context. Cull and Xu (2004) survey managers in 2400 firms from 18 cities across China and find that most managers remark that contacts with government officials are detrimental to the firm value. Wong et al (2004) also find evidence that local government officials maintain considerable power in decision-making and personnel arrangements in listed firms. Based on their study, Chang and Wong (2004) further analyse the decision-making power of the government, shareholders, and managers, and find that relatively higher power of the government results in poorer firm performance, while relatively higher power of the managers results in better firm performance. Chen et al (2004) substantiate the result by examining Chinese firms with current or ex government officials on their boards of directors. Their study show that these firms under-perform firms without such

connections during the three years following their IPO. The aforementioned studies all comment that politically connected firms tend to be based in regions with large fiscal deficits and high unemployment, suggesting that the government sometimes is inclined to avoid layoffs or similar social or political objectives rather than financial performance.

In literature, this is termed as 'rent seeking'. Agrawal and Knoeber (2001) state that firms that need to deal with the government usually have directors with experience in politics to serve an advisory role. Hadlock, Lee, and Parrino (2002) document that CEOs of regulated firms tend to be older, have less prestigious education background, and are more likely to have a legal background than those of unregulated firms. Helland and Sykuta (2004) also find that directors with political backgrounds in the regulated industries serve a rent-seeking role. Faccio (2004) reports at country level evidence that firms, in particular those in higher levels of corruption, use their political connections to extract resources from the state.

Overall, these studies suggest that political connections help firms to seek rents from governments. This is why in late 1998 the government demands all its administrative sectors to sever their links with the enterprises they control, so that a market economy can be developed.

5.5.1.2 Dependency on State-Owned Banks

One direct channel through which political connections, i.e. largest shareholder (the state) may affect firms is by allowing them to borrow from state-owned banks on preferential terms (Cheung et al, 2005). La Porta et al (2002) examine government influence on banks and report that government ownership of banks is pervasive around the world, especially in low-income countries and in countries with under-developed financial sectors, inefficient governments, and poor protection of property rights. This has also caused Type II agency issues between large and small shareholders. Before the reform, SDG was essentially under control of some certain government leaders, and hence investment decisions were not always successful. As can be seen from the 2005 balance sheet, the total amount of short-term borrowing was ¥10.4 billion, almost 90% of which came from state-owned banks. Interviewee C5 admitted, "We borrowed short-term loans from the banks, invested in long-term projects, and incurred huge amount of loss. If we did not borrow from the banks, there would cause unemployment that concerned the government. We sold some lands and some secondary firms to other companies or even individual employees after asset appraisal scheme in order to maintain employment, and hence relieved the pressure on the government."

Moreover, in the 1980s under plan economy, the government instructed national banks to make financial allocation to big SOEs rather than loans. This obviously was a reflection of government owner's non-economic objectives, and of how state ownership affected firm performance. Faccio et al (2004) look at a sample of firms from 35 countries, both in emerging market and developed economies, and show that firms with political connections make more use of debt financing and are more likely to receive bailouts when they face financial distress than firms without such connections. This explains that in China some large SOEs do not have the stress of repayment of bank loans, not to mention bankruptcy.

On the other hand, Interviewee C3 suggested, "The banks were worried that we could not pay back the loans and they came to the company to give pressure. That was the origin of the debt-for-equity scheme. The consequence is that now we have four shareholders and a complete corporate governance structure." At the end of 2006, SDG and China Construction Bank (CCB) set up a five-year contract for strategic cooperation. In the contract, it stated that CCB should provide over ¥3 billion funding and related financial services to SDG, given its good performances after the reform. To be honest, it was only one year after the DIS scheme and nobody could really tell how well SDG would perform in the next five years. Such contract clearly was negotiation between government officials and was imposed on CCB, as it was state owned bank under direct control of the government.

The banking system is still under the strict government control in China and the poor performance does not stop SOEs from continuously receiving a disproportionately large share of the credit extended by the main banks (Cull & Xu, 2003). The bad debt of the major banks is built up year on year and asset qualities are declining. Therefore, in China banks especially the big stated owned banks could never become an effective governance mechanism. This government dominance prevents independent monitoring and nurtures corruption as well as incompetence and ineffectiveness.

5.5.1.3 Information Asymmetry

Another root for agency problem is the aforementioned multiple-layered agency relationship and information asymmetry problem it renders. Large shareholders can influence the board directly with their provincial strategic interests rather than financial interests of all shareholders. Just as principal-agent goal conflict creates agency costs through managerial perquisite consumption and entrenchment (Gedajlovic & Shapiro, 1998; Walsh & Seward, 1990), the powerful directors representing large shareholders, i.e. the State (Bai & Wang,

1998), are likely to advance their personal interests by expropriating from small shareholders. The principals they represent have ambiguous economic and social objectives in investing, and therefore are less able to determine (and hence monitor) the scope at which their assets should be employed (Su et al., 2008). Lack of complete business information and unclear management decisions are generated through all the layers of agency relationships, and so are agency costs. As with other emerging economies, the Chinese capital market is characterised by severe information asymmetry with a developing corporate governance regime, uneven legal enforcement, the last in part due to information asymmetry, incomplete regulation, and a nascent enforcement capability (Chen, 2004; Peng, 2004; Xu & Wang, 1999; Young & McGuinness, 2001; Su et al., 2008).

Traditional view on information asymmetry includes three dimensions: information asymmetry between the owner and manager, between equity holder and manager, and between large and small shareholders. As far as SDG is concerned, most severe information asymmetry sits in the last group, i.e. controlling and minority shareholders. In the listed companies, even top 2 to 10 shareholders have very few shareholdings as compared with the state. Hence the largest shareholder has significant influence over the board by appointing executive directors and other senior management. The insiders, i.e. directors and managers appointed by SDG have far more connections with the government and hence more information about the companies than others. It will also be very costly for minority shareholders to really participate in the everyday operations. Therefore, large shareholders can make business decisions almost on their own at the expense of firm value maximisation. This is what is referred to as expropriation of small shareholders in the literature, as well as Type II agency problems.

Through the interviews, some facts are revealed regarding such issues. For example, SDG has appointed directors (executive and non-executive, as well as independent directors) to SDGI and Tellus. Through such arrangements, SDG can essentially decide on its own the use of funding of these listed companies. One of the occasions is that in 2000 SDGI invested in a joint venture with French company Alcatel with some business that SDGI has absolutely no expertise or experience. Less than five years later Alcatel quit and another Dutch company Draka took it over. Detailed information on the deal was never disclosed. Directors in SDGI admitted there was over investment in the project and there were occasions they disclosed inside information to SDG and decisions were made top down.

Some recent studies (Dharwadkar et al., 2000; Young et al., 2008) apply agency theory to the problem of shareholder conflict, which means that principals cannot be treated as a single entity with common interests. Owners diverge in their preferences for risks and returns, their private costs of monitoring, and their strategic motivations for investing in a company (Su et al., 2008). Moreover, owners who are in a better position to exercise direct pressure in the boardroom, such as government representatives with political background and dominant shareholdings, can increase their provincial interests at the expense of minority owners who do not have similar levels of influence.

In emerging markets like China, with the lack of legal protection, minority shareholders may face expropriation risks from large shareholders who can appoint representatives to board and management positions, or even directly participate in management themselves (La Porta et al., 1999). Hence, the information asymmetry problem, and its attendant risks of expropriation between shareholders and managers, is exacerbated for small shareholders who do not have the benefit of monitoring provided by large and similarly motivated shareholders (Dharwadkar et al., 2000; Chang, 2003; Claessens et al., 2002; Faccio et al., 2001).

As far as the SDG listed companies are concerned, inside directors can use information asymmetry to perform rent seeking through various actions, as discussed in previous sections. Since it is costly for small shareholders to collect information and supervise, they will most likely choose to free ride. As a result, managers (who are appointed by largest shareholder) impair shareholder interest by approving loss making investment decisions, increasing superfluous expenses for personal luxuries, or manipulating retained profit by paying fewer dividends to state shares. This also causes the problem of asset stripping (Qian, 1996). During restructure and reform before listing, state asset can be transformed into collective or private assets in the name of various transactions, such as setting up a joint operation with non-state economies. This is known as related party transactions.

5.5.1.4 Related Party Transactions (RPTs)

Jian and Wong (2003) look into the use of RPTs by controlling companies and find that RTPs can benefit group companies' operations, as well as allow controlling companies to undermine the interest of minority shareholders. Related party transactions (RPT) are very common among Chinese listed companies due to two main characteristics. (1) The pricing policy, settlement ways, and payment methods between related parties are negotiable, and therefore render great flexibility. The process is much easier than regular market transactions, during

which both parties can lower their budgets, raise the efficiency and profitability of their firms and thus gain more power to compete. (2) The related parties may seem to be legitimately equal, while they are in fact not.

In China, the state shares and legal person shares are dominant among listed companies, and publicly traded shares are widely dispersed. In such an ownership structure, small shareholders have less supervision power on RPT. Executive from both parties might then use their control power to pursue personal interests and hence initiate unfair transactions that impair their firms or stakeholders values. For those reasons, RPT between listed companies and their parent company, sister companies, or subsidiaries have a broad range, high frequency and complexity, and huge amounts. SDG was of no exception.

In the interviewees with C5 and C9, there was fact that SDG used RPT to protect the listed company from being delisted, e.g. Tellus. According the Company Law, listed companies that have an operational loss for three consecutive years will stop issuing shares, which is known as Special Treatment (ST). Therefore, parent companies will provide profit or buy off loss from the listed subsidiary so that it will not be ST and continue to raise money in the capital market. On 28/07/2001, according to the transferring agreement, Tellus sold at zero prices to SDG eight losing enterprises. According to the debt settlement agreement, SDG paid the debts of these accepted companies and projects at a total amount of ¥167 million, using 60% of the shareholding of Car Industry Trading Company and SDG Huari Car Company (Huari), and 45% of Zhongtian Industrial Co. & Ltd. The displacement process was completed on 03/09/2003. The 60% shareholding of Huari was registered into Tellus, and the chairperson of SDG board held a concurrent post of chairperson in Huari. In the financials, the only disclosure was names of related parties and dates and amounts of the transactions in a note to the primary statements, while motives behind the transactions and other essential message were nowhere to see.

Another way to protect the related parties is to provide guarantee. In China, many related parties provide guarantee to each other. For example, on 18/10/2004, Tellus signed a Postponed Borrowing Agreement with Shenzhen Development Centre Construction Supervision & Management Co. & Ltd. (SDSM) and SDG. The main content was as follows: the amount that Tellus borrowed from SDSM was due on 26/02/2004. SDSM agreed to postpone the repayment to 26/02/2005, and SDG continued the guarantees. This resulted in ¥6 million borrowing. The interviews actually revealed such a message that as SDG is the largest

shareholder in these related companies they have no other options but to enter into these RPTs, since decisions are made top down.

On the other hand, RPT is also carried out by listed company to meet parent company's need. Sometimes parent companies tend to transfer or relocate assets among listed subsidiaries. In this way, they can change the business and capital structure of listed companies and thus obtain the advantages of being listed indirectly. A result of such RPT is that the listed companies will lose independence and competing ability. On 10/01/2000, SDGI paid an amount of ¥63.87 million cash to buy all the shareholdings of Xinxingsuo Fibre-Optic Cable Communication Co. & Ltd. held by SDG, resulting in 75% of the company's registration capital. On 16/08/2001, SDGI and SDG signed an agreement on transferring 60% of the shareholding of Wired Television Company (WTC) with a cash capital of ¥4,800. The price was based on the appraisal result by an agency. According to the appraisal report, WTC had a gross asset of ¥17.41 million and net asset of ¥8,000.

From the above examples, we can see that the parent company either takes advantage of listed subsidiaries to solve its own financial distress pressure such as cash deficiencies, or in the other way injects capital into the listed subsidiaries to protect them so that it can continue benefit from the capital market. In either way, the listed companies are closely controlled by the parent company, and as a result, the accounting information becomes less objective. This is consistent with the literature. According to the research by Denis and McConnell (2003), controlling shareholders frequently use RPTs to take advantage of minority shareholders by tunnelling. Duan (2001) also finds that unfair RPTs are an important way for controlling companies to infringe the controlled companies' resources and interests. Liu and He (2003) support the studies by showing that the higher the percentage of ownership held by large shareholders, the greater the amount of cash dividends and the more frequent use of RPT sales and purchases activities in order to benefit large shareholders. Song (2004) concludes that proper monitoring of the behaviour of majority shareholders and tunnelling activities are effective means of improving corporate governance.

5.5.2. Agency Costs

Apparently, agency issues generate unnecessary costs to the firm. Agency costs are mostly proxied by Operating, general and administration (OGA) expenses as in Ang et al (2002), Singh and Davidson (2003), Firth et al (2008), and many other studies in China. Through the case study, two other direct measurements are identified and will be discussed below.

As far as the aforementioned agency issues are concerned, maintaining good relationship with the government bodies will incur entertaining expenditure. Asymmetric information and multiple-layered management structure increases the fixed cost for operations, and sometimes largely sacrifices some benefits. Before the reform, there were circumstances that top management neglected the company wealth and shareholder interest and gave up beneficial projects. For example in the irrigation project mentioned before, the chairperson of SDGI investigated the environment and thought it was too shabby to live for a long time, so he gave it up and let another small company obtain the project. It turned out that the project earned huge amounts of money in the following several years.

One of the proxies of agency costs would be administrative cost, which was always very high and was personnel related. Another interviewee C11 purposely mentioned about "post expenses". In most Chinese SOEs, senior executives can claim post expenses during business activities, including accommodations, travelling, and hospitable spending. Normally the higher the position, the higher the spending limits, and therefore certain measurements need to be taken to prevent corruptions. In SDG, post expenses were included in the accounting system, i.e., at the beginning of an accounting year, a budget was given, and claims could be made throughout the year with official receipts. In early years, high executives used the budget for overseas travels, expensive entertainments and clubs, or even luxurious private cars. As illustrated in the financial performances tables, admin costs take up to 40% of total sales for the aforementioned listed companies. In 2004, the government announced a regulation on SOE executives about post expense literally, so SDG made according steps. For example, the internal audit department carried out stronger supervision on the budget control of post expenses. In fact, as C11 pointed out, "Strict control on post expenses actually lowers company costs and improves the overall operation." In this sense, government regulation can be a governance mechanism over agency issues and agency costs.

Another proxy of agency costs representing RPT comes from Other Receivables (ORC). For example, in 2005 SDG had the amount of creditors to subsidiaries of ¥603 million, among which virtually all (¥601 million) items occurred between related parties. Most listed firms in China have unlisted controlling corporate shareholders or parent companies with which they form a business group (Sun & Tong, 2003). Listed companies are required to disclose related party transactions, especially the receivables from their affiliated parent company, in the notes to their financial statements. These receivables represent the amount of resources that are reallocated from the listed company to other member firms of the parent company (Aharony

et al., 2009). There are two types of reallocated resources: operational and non-operational resources. ORC includes transactions that are out of normal business operations such as sales of goods and services, i.e. it includes non-operating activities, e.g. loans and advances. Therefore, it is reasonable to use this measurement as a proxy for agency costs in the empirical study. As Interviewee C9 said, "We use the fund to solve cash flow problems, which is easy to understand. Now we are trying to pay it back."

Actually over 94% of Chinese listed companies are involved in RPT with at least one form of the transactions with related parties including purchases and sales, receivable accounts, payable accounts, guarantee, asset replacement etc. The most common type of transactions is ORC or administration costs. Besides, although theoretically parent companies take advantage of their listed subsidiaries in the way of financial guarantee so that they can obtain benefit out of the capital market or bank loans, the fact is RPT can take place the other way round. As confirmed by the interviewees and other statistical data, the cash guarantee listed companies provide for their parent companies are less than 1/6 the amount that parent companies provide for their listed subsidiaries. Such huge amount of RPT can result in manipulation of accounting information that link the performance of management team to their remunerations, and therefore cause agency costs.

5.6 Corporate Governance Mechanisms Revisited

In this section, both external and internal mechanisms, relevant to SDG, will be discussed, including roles played by the government, the board of directors, the supervisory board, internal and external auditing, and internal control environment such as budgetary system and key management personnel. Each of the aforementioned mechanisms will be analysed to identify their function and impact on firm performance and agency problem, linking the literature and the description of the interviewees. In particular, differences before and after the DIS scheme will be questioned to the interviewees in order to seek whether a change in the ownership structure results in a change of firm performance.

5.6.1 Ownership Structure and the Role of the Government

The impact of the government on company operations and personnel is profound. First, the ownership structure is dominated by state ownership, and therefore state representatives take up a majority of board seats, while individual and corporate investors would occupy very few (Xu & Wang, 1999). Among the state representatives, many are retired government officials

to establish market-oriented economic and legal institutions conducive to effective corporate governance in a transitional economy (Shleifer & Vishny, 1997). Then in August 2006, Director of the SASAC Shenzhen further clarified the objectives, tasks, requirements, and implementations of the reform, whose aim was to reduce excess employment in Chinese SOEs (Dong and Putterman, 2003).

The new shareholders of SDG effectively implemented the new steps towards marketisation. Interviewee C6 mentioned, as a result of the conferences and shareholder meetings, SDG and its subsidiaries had made new proposals on human resource distribution and salaries. She said, "Currently the average salary of SDG employees are decreased by 10%, which is closer to the market standard. Accordingly, we have either merged or cut off excessive departments from the original eleven to seven now." Interviewee B represented the management from the government. He regarded SDG as the biggest company under IHC with high expectations. In 2006, he attended the annual meeting of SDG and made a speech. He said that IHC oversaw an improvement in SDG's development in recent years. For example, SDG paid off the ¥30 million debts borrowed from IHC many years ago, which well suggested a start toward a beneficial cycle. Moreover, Interviewee C1 regarded the ownership change an essential factor in the company's daily operation. There was more than one shareholder in the present so that the supervision came from different parties and hence put more pressure for the board and management team. This was very different from the past, when the government owned full control over the company and took major responsibility for its business.

5.6.2 Board of Directors

There were normally two temporary shareholder meetings each year for auditing reports after the reform. For daily operations, the management team came up with annual business plans formally. The company secretary sends the proposals to every director for their review. If they had any discrepancy opinions, they will talk to the secretary through informal conversations before decision-making. The process is not merely formality as it was before. Before the voting for proposal approval, the opinions of the directors are likely to be consistent. The company secretary works like a bridge between the management team and the directors in exchanging information and opinions about company operations.

Interviewee C3 mentioned, agreement is important in three aspects, firstly among members of the management team, secondly among managers and employees, and thirdly among the company and its shareholders, market, and society. Only by achieving an agreement in all the

Another apparent improvement is the access to information. Previously, directors (especially independent directors) did not have the time and authority to obtain sufficient information in SDG, while currently almost all interviewees in the parent company think that the directors had good access to firm information and they conduct communications with management through the company secretary. There will be all kinds of reports to be sent to them for review about company operations and decisions. In addition, it was actually the Shenzhen government that in charge of the SDG parent company in the past, and then through it performing control right over the listed companies. After the reform, there was great improvement in terms of management and human resources. However, as Interviewee C9 suggested, listed companies might still withhold information that is unfavourable for the company from independent directors, who then will merely depend on regulatory authority to provide support and supervision.

In Tellus, Interviewee E2 mentioned about their recommended internal supervision system. They managed to collect and analyse corporate information through a strengthened internal audit system. Specifically, the audit department was directly managed by the Board of Directors, as well as Supervisory Board. Chair supervisor was appointed as director of disciplinary committee, so that information was shared among all the related departments – board of directors, supervisory board, general manager office, and disciplinary committee. Furthermore, the audit division in Tellus carried out auditing in all the subsidiaries one month after every quarter, as well as on special projects in order to reinforce supervision. Whenever there was a problem, the general manger office would issue an announcement and the audit division would make sure solutions were sought. This was deemed a big improvement from corporate governance perspective compared with previous practice.

5.6.3 Supervisory Board

Many previous studies suggest that supervisory board in most Chinese SOEs are artificial, and so are the audit departments. Interviews with C10 actually articulated the questions. As far as SDG is concerned, there are three typical problems with supervising divisions.

Firstly, the independence level of supervising staff is very low and thus the supervision power is very limited. As C10 said, "The supervisors are paid by the company; therefore their interests tend to be associated with the supervisees. The board chairperson and general manager are the absolute leader in the company, and the supervisors are intimidated by their power to carry out efficient supervision."

facets, can the company pursue value maximisation and maintain a sustainable development. He further pointed out, "in the past, only the large shareholders can recommend and nominate independent director candidates to the board", and therefore it was difficult to ensure the independence of these people because they had close relationship with top managers, who were also appointed by the same principal.

Afterwards, independent directors are actually picked from the market, and there have been focus on their sector experience and expertise. This has been regarded an improvement in the corporate governance of the company, because outsider directors actually care about the operations of the business and that they have backgrounds as lawyers, bankers, investment specialists, or consultants. Such outsider expertise enables reduction of agency costs (Huang, et al, 2006).

SDG is like most SOEs that used to have three "old meetings", which are communist party committee, employee committee, and trade union meetings. New company law states that every company now should have three "new meetings", i.e., shareholders meeting, board of directors meeting, and supervisory board meeting. One aspect of corporate governance reform is to deal with the conflicts and evolution from the old to the new system, which is a gradual and complex process. In SDG, all these committees and boards exist, just like most of all Chinese SOEs (as per Wu (1998), the number was 80% in 1998).

All the interviewees think that the most efficient solution to this transform is to make the heads of relevant bodies the same people. For example, the head of trade union should be the head of supervisory board. In the 2007 self evaluation of corporate governance practice of SDGE, the main issue was yet to set up sub committees including strategy, nomination, internal audit, and remunerations committees. The management team proposed an incentive plan to its employees in 2004 and borrowed loans from individual employees in 2006. These proposals went live without any approval from the board or other shareholders. Another issue was one of the independent directors being a pure formality because he never actually carried out any responsibilities or attended any meetings. Again this was in contrast with the CSRC Code in that independent directors are supposed to "bear the duties of good faith and due diligence toward the listed company and all the shareholders", and "earnestly perform their duties". After the reform, SDGE also managed to establish an internal controls system to deal with these issues, and in particular, it set up a plan to repay the employee loans and hence reduce finance costs.

Secondly, even if there is supervision, the problems investigated are far too inadequate. This is because there are overlaps between supervising divisions, while lacking specified responsibilities. Another problem is, "Many of the supervising staffs are not professionally trained. Moreover, we cannot ignore information asymmetry."

Thirdly, the supervising system in the company appeared to be strong but in fact, the operation was weak. There were supervisory board, disciplinary committee, financial officers, audit committee, and some other functions in SDG. However, different divisions lacked efficient communications and supports from each other. Some problems were over stressed, while others were neglected.

In order to solve the mentioned problems, SDG had applied certain rules in practice. The responsibilities of chair supervisor, disciplinary director, and CFO were clearly specified to avoid waste of time and resource, as well as decrease multiple-agent problem. Additionally, SDG had routine meetings for all the supervising divisions to report their work and share information, in which way the costs were largely reduced. The company also set up a budget for training programs in financial management, auditing, and law. There were supplementary seminars to discuss issues and solutions encountered in everyday supervision. "The results are obvious," as C10 said, "because we have thus put supervision beforehand rather than just problem solving."

5.6.4 Auditors

On the one hand, SDG has been using a local accounting firm as their external auditor, which then brings the doubt of the quality of the audit work. Firstly, there is threat of familiarity, which is known in literature as the effect of long tenure of auditors. When the auditors work on the same client for a long time, they become acquainted with management and tend to trust the sufficiency and appropriateness of the information they provide. Secondly, there is threat of self-interest, especially with large companies, such as audit fees. Whether the payment is long due or how much the fee can be might be dependent on the audit opinion in a worst-case scenario. The risk here is therefore whether the auditor will compromise their integrity in order to keep a big client happy, especially when local accounting firms facing big SOEs. On top of the aforementioned points, non-public firms face less strict regulations in disclosures in their financial statements, so the readers of the reports cannot easily identify manipulation of the accounts or see the full picture.

On the other hand, Interviewee C8 gave a long speech about the importance of internal audit in SDG as an effective supplement. In 2006, the group took two major steps in audit control. On the one hand, it reassigned chief financial officers and finance manager to fully owned subsidiaries in order to reinforce internal control in them. On the other hand, it set up the audit supervision department and strengthened external audit control over the subsidiaries. He suggests that in a group company such as SDG, internal audit is essential in supervision and control due to the multiple agent structures. More specifically, some of the SDG subsidiaries experienced penalty or even closure because their CEO or CFO manipulated investment with fraud transactions. In SDG itself, some management members still claimed part-time stipends even there was strict regulations against such behaviour. These violations reflected weak audit control and audit supervision in the company. Therefore, Interviewee C8 always emphasised on internal audit during board meetings or management meetings.

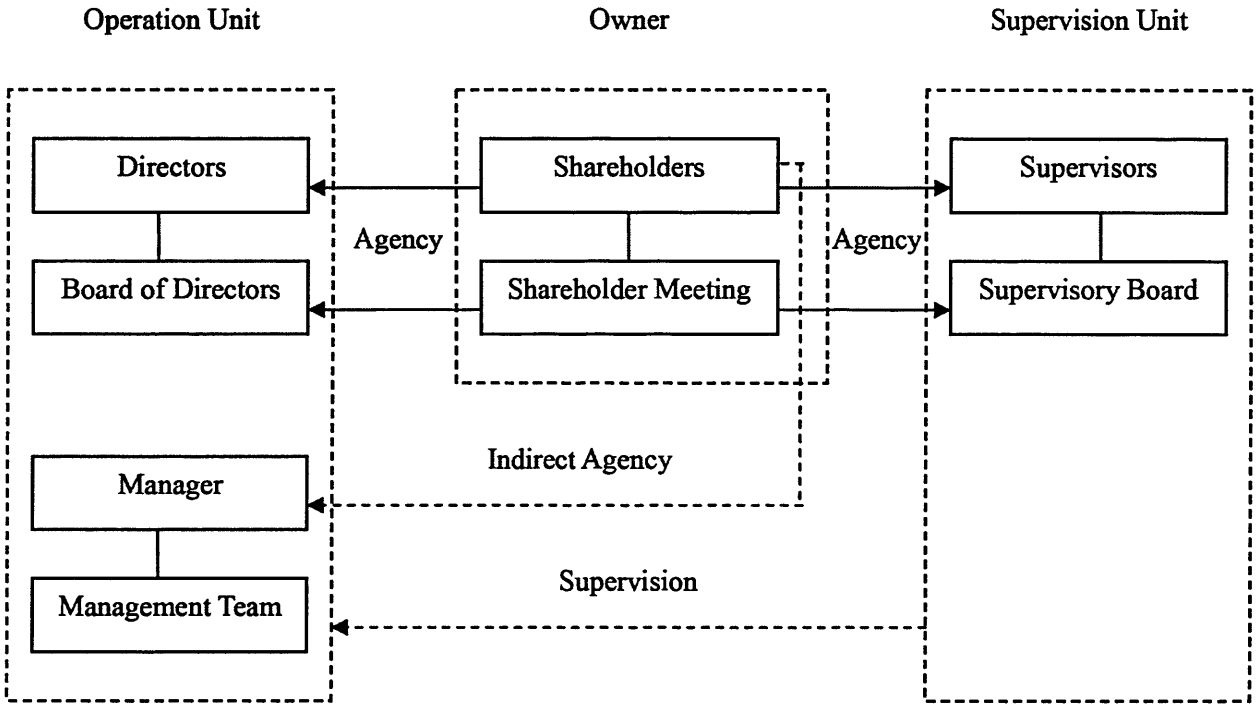
Interviewee C9, C10 and C11 highly advocated the budget control system in SDG, which they thought was a very well developed governance mechanism in the group as suggested by internal auditing. They commented that budget was compulsory, official and enforced, which was normally not subject to manipulation or modification in any way. Relevant audit work was carried out on operations within the strict budget control to realise effective supervision. Interviewee C1 talked about some details of the SDG budget control system in terms of manufacture budget, cost budget, and investment budget. The first step was budget making, which was to be established within the first quarter of the year. The second step was to approve investment proposals according to the budget system. The third and last step included performance assessment based on budget control and decision of rewards. In this way, the employees became more actively involved in the operation and performance of the company and the company itself was more competitive in the market.

5.6.5 Corporate Culture – All about People

Theorist, policy makers, and practitioners share the intuition that corporate governance reflects national culture (Licht et al, 2005), although researchers have difficulty operationalising culture to develop testable hypotheses. Stulz and Williamson (2003) and Beck et al (2000) used countries' predominant religion as a proxy for their national culture and distinguish culture from structural aspects of society that might influence corporate governance. However, this macro classification does not apply to the complexity of religious variation in China and in particular micro culture differences within individual companies. Besides, the mentioned studies only focus on how culture affects legal rules following LLSV.

In China, corporate culture has philosophical force in the design and implementation of governance mechanisms. The conversation with Interviewee C4 revealed a multiple-layer management pattern in the SDG as shown in Figure 5.2 below. There were also professional committees under the board of directors, including strategy committee, audit committee, nomination committee, and remuneration committee.

Figure 5.2 Multiple Agency Relationships



Due to the existence of various functional departments in the parent company and the fact that it owned several subsidiaries, business instruction or relevant information was delivered through a very long chain involving many people and procedures. Authorisation was ambiguous, and the allocation of power, responsibility, and profit was unreasonable due to lack of sufficient information.

For example, SDG used to have a mixed organisational structure, i.e. there are functional departments such as human resources, finance, marketing, as well as divisional departments that relate to specific projects or regions. This resulted in dual command that came from different managers or directors. Sometimes instruction would also come from government bodies in the form of red headed letter issued by the government.[32] Therefore, conflicts sometimes arose between all these sources, which then led to time-consuming meetings that

[32]This is a formal yet private and confidential document outlining government procedures and reform projects issued by government bodies and sent to large corporations for implementation. It is normally printed with the title in big red fonts hence the name.

Chapter 6 Econometric Analysis

6.1 Introduction

The previous chapters have discussed how corporate governance mechanisms can work to mitigate agency problems and reduce agency costs. This chapter aims to test whether various corporate governance mechanisms affect agency costs using secondary data. In doing so, this chapter also examines whether the two new proxies of agency costs outperform traditional proxies. Chapters 5 and 6 therefore work together to explore real agency issues in Chinese listed companies and serve the purpose of the study.

More specifically, in this chapter both traditional variables as well as new variables for agency costs will be used in the econometric model so that the results can be compared as to which variables are more suitable in the Chinese context. Econometric modelling and testing will be carried out to examine the relationship between various ownership structures, board characteristics, auditors, dividend policy and agency costs on a sample of 6344 firm years during 2000-2005.

The measurement of agency costs will be categorised into two groups: (1) performance indicators – as using Tobin's Q and Sales on Asset (SOA), Return on Asset (ROA), and Return on Equity (ROE); and (2) cost indicators – as using Free Cash Flow (FCF), Administrative Expenses (ADM), and Other Receivable Accounts (ORC). Among the proxies in the second group, FCF and ORC are new proxies not normally used in previous studies.

The analysis also includes investigation of the causality of variables and tests for the potential endogenity of ownerships, and the test for industry effects to make sure the results are robust. The findings will help devise effective measures for agency issues to facilitate future studies in China and other transitional economies. The rest of the chapter is organised as follows. Section 2 formulates hypotheses. Section 3 describes data sources and presents summary statistics of relevant variables. Section 4 presents the models for, and results of, hypothesis testing. Section 5 discusses the results of the robust tests. The last section presents consolidated results and concludes the chapter.

took up individual's time and commitments and caused stress. According to some of the interviewees, such meetings were often not productive and the dilution and confusion of authorities were normally not solved.

Theoretically, the governance system can be divided into two categories, informal institution, and formal institution (Zhang, 1999). The informal institution, unspecified in the formal contracts, formed, and accepted during a long period, is known as norm, which includes moral terms and culture. To some extent, the company culture can affect the operation costs and thus firm performance (Nee, 1998). All the interviewees in SDG mentioned about the company culture, to which they paid great attention. The top managers all agreed that corporate management and operation is absolutely dependant on the people who are running them. Therefore, people are the essence of a company, and how they behave is crucial to the performance of that company.

This philosophy formed the foundation of SDG's culture during their reform. As Interviewee C2 stated, "structure and strategy are only effective when the people who form them can actually implement them." He further concluded, "A dynamic corporate culture will make supervision easier as it forms self regulation and self organising, so that all the resources are efficiently allocated to realise reasonable utilisation that every management member pursues." This culture, according to him, was decided by the leaders of the company, including organisation structure, regulations, personnel, and many other mechanisms.

In other words, if the leaders of a company promoted "implicit rules," then they would use their power in pursuit of personal benefits; if they advocated "explicit rules," then everything was rigorously controlled to achieve a balance between performance and remuneration. The attitude certainly affected those of the subordinates. Applying this viewpoint, SDG had begun to establish a specific procedure of recruitment including professional training and period of probation.

5.7 Summary

This chapter comprehensively describes the case study in SDG, a typical Chinese SOE with three listed subsidiary companies. The group company has all the drawbacks that most Chinese SOEs have, but also represents the reform and development they are experiencing. All the interviewees are from different tiers and sectors including government, authorisation, parent company, and subsidiaries. Moreover, they stand for different roles, such as

government officials, managers, directors, supervisors, and division leaders. The data collected in this case contribute to the whole research in four ways, as corresponding to the objectives stated in the introduction section.

Firstly, general and specific agency issues are discussed in the interviews, which have filled in the gap in the previous literature review chapter with relevant Chinese context, worked as a valuable supplement to the background introduction, and further developed a lively picture of the real business world. For example, although the impacts of RPT on asset allocation among listed companies are widely discussed in academic researches, previous studies mainly focus on how RPT affects the middle or small shareholder rights and neglect how it affects the agency mechanism and agency costs. This case explores the relationship between existing agency issues and relate them to agency costs, and it further provides an empirical foundation for the definitions of variables for quantitative analysis in the following chapter.

Secondly, prior studies stress Type I agency problem, while in Chinese listed companies the Type II agency problems are more severe, especially when the largest shareholder is the state and when it has absolute control over the company. This is due to the nature of state shares and/or significance of political connections to the government.

More specifically, previous studies in the Chinese context have been focusing on the effect of decentralisation of decision-making on the performance of SOEs or comparison of differences in performances between state-owned and non state-owned firms, while this study explores how recent ownership reforms actually impact on agency costs in SOEs. The interview results show in a more practical and comprehensive way that politically owned SOEs sometimes want to achieve economically inefficient objectives, supported by real business examples given by the interviewees. Such political objectives generally include hiring more workers than needed or maintaining excess employment at the expense of firm performance to win political support or to avoid social instability due to high unemployment, and the other facts as mentioned in previous sections.

Thirdly, through discussion with various people in the case companies, valid measurements of agency costs are identified. This has long been the pursuit of scholars in the agency theory field, especially those interested in the Chinese economy. Administration costs and other receivables are the new variables to be tested in next chapter, apart from the traditional proxies such as Tobin's Q, free cash flow, sales to asset ratio, return on assets, and/or return

6.2 Hypotheses

From prior discussions, the following governance mechanisms are chosen to form testable hypotheses, because they are found most effective through the case study.

6.2.1 Ownership

Empirical results in western countries showed that the relation between state ownership and Tobin's Q was significantly convex throughout (e.g. McConnell & Servaes, 1990). This convex relation may be explained as follows. When privatising a former state-owned firm, the government systematically reduces the state ownership. At a level above the reflection point, investors may not be convinced that the government is fully committed to privatisation and market monitoring. In the absence of a competitive property rights market and a well-functioning legal framework, partial privatisation may be detrimental to firm value due to expropriation of public assets by insiders. Therefore, firm value declines as state ownership decreases.

As the government continues to reduce its stake in the privatised firm to below the reflection point, market discipline and monitoring become effective in reducing agency costs. Therefore, after some point, firm value increases as state shares decline. Tian (2003) studied 826 listed Chinese firms from 1994-1998 and finds a similar U-shaped relation between firm value and state ownership. A renowned piece of research with the Chinese listed companies was done by Xu and Wang (1999). They investigated how ownership structure affects the performance of listed companies in both Shanghai and Shenzhen stock exchanges, and found that firm profitability was either negatively correlated or uncorrelated with the fraction of state shares, while Qi, Wu and Zhang (2000) found a negative relationship.

Although prior studies gave uncertain results in terms of how state ownership affects firm performance, the case study generated a clearer idea of how it works. In firms with high state ownership such as SDG subsidiaries Tellus, insiders gained control either through direct government appointments or indirect political influence, despite owning few or no cash flow rights. Moreover, the government lacked transferable residual claims, preferred social and political policy goals over profit maximisation, and employed staff based on political connections rather than ability to perform, or encountered greater information asymmetries and higher transaction costs (Sun & Tong, 2003). Politicians had incentives to control and subsidise SOEs to achieve economically inefficient objectives for political purposes. In

2004). On the other hand, legal person shares are not tradable, thus their holders cannot speculate in the market to get short-term return as some public investors do. Return of holding legal shares only comes from dividend. In this sense, holders of legal person shares have most incentive to monitor companies' development and to maximise the shareholders' benefits, and thus reduce the agency costs caused by conflict between management and control. Unlike state shareholders, holders of legal person shares operating under independent accounting systems are formally responsible for their profits and losses. They therefore have stronger profit-motives. Furthermore, holders of legal person shares are unlikely to be plagued by the free-riding problem because their shareholding is relatively large (Xu & Wang, 1999; Qi et al. 2000). In addition to strong incentives, they have the capacity to oppose local party committees directly in the decision-making process due to extensive control rights associated with large shareholding. Given the above, it is expected that:

H1c: The proportion of legal person ownership is negatively associated with agency costs and hence positively associated with firm performances.

Jensen (1993) suggests that managerial shareholdings help align the interests of shareholders and managers, and as the proportion of managerial equity ownership increases, so does corporate performance. Ang et al (2000) provide evidence on corporate ownership structure and agency costs and conclude that higher managerial ownership significantly and positively influences the corporate asset utilisation efficiency. Singh and Davidson (2003) extend their work to large publicly traded corporations, investigate the role of outside block ownership in terms of their proportion of equity ownership, and make a similar conclusion.[33] However, as managerial ownership is minor as compared with other types of shareholdings, the impact on firm performance and agency costs is not expected to be very significant. Nonetheless, the following hypothesis is developed:

H1d: The proportion of managerial ownership is negatively associated with agency costs and hence positively associated with firm performances.

Foreign listing should increase shareholders' values because of a better external governance regime compared to that in emerging markets and commitment to a higher level of disclosure. In China, the groups with foreign joint ventures may perform better because the information regarding technological improvement or beneficial business arrangements obtained from

[33] Singh and Davidson (2003), "In large publicly traded corporations, managerial ownership significantly alleviates principal-agent conflicts even in the presence of other agency deterrent mechanisms."

particular, they might require an SOE to hire more workers than needed to increase employment, or to maintain excess employment even when a firm's performance declined (Shleifer & Vishny, 1997). This is also evidenced by the SDG group before personnel restructuring. In this sense, the following hypothesis is developed:

H1a: The proportion of state ownership is positively associated with agency costs and hence negatively associated with firm performances.

The control shareholders often have better access to information, hold more power in selecting management, and involve in key decision-makings. Especially when the manager holds fewer shares and is subordinate to controlling shareholders, control shareholders impinge upon the interests of small shareholders by way of non-payout of dividends and diversion of profits. The exploitation of small shareholders by controlling shareholders constitutes ex ante an expropriation threat that reduces managerial initiative and non-contractible investments and may come into conflict with performance-based incentive schemes (Burkart, 1997).

The main characteristic of the Chinese corporate governance is the over concentration of equity structure. Most of the listed firms in China are transformed from SOEs. Ownership structure displays the evidence of the co-existence of control shareholders, who are normally related to the state and many other small and comparatively weak shareholders. State shares are uniquely large and dominate company management, which then results in controlling shareholder making decisions without consultation of other minority shareholders as in the SDGE case, and therefore the following is expected:

H1b: The ownership concentration is positively associated with agency costs and hence negatively associated with firm performances.

In China, many studies suggest that companies with high level of legal person shares perform better. Qi, Wu and Zhang (1996) pointed out that in Shanghai Stock Exchange all firm performance measures were positively related to the percentage of shares held by legal persons in the period from 1991 to 1996. Xu and Wang (1999) achieved similar results by using a sample of listed firms in both Shanghai and Shenzhen stock exchanges. Since those who have legal person shares do not have the dominant voting right, it is not easy for them to expropriate minority shareholders interest through connected transactions (Jing, Zhou & Tse,

Aggarwal and Nanda (2004) assume that directors have potentially different objectives and that their board membership confers to them the right to contract with the firms' executives. They show how this can arise in equilibrium and can be consistent with the fiduciary responsibility of board members to shareholders and they then examine how the size of a firm's board of directors impacts managerial incentives and firm performance. Using a sample of 842 firms from the years 1998 to 2001 (2148 firm-year observations) from the S&P 500, S&P MidCap 400 and S&P SmallCap 600, they reach several results. First, they predict that board size will be larger when there are more firm objectives. Second, the larger the board size, the weaker the incentives are for stock price performance. Third, the larger the board is and the weaker incentives are, the weaker is firm performance (Aggarwal & Nanda, 2004).

Yermack (1996) reports a statistically significant, negative correlation between the board size and firm value in his empirical study. Eisenberg, Sundgren and Wells (1998) also find that small boards are more effective than large boards. As we can see that when board size increases, problems relating to communication, process, decision-making and coordination increase, and the ability of the board to control management decrease, thus leading to agency problems (Eisenberg, Sundgren & Wells, 1998). Li and Cui (2003) carry out an empirical study on agency costs and board size in Chinese listed companies, and reach the same conclusion. From the findings of those previous works, we have important implication for corporate governance such that it is possible to improve board effectiveness by restricting board size. Based on the more recent empirical research, it is expected that smaller boards will be associated with reduced agency costs.

H2a: The size of the board is positively associated with agency costs and hence negatively associated with firm performances.

According to agency theory, the company is less likely to suffer loss from the collusion between the managers and the independent directors who come from different external agencies (Fama & Jensen, 1983). Fama and Jensen (1983) argue that board outsiders, besides providing expert knowledge, are also the first line of defence in monitoring managers and guarding shareholder interests. According to them, independent directors would be motivated to monitor the management because they have incentives to develop reputations in decision control. Independent directors are encouraged to express the independent opinion of the major events occurred in the company including nomination, appointment or replacement of directors, appointing and dismissing senior managers, remuneration for directors and senior

overseas partners, such as the CEPA concept with SDGE, may improve the productivity and performance. This hypothesis is also consistent with those from previous studies conducted in Chinese listed companies, such as that by Sun and Tong (2003), and Xu, Zhu and Lin (2002).[34] The findings indicate that foreign investors can monitor and positively influence management of the firm. They may also indicate that the presence of foreign ownership forces management to act more consistently with firm value maximisation.

Foreign ownership allows access to international capital markets and hard currency and, in turn, access to advanced technology and international managerial talents. Preserving this access is beneficial to shareholders. Foreign investors are predominantly non-state investors operating under hard budget constraints and who have strong incentives to maximise the return of their investment. Furthermore, unlike domestic investors whose investment opportunities are constrained by capital controls, foreign investors can select their stock-portfolio on the international capital market and benefit from abundant investment opportunities worldwide. From this perspective, it is reasonable to assume that foreign investors should be more intolerant to detrimental party interference. Since foreign investors act basically as profit maximisers and can profit from the presence of worldwide investment opportunities, we can nevertheless hypothesise that:

H1e: The proportion of foreign ownership is negatively associated with agency costs and hence positively associated with firm performances.

6.2.2 Boards

Traditional view of the role of boards of directors is that boards monitor management and resolve agency problems between shareholders and management. However, since not all directors on the board have a single, identical objective to maximise shareholder value, the size of the board of directors is expected to be associated with less effective board monitoring,[35] based on the argument that larger boards are less effective and more susceptible to the influence of the CEO (Jensen, 1993).

[34] They conclude that ownership structure also matters to performance: relative to shareholding by the state, foreign ownership has a positive effect, individual (including employee) shareholding has a negative effect, whereas the effect of collective and legal person shareholding is indistinguishable from state shareholding.

[35] Eisenberg, Sundgren and Wells (1998) argue that as board size increases, increased problems of communication, process, decision making and coordination, and decreased ability of the board to control management thereby leading to agency problems. However, other have argues that larger boards may be able to create a stronger network with the external environment and to produce a more extensive resource base (Pfeffer, 1973; Pearce & Zahra, 1992).

East Asian auditors potentially have a stronger governance role because the conventional corporate control systems are weak in protecting outside investors.[36] As in DeAngelo (1981), large audit firms have incentives to supply a higher level of audit quality and to some extent; auditor size is a proxy for unobservable audit quality. This is because large audit firms have more clients and if they lack independence or provide a low-quality audit, they are likely to lose them. From this perspective, large audit firms are likely to conduct a true and fair check on the firm's financial statements and management behaviours, and thus provide the company shareholders with high-quality audit reports.

Agency theory hypothesises an inherent moral hazard problem in management-control relations that gives rise to agency costs. The demand for auditing is assumed the efficient resolution of agency problem because audited annual reports are widely viewed as a means of mitigating agency costs (Defond, 1992). Also as agency costs increase, there is a demand for high quality auditing, either voluntarily undertaken by managers as a bonding mechanism or externally imposed as a monitoring mechanism by shareholders and creditors (Watts & Zimmerman, 1986).

Apart from these early studies, Defond, Wong and Li (2000) support the positive size effects by providing evidence that larger audit firms tend to issue more modified opinions. Fan and Wong (2005) find that in East Asia where the legal institutions are less developed, auditors do play a significant governance role as evident by the positive relation between agency problems and large audit firm choice.

Accordingly, in most auditing markets, there exists a large body of empirical studies supporting the existence of a positive relationship between audit firm size and audit quality; hence the Big Four audit firms are trusted to be able to produce high-quality audits, which lead to the following:

H4: The size of the external auditor is negatively associated with agency costs and hence positively associated with firm performances.

[36]With the presence of Big Five accounting firms and other international firms across East Asia, the international market for external auditors are much more established than the market for credible independent directors. Neither is there a viable market for corporate control in this region, mainly a result of the concentrated ownership. Hostile takeovers are extremely rare. (Fan & Wong, 2001)

managers, and those they consider detrimental to the interests of minority shareholders. Hence, it is reasonable that their presence will improve firm performance and thus alleviate agency problems and reduce agency costs.

On the other hand, insider control could lead to many agency problems such as asset stripping, poor investment decision, decapitalisation through excessive wage increase, and increases in other private benefits (Wang, 2003). Since the independent director system was introduced in China only from 2001, it is interesting to see how it works in Chinese listed companies.

During the 1990s, a typical listed joint-stock company in China had a mixed ownership structure with three predominant shareholder groups – the state, legal person investors, and individual investors – each with approximately one-third of the stock (Xu & Wang, 1999). At the board level, in addition to inside directors, there are correspondingly these three kinds of non-management directors. Agency theory suggests that firm performance is positively related to the presence of large shareholders, i.e., blockholders (Shleifer & Vishny, 1997).

Empirical research in developed economies such as the United States (Hill & Snell, 1988) and emerging economies such as China (Qi, Wu, & Zhang, 2000; Xu & Wang, 1999) and India (Ramaswamy, Li, & Veliyath, 2002) largely confirms this proposition. Extending this logic, at the board level outside directors representing large shareholders may more likely be concerned with performance in order to maximise their investment. Beasley (1996) discovers that firms with boards dominated by outside directors are less likely to engage in accounting fraud. Within an agency theory framework, because of their independence, non-executive directors (NEDs) are seen as useful because they can monitor and control the actions of opportunistic executive directors (Jensen & Meckling, 1976). As a practical matter, NEDs are potentially effective because they "have incentives to develop reputations as experts in decision control" (Fama & Jensen, 1983). Hence, it is predicted that:

H2b: The proportion of independent directors is negatively associated with agency costs and hence positively associated with firm performances.

For the above two hypothesis, the case study has revealed opposite opinions from the literature, which might in fact be more relevant to the Chinese context. In the case companies, board size actually improves firm performance due to the involvement of more directors with adequate professional qualifications and experiences so that business operations are properly

Several studies examine the relation between the stock price reactions to dividend increases as it relates to the overinvestment problem, using Tobin's Q as a proxy for overinvestment. Lang and Litzenberger (1989) report more positive stock-price reactions, on average, to announcements of dividend increases by firms that are over-investing than firms that are not.

In contrast, Denis, Denis and Sarin (1994) and Yoon and Starks (1995) find no evidence that the stock-price reaction to dividend increases is significantly related to Tobin's Q, controlling for dividend yield. Lippert, Nixon, and Pilotte (2000) examine the relation between pay-performance sensitivity and the stock-price reaction to dividend-increase announcements. They report that high pay-performance sensitivity is inversely related to the price response to dividend increases. Their finding is consistent with agency theory in that high pay-performance sensitivity decreases agency costs so that dividends become less important.

Dividend increases can signal positive news to shareholders for a variety of reasons. For instance, an increase in the level of dividends can signal higher levels of current or future cash flows. For firms with few growth opportunities, dividends can provide information about the likelihood that managers will waste cash flows on non-optimal projects. For firms with both high growth opportunities and high agency costs, dividend increases can benefit shareholders if managers are forced to use the external capital markets to fund the firm's growth and thus are subjected to additional monitoring.

According to the theory, in order to reduce the amount of free cash flow, which may be wasted by the insiders or committed to unprofitable projects, dividends payout forces managers to abide by the discipline of financial markets. As a result, the outsiders prefer dividends to retained earnings. From the above discussion, it is expected that:

H3: The payment of dividends is negatively associated with agency costs and hence positively associated with firm performances.

6.2.4 External Auditor

Theory suggests that some monitoring and bonding mechanisms may develop to mitigate the agency problem and hence reducing the financing costs (Jensen & Meckling, 1976). One such method is for the controlling owner of a firm to hire an independent external auditor to testify the accuracy of its financial statements.

6.3 Data Source

6.3.1 Sample Selection

Financial data and other publicly available data will be collected from the Centre of China Economic Research Services (CCER) database at Peking University.[37] Their Financial Statement of Industrial Companies database gives basic information about Chinese listed companies as well as their yearly balance sheet items, income statement items, market related data, auditor and audit opinions, and supplementary items. Their Corporate Governance database gives information on the yearly ownership structure of listed companies, their board size and composition, and board meeting frequencies and attendances.

To make the data more comprehensive and complete, other sources of data are also used, including those provided by the China Stock Market and Accounting Research (CSMAR) database, issued by Shenzhen GTA Technology Company Ltd. (www.gtarsc.com). These are the two most commonly used databases for China-related research, and have been used by many other empirical researchers. Most recently China Financial Database (CFD) has become a more popular database for financial studies in China, which is provided by Wind Consultancy Ltd. (www.wind.com.cn) based in the Shanghai financial centre. After compiling the data, information is then double-checked, and consistency of the collected data is perfectly maintained after such cross-checking. The accuracy of data is also checked against past documents and official websites, e.g., the websites of both Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE), and the web site of China's Securities Regulatory Commission (www.csrc.org.cn).

Panel data[38] from 2000 to 2005 will be used for empirical analysis. This is because the history of Chinese stock market began from 1992; and from then on to 1999, it experienced rapid growth and frequent reforms and thus revealed high volatility, although without regular large amount of transactions. More importantly, the regulation of independent directors was fully implemented only back in 2002. By analysing data before and after the regulation I can then compare how this mechanism affects agency problem. Three years gap in both directions seem reasonable.

[37]CCER (www.ccerdata.com) provides users with in-depth data services, whose data quality and database structure reach the same standard as counterpart in the US, such as CRSP and Compustat (CCER Web Site).

[38]Panel data have advantages that cross sectional or time series data do not hold. For example, Hermalin and Weisbach (2003) argue that they can control effects of mutual affection of corporate governance and corporate governance on findings in a degree by using panel data.

Many works use Tobin's Q as a measurement of firm performance in the accounting and finance literature, and hence an inverse indicator of agency costs.[40] In theory, the Q ratio identifies the juxtaposition of managerial efficiency of capital and the financial cost of capital. However, there are two problems here: first, Tobin's Q as used by many authors is ill-defined from its original meaning – firm's market value over replacement cost of the physical assets; second but more importantly, researches are restricted by previous work typically done in the US or UK context and ignore the unique economic and political setting in China. Hence, the definition of Q is changed to fit the Chinese context, and is as follows: the sum of market value of tradable shares and book value of total liabilities over book value of total assets (same as in Chung & Pruitt, 1994; Agrawal & Knoeber, 1996; Chen, 2001; Hovey et al, 2003, etc.). Wei et al (2005) censor Q at the 1st and 99th percent tiles to alleviate the influence of extreme outliers, which is also used in this study.

Jensen (1986) and Easterbrook (1984) think that when a company has surplus FCF, management can use the cash freely and hence incur agency costs, therefore FCF can serve as a direct proxy for agency costs. In other words, higher FCF represent higher agency costs. When calculating FCF, we need to exclude those cash outflows for necessary investment activities, e.g. those used to purchase long-term investments, non-current and intangible assets, and WIP, all of which can be obtained from companies' annual reports.

There are two main alternative measurements of agency costs in previous studies in China. The first measure for agency costs is ROA, which is defined as the ratio of profit before extraordinary items over the book value of total assets (e.g., Xu et al., 2002).[41]

An alternative measure of agency costs is the ratio of ROE, as a measure of profitability (e.g., Li & Cui, 2003). This indicator measures profitability from a different angle. Most Chinese listed firms are transformed from SOEs. In order to protect the value of state assets, fixed assets depreciation rates are centrally determined and often are artificially low, thus leading to an upward bias in fixed asset estimates. Current assets include some stockpiled goods that either cannot be sold at their book value, or cannot be sold at all. ROE is clearly a more preferable indicator of profitability, matching the common usage of the market economics (Li & Cui, 2003).

[40]For examples, see Morck et al (1988), McConnell & Servaes (1990), Chung & Pruitt (1994), Lang & Stulz (1994), Chen (2001), Hovey et al (2003), etc.

[41]This is necessary because managers of Chinese listed companies often manage the reported bottom-line profit figures via one-time accounting items, e.g. via investment income, sale of assets (Chen & Yuan, 2004).

The initial data comprises all companies listed in both Shanghai and Shenzhen stock exchanges, which excludes finance and insurance industry because their reporting system is different from those of non-financial firms. Two additional criteria are enforced for filtering. First, a firm should have been listed at least one full year at the end of each year during 2000-2005 so that the performance is not significantly affected by new listing. Secondly, a firm should not have missing data. After applying the two rules, the sample consists of 6344 observations during the period.

6.3.2 Variable Definitions

6.3.2.1 Agency Costs Proxies

The dependent variable is the agency costs in listed Chinese companies. In this study, agency costs are measured by seven proxies, i.e., Tobin's Q. sales to total assets (SOA), return on assets (ROA) and return on equity (ROE), free cash flow (FCF), administrative expenses (ADM), and other receivables (ORC). These measures are explained and their adoption justified, below.

Table 6.1 Definitions of Dependent Variables

Group	Variable	Definition
Performance Indicator	Q	Market value of equity[39] plus book values of long-term debt and short-term liability, over book value of total assets
	ROE	Net profit before extraordinary items divided by the average book value of owners' equity
	ROA	Net profit before extraordinary items over the average book value of total assets
	SOA	Sales to total assets
Cost Indicator	ADM	Administration expenses scaled by revenue
	ORC	Other receivables scaled by total assets
	FCF	Cash inflow from operating activities less cash outflow in capital investments (e.g. long-term investments, non-current assets, intangibles, work-in-progress)

[39]As the shares held by the state and most legal persons are not publicly tradable, the market value of non-tradable shares are calculated as the number of total non-tradable shares multiplied by net assets per share (e.g., Zou et al., 2003). The market value of tradable shares is computed as the year-end share price multiplied by the number of tradable shares.

Table 6.2 Descriptive Statistics: Dependent Variables (2000-2005)

YR	2000	2001	2002	2003	2004	2005	Pool
Count	835	971	1053	1114	1156	1215	6344
SOA							
Mean	0.5164	0.5190	0.5493	0.5926	0.6552	0.7006	0.5962
Minimum	0.0064	0.0249	0.0054	0.0131	0.0273	0.0174	0.0054
Maximum	4.0658	4.5777	4.9093	6.6178	7.0420	7.3884	7.3884
Standard Deviation	0.4055	0.4254	0.4338	0.4916	0.5259	0.5763	0.4916
Q							
Mean	1.3685	1.3683	1.3556	1.3408	1.3343	1.3433	1.3504
Minimum	1.0363	1.0284	1.0320	1.0218	1.0324	1.0285	1.0218
Maximum	1.9453	1.7924	1.8570	1.7860	1.9467	1.8348	1.9467
Standard Deviation	0.1466	0.1497	0.1510	0.1523	0.1494	0.1446	0.1495
ROE							
Mean	0.0530	0.0318	0.0206	0.0279	0.0311	0.0204	0.0297
Minimum	-0.9007	-0.8911	-0.9888	-0.9783	-0.9541	-0.9567	-0.9888
Maximum	0.7920	0.4911	0.6898	0.4828	0.4938	0.3813	0.7920
Standard Deviation	0.1224	0.1267	0.1434	0.1265	0.1345	0.1511	0.1357
ROA							
Mean	0.0636	0.0458	0.0417	0.0467	0.0490	0.0444	0.0480
Minimum	-0.7432	-0.4334	-0.3526	-0.3874	-0.4659	-0.2970	-0.7432
Maximum	0.3480	0.2546	0.3742	0.3317	0.5379	0.3019	0.5379
Standard Deviation	0.0636	0.0625	0.0672	0.0607	0.0691	0.0659	0.0653
ADM							
Mean	0.1141	0.1263	0.1510	0.1237	0.1149	0.1110	0.1233
Minimum	0.0038	0.0000	0.0000	0.0000	0.0000	0.0020	0.0000
Maximum	4.6311	3.3170	9.4529	4.1753	5.2343	3.8112	9.4529
Standard Deviation	0.2084	0.1906	0.3781	0.2089	0.2125	0.1803	0.2393
ORC							
Mean	0.0001	0.0673	0.0635	0.0557	0.0542	0.0601	0.0520
Minimum	0.0000	0.0000	0.0001	0.0001	0.0000	0.0000	0.0000
Maximum	0.0583	0.5439	0.7017	0.5950	0.5788	1.1002	1.1002
Standard Deviation	0.0026	0.0819	0.0811	0.0753	0.0787	0.1012	0.0814
FCF							
Mean	-0.0281	-0.1052	-0.0983	-0.0856	-0.0704	-0.0356	-0.0708
Minimum	-4.3529	-7.5348	-9.8871	-5.6999	-6.2921	-4.3722	-9.8871
Maximum	9.9330	3.2036	6.4061	2.0608	2.4406	12.9559	12.9559
Standard Deviation	0.5019	0.4974	0.6858	0.4302	0.4295	0.5055	0.5145

When profit is measured as the return to equity holders, higher return on equity may indicate less agency conflict. Operationally, ROE is obtained by using profit before extraordinary items divided by the average of owners' equity during a given year (e.g., Qi et al., 2000).

Additionally, since a single measure such as ROE may be inadequate, sales growth (GRO) is used to triangulate the important construct of firm performance. Theoretically, ROE is a financial measure that agency theory is more concerned with whereas sales growth represents resource inflows closer to resource dependence theory.

La Porta et al (1999) point out that the central agency problem is the expropriation of minority shareholders by controlling shareholder, which is categorised as a second type of agency problem. China, where both legal enforcement and corporate governance are weak, is no exception (Liu, 2005). Liu states that since more than 78% of listed companies belong to certain groups and have parent firms as the controlling shareholders, parent firms can easily tunnel the firm resources out of the listed entities. Numerous studies illustrate how listed firms' controlling shareholders expropriate the minority shareholders and tunnel firm resources (e.g. Jian & Wong, 2003; Lee & Xiao, 2004; Bai, Liu & Song, 2004).

In a recent study by Jiang et al (2005), the researchers use Other Receivables (ORC) as an indicator of tunnelling and conclude that companies with large ORC balances experience worse future operating performance and are much more likely to become candidate for delisting. In the same way, Cheung et al (2005) obtain data on firms undertaking related party transactions (RPT) with SOEs, and analyze the characteristics of these transactions, and the corporate governance characteristics of the firms undertaking them. Aharony et al (2010) also use receivables – payables due to RPT to proxy tunnelling.

From Table 6.2 below, we can see that the average ROE is 3%, ROA is 4.8%, SOA is 59.6%, ADM is 12.3% during the six year period, and Tobin's Q is 1.35. Q displays a generally declining trend over time since year 2000, which probably reflects a drop in the stock market, or deterioration in firm profitability as suggested by prior literature. This is broadly in line with the figures reported in other studies.

6.3.2.2 Independent Variables

Four types of ownership structure will be picked out for testing – the state (STS), legal person (LPS), managerial (MGS), and foreign (FRS) – which will be measured as the percentage of equity shares at year-end. This is in accordance with many previous studies (e.g., see Xu & Wang, 1999; Wang, 2003). However, the focus is on the first two types of ownerships as it is found in most studies that the latter two do not affect firm performance and in a majority of Chinese listed firms managerial and foreign ownerships are inconsequential. In order to capture the effect of ownership concentration for testing H1b, the percentage of largest shareholding and top 10 shareholdings are also included in the same model, as discussed previously.

Three board characteristics will be used in the study to test their impact on agency costs – the size of the board (Bsize), the composition of the board (Bcom), and the frequency of board meetings (Bmet) – which are all related to the board of directors. In addition, the size regarding supervisory board (SBsize) is also used as a test variable. Previous studies about the function and impact of supervisory board within corporate governance regime mainly focused on the qualitative side and this study will make a breakthrough in obtaining quantitative support as well. Other variables include the size of external auditor (AUD) and dividend payment (DIV) as described in previous sections. A summary of the variables and predicted signs are given in Table 6.3 below:

As mentioned earlier, state and institutional shares are similar yet different. They are similar in that they are owned by different levels of government. They are different in their primary interest in the firm as well as their incentives and ability to monitor management. It is plausible that institutional shareholders have greater incentives and better mechanisms to monitor management. Their interest is more aligned with value maximisation than that of the state, which may have political motives in the firm, such as preserving employment levels (Boycko, Shleifer & Vishny, 1996).

As per Table 6.5, average number of directors on the board is 9 during the six years, and average number of independent directors is less than 3, resulting in the percentage of independent directors being less than 30%. We can also see clearly the big gap between results before and after 2002, when the independent director system was introduced among Chinese listed companies. The percentage of independent directors has been increasing since 2002, with an average being about 46% in 2005. The average number of supervisors displays a stable level of 4 people, normally with some employee representatives and independent supervisors. Board of directors usually meet up 7 times every year, with an average of almost 9 times in 2002 probably due to the introduction of independent director system. Dividend payment is minor.

Table 6.3 Definitions of Independent Variables and Predicted Signs

Group	Variable	Definition	Predicted Sign	
			Performance	Cost
Ownership	STS	Percentage of state shareholdings	-	+
	LGS	Percentage of largest shareholdings	-	+
	TOP10	Percentage of top 10 shareholdings	-	+
	LPS	Percentage of legal person shareholdings	+	-
	MGS	Percentage of managerial shareholdings	+	-
	FRS	Percentage of foreign shareholdings	+	-
Boards	Bsize	Number of directors on the board	-	+
	Bcom	Percentage of independent directors on the board over total number of directors	+	-
	Bmet	Number of board meetings held during the period	+	-
	SBsize	Number of supervisors on the board	+	-
Auditor	AUD	Dummy variable that takes the value of 1 when external auditor is one of the Big Four and the value of 0 otherwise	+	-
Dividend	DIV	Cash dividend payments made during the period	+	-

From the ownership variable table below (Table 6.4), we can see that state shareholding remains significant over time but reveals a decreasing trend from 37% to 32% during the sample period, with an average of 36%. This dominance has not changed significantly however from the trend we can see the direction of economic reform and the wish to improve current situation. Largest shareholding averages at 43%, with the majority being state ownership and legal person ownership, while top 10 shareholdings have an average percentage of 61%. This shows quite a high concentration in the Chinese listed companies and is consistent with the fact that the state still has dominant control. Legal person shares increase through time and stay around 21.8%. Managerial shareholdings are still minor, with an average of 0.01%, although we can see an increasing trend. This probably suggests the fact that improved governance structure gives management team more incentive to pursue company wealth maximisation. Foreign shareholdings stand at 1.75% on average.

Table 6.5 Descriptive Statistics: Other Independent Variables (2000-2005)

YR	2000	2001	2002	2003	2004	2005	Pool
Count	835	971	1053	1114	1156	1215	6344
DIV							
Mean	0.0800	0.0694	0.0668	0.0651	0.0754	0.0689	0.0706
Minimum	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
Maximum	0.7000	0.6600	0.6000	1.0000	1.0000	1.0000	1.0000
Standard Deviation	0.0975	0.0894	0.0946	0.1026	0.1088	0.1140	0.1023
Bsize							
Mean	9.5066	9.4016	9.9259	9.9300	9.8166	8.3597	9.4713
Minimum	5.0000	4.0000	4.0000	5.0000	4.0000	1.0000	1.0000
Maximum	19.0000	19.0000	19.0000	19.0000	19.0000	30.0000	30.0000
Standard Deviation	2.5752	2.5228	2.3114	2.1811	2.2229	3.7752	2.7430
Bcom							
Mean	0.0098	0.0554	0.2360	0.3259	0.3403	0.4644	0.2571
Minimum	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000
Maximum	0.3333	0.5000	0.6667	1.0000	0.6000	1.0000	1.0000
Standard Deviation	0.0437	0.1025	0.0827	0.0632	0.0518	0.2204	0.1953
Bmet							
Mean	5.5401	6.2307	8.6629	7.7316	7.3192	7.4774	7.2442
Minimum	1.0000	1.0000	2.0000	2.0000	2.0000	3.0000	1.0000
Maximum	22.0000	33.0000	34.0000	32.0000	29.0000	30.0000	34.0000
Standard Deviation	2.6206	2.9435	3.1420	3.1763	2.9824	3.0667	3.1594
SBsize							
Mean	4.3293	4.3666	4.2906	4.2899	4.2448	3.1251	4.0757
Minimum	0.0000	2.0000	1.0000	2.0000	1.0000	1.0000	0.0000
Maximum	13.0000	11.0000	10.0000	12.0000	13.0000	16.0000	16.0000
Standard Deviation	1.3809	1.3786	1.3922	1.4516	1.4658	1.6329	1.5328

6.3.2.3 Control Variables

There are also some other control variables, such as the firm size (SIZE) and age (AGE). They are included in the regressions to control for other potential influences on the agency costs of firms. The table below presents their definitions and predicted signs:

Table 6.6 Definitions of Control Variables and Predicted Signs

Variable	Definition	Predicted Sign	
		Performance	Cost
AGE	Number of years after IPO	-	+
SIZE	Natural logarithm of book value of total assets	-	+
LEV	Book value of total liabilities over book value of total assets	+	-
TAN	Net fixed assets over total assets	-	+
GRO	Sales growth rate	+	-
IND	Dummy variable that takes the value of 1 when the company is in one of the six main industries classified by CSRC (manufacturing, conglomerate, transmission, banking/financial industries, real estate/properties, and public utilities) and the value of 0 otherwise	+	-

Firm size is defined as the natural logarithm of book value of total assets. Previous research has found that the size of a firm can affect agency costs in many ways. As in Wang (2003), large firms can exploit economies of scale, and on the other hand, be less efficient because of the loss of control by top managers over strategic and operational activities within the firm. Thus, size can have both positive and negative consequences on agency costs. Size may also be treated as a variable to control for competitive conditions because large firms usually have higher market power in the product market and thus may attain performance that is superior to that of small firms. Moreover, Watts and Zimmerman (1986) suggest that firm size also proxy for political cost because large firms could get more attention from the government, and thus alleviate the agency problem to some extent.

Besides, the number of years after IPO can have a significant effect on firm performance. For example, Aharony, Lee and Wong (2000) show that there is a significant earnings decline pattern post-IPO for a sample of Chinese listed companies. More recently, Chen and Shih (2003) also find the firm's financial performance tends to fall rapidly year after year since their IPO. Whether this is related to agency costs is unpredictable, but certainly, it is reasonable to include them into discussion.

Table 6.7 gives a descriptive summary of all the control variables including listing age, tangibility, firm size, leverage, and annual sales growth rate.

Table 6.7 Descriptive Statistics: Control Variables (2000-2005)

YR	2000	2001	2002	2003	2004	2005	Pool
Count	835	971	1053	1114	1156	1215	6344
AGE							
Mean	11.5501	10.9539	10.6408	10.3204	9.9745	9.3642	10.3862
Minimum	8.0274	7.0082	6.0137	4.9260	3.8329	2.5671	2.5671
Maximum	17.0685	17.0685	17.0685	17.0685	17.0685	17.0685	17.0685
Standard Deviation	2.1061	2.4218	2.6037	2.8195	3.0833	3.4970	2.9225
SIZE							
Mean	20.9306	21.0093	21.0968	21.2072	21.2953	21.3111	21.1581
Minimum	18.5561	18.7842	18.7976	17.9174	18.3241	18.3224	17.9174
Maximum	24.0186	24.7844	26.6324	26.6900	26.8547	26.9782	26.9782
Standard Deviation	0.8323	0.8181	0.8619	0.9019	0.9579	0.9865	0.9121
LEV							
Mean	0.4349	0.4374	0.4570	0.4757	0.4916	0.4965	0.4682
Minimum	0.0091	0.0117	0.0126	0.0108	0.0081	0.0126	0.0081
Maximum	0.9373	0.9211	0.9703	0.9611	0.9626	0.9775	0.9775
Standard Deviation	0.1665	0.1694	0.1725	0.1783	0.1746	0.1784	0.1754
TAN							
Mean	0.2837	0.3030	0.3117	0.3161	0.3251	0.3332	0.3140
Minimum	0.0008	0.0017	0.0008	0.0013	0.0021	0.0014	0.0008
Maximum	0.8762	0.9102	0.9463	0.9643	0.9675	0.9199	0.9675
Standard Deviation	0.1665	0.1694	0.1725	0.1783	0.1746	0.1784	0.1754
GRO							
Mean	0.2417	0.1990	0.2507	0.2893	0.3476	0.2250	0.2611
Minimum	-1.7330	-0.9204	-0.9734	-0.8665	-0.8942	-0.8431	-1.7330
Maximum	6.8502	6.9498	7.1133	20.9020	12.3576	13.5266	20.9020
Standard Deviation	0.6242	0.6215	0.6465	0.8643	0.8830	0.7608	0.7522

We can see from the table above that leverage and tangibility show less fluctuation over the years, while growth varied year on year. I have picked companies that have been listed for at least two years as at 2005 year end to exclude IPO effects as previously discussed. During the sampling period of 2000-2005, China's macroeconomic factors such as interest rates, unemployment rates, and other global economic events differ from year to year. These macro factors may cause time-series effects of ownership on firm value. To control for time series effects, the sample analysis is split based on AGE as well, i.e. regression is run on each year

during the period as well as on the pooled data. Year dummy variables (YR) are also used to the pooled sample firm years. For example, YR00 is the dummy variable for 2000 and equals one for all observations in 2000 and zero otherwise, and so on and so forth.

6.3.2.4 Correlation

A major role of doing such a bi-variate analysis is to see whether the variables have multi-collinearity problems. From Table 6.8, we can see that state shares and legal person shares have a significant negative correlation, which is -0.85. This is the reason why I need to analyse their relationship with agency costs in separate regressions.

In contrast with the hypothesis, we can see that STS is positively related to performance variables and negatively related to cost variables (except for FCF), while LPS is almost the other way round. Ownership concentration works in the same way as STS, which is reasonable because they essentially mean the similar concept.

In consistence with the hypothesis, FRS and MGS are positively correlated with firm performance, as is in previous theoretical and empirical studies, however mostly not significant. Their relationships with cost measurements are positively correlated as predicted.

BOD and supervisory board sizes are positively correlated with performance variables and negatively correlated with cost indicators in most cases, which is contradictory to the hypothesis. Board composition and meeting frequency have mixed results.

AUD and DIV have predicted relationships with the variables. For other control variables, LEV is negatively and significantly correlated with performance measurements due to the unique Chinese background, while SIZE also has mixed results.

More details are presented in Table 6.8 below. The first line next to each variable is the Pearson correlation and the bottom line underneath it shows significance levels (2 tailed). As we can see, mostly the observation significance level is within 0.05, i.e. 5%.

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

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

MGS	.003	.008	.027 (*)	.029 (*)	-.009	-.022	-.001	-.038 (**)	-.006	-.033 (**)	.005	-.013	1	.065 (**)	-.009	.008	.023	-.011	-.018	-.017	-.069 (**)	-.016	-.015	-.027 (*)	.000
	.791	.518	.032	.020	.498	.084	.949	.003	.610	.009	.683	.311		.000	.497	.531	.067	.386	.154	.172	.000	.211	.239	.033	.974
DIV	.120 (**)	.153 (**)	.374 (**)	.454 (**)	-.126 (**)	-.264 (**)	.058 (**)	.101 (**)	-.079 (**)	.191 (**)	.190 (**)	.041 (**)	.065 (**)	1	.113 (**)	.070 (**)	-.020	-.058 (**)	.028 (*)	.003	-.203 (**)	.274 (**)	-.218 (**)	.068 (**)	.059 (**)
	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.000	.001	.000		.000	.000	.110	.000	.025	.786	.000	.000	.000	.000	.000
AUD	.068 (**)	.026 (*)	.078 (**)	.084 (**)	-.026 (*)	-.082 (**)	.013	.024	-.041 (**)	.063 (**)	.131 (**)	.270 (**)	-.009	.113 (**)	1	.068 (**)	.050 (**)	.040 (**)	.039 (**)	.001	.053 (**)	.278 (**)	-.074 (**)	.053 (**)	-.001
	.000	.038	.000	.000	.040	.000	.291	.061	.001	.000	.000	.000	.497	.000		.000	.000	.001	.002	.925	.000	.000	.000	.000	.911
Bsize	-.019	.036 (**)	.049 (**)	.039 (**)	-.038 (**)	-.073 (**)	.011	.084 (**)	-.060 (**)	.007	.067 (**)	.041 (**)	.008	.070 (**)	.068 (**)	1	-.319 (**)	-.011	.268 (**)	-.047 (**)	.003	.168 (**)	.003	.032 (*)	-.005
	.121	.004	.000	.002	.003	.000	.392	.000	.000	.594	.000	.001	.531	.000	.000		.000	.364	.000	.000	.820	.000	.796	.010	.715
Bcom	-.078 (**)	.113 (**)	-.031 (*)	-.038 (**)	-.019	.105 (**)	.005	-.076 (**)	.031 (*)	-.079 (**)	-.017	.039 (**)	.023	-.020	.050 (**)	-.319 (**)	1	.175 (**)	-.195 (**)	.009	-.169 (**)	.125 (**)	.119 (**)	.055 (**)	-.005
	.000	.000	.014	.003	.139	.000	.681	.000	.013	.000	.180	.002	.067	.110	.000	.000		.000	.000	.464	.000	.000	.000	.000	.713
Bmet	-.138 (**)	-.021	-.074 (**)	-.053 (**)	.052 (**)	.142 (**)	-.027 (*)	-.042 (**)	.013	-.064 (**)	-.036 (**)	.019	-.011	-.058 (**)	.040 (**)	-.011	.175 (**)	1	-.030 (*)	-.074 (**)	.017	.052 (**)	.138 (**)	-.081 (**)	.042 (**)
	.000	.101	.000	.000	.000	.000	.034	.001	.286	.000	.004	.132	.386	.000	.001	.364	.000		.018	.000	.173	.000	.000	.000	.001
SBsize	.034 (**)	.016	.030 (*)	.030 (*)	-.042 (**)	-.047 (**)	.012	.143 (**)	-.098 (**)	.064 (**)	.055 (**)	-.003	-.018	.028 (*)	.039 (**)	.268 (**)	-.195 (**)	-.030 (*)	1	.029 (*)	.081 (**)	.098 (**)	-.030 (*)	.063 (**)	-.030 (*)
	.006	.210	.018	.015	.001	.000	.324	.000	.000	.000	.000	.831	.154	.025	.002	.000	.000	.018		.021	.000	.000	.019	.000	.017
IND	.066 (**)	-.162 (**)	.021	.025 (*)	-.020	-.073 (**)	-.024	.030 (*)	-.044 (**)	.070 (**)	.042 (**)	.062 (**)	-.017	.003	.001	-.047 (**)	.009	-.074 (**)	.029 (*)	1	-.042 (**)	.054 (**)	-.041 (**)	.102 (**)	-.013
	.000	.000	.091	.043	.109	.000	.058	.017	.000	.000	.001	.000	.172	.786	.925	.000	.464	.000	.021		.001	.000	.001	.000	.301
AGE	-.160 (**)	.005	-.102 (**)	-.101 (**)	.083 (**)	.110 (**)	.071 (**)	-.146 (**)	.061 (**)	-.183 (**)	-.317 (**)	-.003	-.069 (**)	-.203 (**)	.053 (**)	.003	-.169 (**)	.017	.081 (**)	-.042 (**)	1	-.006	.141 (**)	-.074 (**)	-.033 (**)
	.000	.687	.000	.000	.000	.000	.000	.000	.000	.000	.000	.819	.000	.000	.000	.820	.000	.173	.000	.001		.646	.000	.000	.008
SIZE	-.231 (**)	.131 (**)	.209 (**)	.200 (**)	-.197 (**)	-.173 (**)	.027 (*)	.191 (**)	-.238 (**)	.194 (**)	.079 (**)	.159 (**)	-.016	.274 (**)	.278 (**)	.168 (**)	.125 (**)	.052 (**)	.098 (**)	.054 (**)	-.006	1	.173 (**)	.131 (**)	.015
	.000	.000	.000	.000	.000	.000	.034	.000	.000	.000	.000	.000	.211	.000	.000	.000	.000	.000	.000	.000	.646		.000	.000	.231
LEV	-.776 (**)	.122 (**)	-.236 (**)	-.237 (**)	.044 (**)	.201 (**)	-.058 (**)	-.058 (**)	.042 (**)	-.127 (**)	-.111 (**)	-.037 (**)	-.015	-.218 (**)	-.074 (**)	.003	.119 (**)	.138 (**)	-.030 (*)	-.041 (**)	.141 (**)	.173 (**)	1	-.083 (**)	.089 (**)
	.000	.000	.000	.000	.000	.000	.000	.000	.001	.000	.000	.003	.239	.000	.000	.796	.000	.000	.019	.001	.000	.000		.000	.000
TAN	.124 (**)	-.065 (**)	.029 (*)	.056 (**)	-.008	-.173 (**)	.062 (**)	.122 (**)	-.094 (**)	.093 (**)	.096 (**)	.071 (**)	-.027 (*)	.068 (**)	.053 (**)	.032 (*)	.055 (**)	-.081 (**)	.063 (**)	.102 (**)	-.074 (**)	.131 (**)	-.083 (**)	1	-.040 (**)
	.000	.000	.019	.000	.507	.000	.000	.000	.000	.000	.000	.000	.033	.000	.000	.010	.000	.000	.000	.000	.000	.000	.000		.002
GRO	-.104 (**)	.148 (**)	.187 (**)	.182 (**)	-.130 (**)	-.065 (**)	.047 (**)	-.045 (**)	.032 (*)	-.026 (*)	.007	.025 (*)	.000	.059 (**)	-.001	-.005	-.005	.042 (**)	-.030 (*)	-.013	-.033 (**)	.015	.089 (**)	-.040 (**)	1
	.000	.000	.000	.000	.000	.000	.000	.000	.011	.038	.589	.048	.974	.000	.911	.715	.713	.001	.017	.301	.008	.231	.000	.002	

Table 6.8 Pearson Correlation (6344 Observations for 2000-2005)

	Q	SOA	ROE	ROA	ADM	ORC	FCF	STS	LPS	LGS	TOP10	FRS	MGS	DIV	AUD	Bsize	Bcom	Bmet	SBsize	IND	AGE	SIZE	LEV	TAN	GRO
Q	1	-.106 (**) .000	.089 (**) .000	.098 (**) .000	.020 .116	-.103 (**) .000	.060 (**) .000	.271 (**) .000	-.133 (**) .000	.358 (**) .000	.371 (**) .000	.085 (**) .000	.003 .791	.120 (**) .000	.068 (**) .000	-.019 .121	-.078 (**) .000	-.138 (**) .000	.034 (**) .006	.066 (**) .000	-.160 (**) .000	-.231 (**) .000	-.776 (**) .000	.124 (**) .000	-.104 (**) .000
SOA	-.106 (**) .000	1	.188 (**) .000	.176 (**) .000	-.228 (**) .000	-.134 (**) .000	.108 (**) .000	.043 (**) .001	-.032 (*) .010	.083 (**) .000	.079 (**) .000	.014 .266	.008 .518	.153 (**) .000	.026 (*) .038	.036 (**) .004	.113 (**) .000	-.021 .101	.016 .210	-.162 (**) .000	.005 .687	.131 (**) .000	.122 (**) .000	-.065 (**) .000	.148 (**) .000
ROE	.089 (**) .000	.188 (**) .000	1	.804 (**) .000	-.439 (**) .000	-.402 (**) .000	.084 (**) .000	.053 (**) .000	-.030 (*) .016	.121 (**) .000	.140 (**) .000	.024 .054	.027 (*) .032	.374 (**) .000	.078 (**) .000	.049 (**) .000	-.031 (*) .014	-.074 (**) .000	.030 (*) .018	.021 .091	-.102 (**) .000	.209 (**) .000	-.236 (**) .000	.029 (*) .019	.187 (**) .000
ROA	.098 (**) .000	.176 (**) .000	.804 (**) .000	1	-.399 (**) .000	-.379 (**) .000	.116 (**) .000	.070 (**) .000	-.051 (**) .000	.131 (**) .000	.148 (**) .000	.019 .129	.029 (*) .020	.454 (**) .000	.084 (**) .000	.039 (**) .002	-.038 (**) .003	-.053 (**) .000	.030 (*) .015	.025 (*) .043	-.101 (**) .000	.200 (**) .000	-.237 (**) .000	.056 (**) .000	.182 (**) .000
ADM	.020 .116	-.228 (**) .000	-.439 (**) .000	-.399 (**) .000	1	.246 (**) .000	-.101 (**) .000	-.080 (**) .000	.074 (**) .000	-.095 (**) .000	-.057 (**) .000	.004 .739	-.009 .498	-.126 (**) .000	-.026 (*) .040	-.038 (**) .003	-.019 .139	.052 (**) .000	-.042 (**) .001	-.020 .109	.083 (**) .000	-.197 (**) .000	.044 (**) .000	-.008 .507	-.130 (**) .000
ORC	-.103 (**) .000	-.134 (**) .000	-.402 (**) .000	-.379 (**) .000	.246 (**) .000	1	-.043 (**) .001	-.112 (**) .000	.105 (**) .000	-.155 (**) .000	-.109 (**) .000	-.035 (**) .006	-.022 .084	-.264 (**) .000	-.082 (**) .000	-.073 (**) .000	.105 (**) .000	.142 (**) .000	-.047 (**) .000	-.073 (**) .000	.110 (**) .000	-.173 (**) .000	.201 (**) .000	-.173 (**) .000	-.065 (**) .000
FCF	.060 (**) .000	.108 (**) .000	.084 (**) .000	.116 (**) .000	-.101 (**) .000	-.043 (**) .001	1	.048 (**) .000	-.033 (**) .008	.036 (**) .004	.047 (**) .000	.020 .118	-.001 .949	.058 (**) .000	.013 .291	.011 .392	.005 .681	-.027 (*) .034	.012 .324	-.024 .058	.071 (**) .000	.027 (*) .034	-.058 (**) .000	.062 (**) .000	.047 (**) .000
STS	.271 (**) .000	.043 (**) .001	.053 (**) .000	.070 (**) .000	-.080 (**) .000	-.112 (**) .000	.048 (**) .000	1	-.853 (**) .000	.594 (**) .000	.404 (**) .000	-.077 (**) .000	-.038 (**) .003	.101 (**) .000	.024 .061	.084 (**) .000	-.076 (**) .000	-.042 (**) .001	.143 (**) .000	.030 (*) .017	-.146 (**) .000	.191 (**) .000	-.058 (**) .000	.122 (**) .000	-.045 (**) .000
LPS	-.133 (**) .000	-.032 (*) .010	-.030 (*) .016	-.051 (**) .000	.074 (**) .000	.105 (**) .000	-.033 (**) .008	-.853 (**) .000	1	-.352 (**) .000	-.059 (**) .000	-.060 (**) .000	-.006 .610	-.079 (**) .000	-.041 (**) .001	-.060 (**) .000	.031 (*) .013	.013 .286	-.098 (**) .000	-.044 (**) .000	.061 (**) .000	-.238 (**) .000	.042 (**) .001	-.094 (**) .000	.032 (*) .011
LGS	.358 (**) .000	.083 (**) .000	.121 (**) .000	.131 (**) .000	-.095 (**) .000	-.155 (**) .000	.036 (**) .004	.594 (**) .000	-.352 (**) .000	1	.590 (**) .000	-.046 (**) .000	-.033 (**) .009	.191 (**) .000	.063 (**) .000	.007 .594	-.079 (**) .000	-.064 (**) .000	.064 (**) .000	.070 (**) .000	-.183 (**) .000	.194 (**) .000	-.127 (**) .000	.093 (**) .000	-.026 (*) .038
TOP10	.371 (**) .000	.079 (**) .000	.140 (**) .000	.148 (**) .000	-.057 (**) .000	-.109 (**) .000	.047 (**) .000	.404 (**) .000	-.059 (**) .000	.590 (**) .000	1	.268 (**) .000	.005 .683	.190 (**) .000	.131 (**) .000	.067 (**) .000	-.017 .180	-.036 (**) .004	.055 (**) .000	.042 (**) .001	-.317 (**) .000	.079 (**) .000	-.111 (**) .000	.096 (**) .000	.007 .589
FRS	.085 (**) .000	.014 .266	.024 .054	.019 .129	.004 .739	-.035 (**) .006	.020 .118	-.077 (**) .000	-.060 (**) .000	-.046 (**) .000	.268 (**) .000	1	-.013 .311	.041 (**) .001	.270 (**) .000	.041 (**) .001	.039 (**) .002	.019 .132	-.003 .831	.062 (**) .000	-.003 .819	.159 (**) .000	-.037 (**) .003	.071 (**) .000	.025 (*) .048

6.4 Methodology and Empirical Results

6.4.1 Model

I will use pooled OLS regressions to explain variations in Q as a function of aforementioned corporate governance (CG) mechanisms. OLS regressions are a common technique used for data analysis in the financial world. The procedure has strong theoretical justification if a few assumptions made about how the data are generated are met. The dependent variable describes some causal or behavioural process. The independent variables play the role of experimental or treatment variables. The error term captures the effects of all omitted variables.

There is one set of assumptions, known as the Gauss-Markov assumptions, which are sufficient to guarantee that ordinary regression estimates will have good properties. First assumption is that the errors ε has an expected value of zero. This means that on average the errors balance out. Second assumption is that the independent variables are non-random, i.e. the independent variables will in fact be independent of the disturbance and have finite variances. Third assumption is that the independent variables are linearly independent, i.e., no independent variable can be expressed as a (non-zero) linear combination of the remaining independent variables. The failure of this assumption, known as multicollinearity, makes it infeasible to disentangle the effects of the supposedly independent variables. State shareholdings and legal persons will be examined in separate equations for their high correlation to avoid potential multicollinearity. The ownership concentration effect will also be investigated.

The regression equations are as follows:

(1)

$$Q = \alpha_0 + \alpha_1 STS + \alpha_2 STS^2 + \alpha_3 Bsize + \alpha_4 Bcom + \alpha_5 Bmet + \alpha_6 SBsize + \alpha_7 AUD + \alpha_8 DIV + \alpha_9 CON + \varepsilon$$

(2)

$$Q = \beta_0 + \beta_1 LPS + \beta_2 LPS^2 + \beta_3 Bsize + \beta_4 Bcom + \beta_5 Bmet + \beta_6 SBsize + \beta_7 AUD + \beta_8 DIV + \beta_9 CON + \varepsilon$$

CON contains all the control variables including LGS, TOP10, MGS, FRS, SIZE, AGE, LEV, TAN, GRO, and IND. About the control variables (indicated by CON in the equations), we argue that the bigger the firm, the more severe the agency problem thus poorer performance, hence the sign is expected negative. Leverage affects firm performance in several ways. Morck et al (1998) discuss tax shields and report a positive relationship between leverage and performance. In China, Qi et al (2000) and Sun and Tong (2003) also find a positive impact of leverage on market-to-book-value ratio of the firm. Tangibility is included to control for capital market influences and managerial decisions (Wiwattanakantang, 1999), and we predict a negative sign as in Tian (2001), while growth is expected to be a positive sign of firm performance.

6.4.2 CG Mechanisms and Q

First, by using an ordinary least square (OLS) regression I conduct tests that consider the relation between various CG mechanisms and firm performance. As there might be potential heteroskedasticity and serial correlation of residuals problems, Newey and West (1987) have proposed a covariance estimator that is consistent in the presence of both heteroskedasticity and autocorrelation of unknown form, and thus the Newey-West method is used for the estimation.

VIF for the variables ranges from 1.01 to 3.08, which is way below the rule of thumb value of 10,[42] hence indicating unlikely multicollinearity. The only exception is STS and STS^2 because they are obviously highly related. However if we exclude STS^2 from the regression, the results are very similar and the VIF for STS is around 3.

The regression results are presented in Table 6.9 below. The first line next to each variable is the standardised beta values, and the line underneath it (of the italic numbers) is the t significance level.[43] At the bottom of the table Adjusted R^2, Durbin-Watson test, and F test values (suggesting the models are all significant) are also presented. To save space, the statistics for constants are not presented. This applies to Tables 6.9 to 6.14 in the following sections.

[42]Kutner, Nachtsleim, Neter (2004) "Applied Linear Regression Models", 4th Edition, McGraw-Hill

[43]In Tables 6.9 to 6.14, * means significant at 10%, ** at 5%, and *** at 1%.

Table 6.9 Tobin's Q and CG Mechanisms with STS

Q	2000	2001	2002	2003	2004	2005	Pool
STS	-0.09*	-0.01	-0.02	-0.04	-0.11**	-0.06	-0.07***
Sig (1 tailed)	*0.08*	*0.41*	*0.37*	*0.25*	*0.02*	*0.13*	*0.00*
STS^2	0.25***	0.17**	0.18**	0.22***	0.27***	0.16***	0.22***
Sig (2 tailed)	*0.00*	*0.02*	*0.01*	*0.00*	*0.00*	*0.01*	*0.00*
LGS	0.21***	0.17***	0.13***	0.09***	0.09***	0.07***	0.12***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TOP10	0.13***	0.18***	0.17***	0.17***	0.14***	0.15***	0.16***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
FRS	0.09***	0.07***	0.08***	0.06***	0.05***	0.04***	0.06***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.01*	*0.00*
MGS	0.00	0.01	0.01	0.00	0.01	-0.02*	0.01
Sig (1 tailed)	*0.42*	*0.26*	*0.35*	*0.48*	*0.29*	*0.06*	*0.17*
DIV	-0.05***	-0.07***	-0.03**	-0.03**	-0.05***	-0.08***	-0.06***
Sig (1 tailed)	*0.00*	*0.00*	*0.03*	*0.04*	*0.00*	*0.00*	*0.00*
AUD	-0.01	0.00	0.03**	0.04***	0.04***	0.03**	0.02***
Sig (1 tailed)	*0.37*	*0.40*	*0.03*	*0.01*	*0.00*	*0.04*	*0.00*
Bsize	0.00	0.01	0.00	0.01	0.00	0.04**	0.01**
Sig (1 tailed)	*0.43*	*0.21*	*0.43*	*0.33*	*0.46*	*0.04*	*0.04*
Bcom	-0.02	0.00	-0.02	-0.01	-0.02*	0.04*	0.06***
Sig (1 tailed)	*0.12*	*0.48*	*0.17*	*0.17*	*0.10*	*0.05*	*0.00*
Bmet	0.00	-0.03*	-0.02	-0.02	-0.02*	0.00	-0.02***
Sig (1 tailed)	*0.46*	*0.05*	*0.15*	*0.11*	*0.07*	*0.43*	*0.00*
SBsize	0.02	0.01	0.02	0.01	0.01	-0.01	0.00
Sig (1 tailed)	*0.21*	*0.36*	*0.13*	*0.36*	*0.22*	*0.18*	*0.45*
IND	0.02	0.02*	0.03*	0.03**	0.02*	-0.02*	0.02***
Sig (1 tailed)	*0.20*	*0.08*	*0.06*	*0.02*	*0.06*	*0.09*	*0.00*
AGE	0.02	0.03*	0.02	0.03**	-0.01	0.17***	0.04***
Sig (1 tailed)	*0.15*	*0.07*	*0.15*	*0.02*	*0.19*	*0.00*	*0.00*
SIZE	-0.13***	-0.15***	-0.20***	-0.22***	-0.22***	-0.23***	-0.19***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	-0.68***	-0.70***	-0.67***	-0.70***	-0.71***	-0.76***	-0.71***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	0.04**	0.02	0.03**	0.02*	0.04***	0.07***	0.04***
Sig (1 tailed)	*0.02*	*0.12*	*0.02*	*0.07*	*0.01*	*0.00*	*0.00*
GRO	-0.05***	-0.01	-0.07***	0.01	-0.03**	0.01	-0.02***
Sig (1 tailed)	*0.00*	*0.18*	*0.00*	*0.20*	*0.03*	*0.29*	*0.00*
Adjusted R^2	0.74	0.76	0.74	0.76	0.75	0.77	0.75
Durbin-Watson	1.95	1.88	1.84	1.87	1.84	1.87	1.83
F Statistics	136.11	168.68	167.16	198.13	197.97	222.36	1038.20

From the table above, we can see an insignificant negative relationship between STS and Q throughout four of the six years. Interestingly enough, LGS and TOP10 have positive relationships with Q. The coefficients for STS^2 are all significantly positive, suggesting a U shape relationship, which is consistent with some prior studies.

Throughout all six years, FRS has significant positive relationship with performance and this is in consistency with the hypothesis. MGS also has consistent positive relationship with performance however the results are insignificant. This is probably due to their portion of shareholdings being too small to influence the firm operation.

AUD only seems to work after 2002. From the case study, we know that the independency of external auditors has been improving especially after the capital market scandals both worldwide and in China. Big Four enter the Chinese market by establishing joint ventures with local accounting firms for protectionism, and hence in early years their independence is largely influenced by local government. With large SOEs and their listed subsidiaries being strategically important to the local government, the quality of audit and appropriateness of disclosure are both subject to scepticism. The introduction of independent directors in 2002 has brought in more professional knowledge and expertise in the board so that sub committees are established, e.g. audit committee, to work with professional bodies to help develop effective governance mechanisms, and hence it is expected to function better.

As other variables are concerned, the sizes of the boards broadly have positive yet insignificant relationships with performance. The presence of independent directors did not work effectively in affecting performance. According to some of the interviewees, there are limited qualified independent directors out in the resource market in China. Size is negatively related to Q, which is consistent with the prediction. TAN is positively related while GRO has mixed results. One of the explanations for tangibility impact is that when companies invest cash in fixed assets the level of free cash flow for management is reduced hence agency costs. The adjusted R^2 statistics show that the independent variables combined can explain a substantial amount of the variation in firm performance, which is about 75%.

Unlike our prediction, the relationship between legal person ownership and firm performance is also negative and significant. This shows that state shares and legal person shares behave similarly sometimes, as many of the legal entities are owned fully or partially by different levels of government. LPS^2 also shows a similar U shape relationship. However, FRS has now only shown significant and positive signs in affecting performance in four out of the six years.

Dividend payment remains negatively and significantly related, while AUD is again positively related after 2002, due to the same reason as before, i.e. introduction of independent directorship system.

The adjusted R^2 is again 74% for the pooled samples, which means that the independent variables can well explain the variation of firm performance.

6.4.3 CG Mechanisms and Other Performance Indicators

The above section uses Tobin's Q to measure firm performance. Considering that Tobin's Q is a proxy for investment opportunities and is forward looking in that market value is a reflection of future operations (Wei et al, 2005), we may want to use some other proxies that are backward looking and computed using historical accounting data.

As discussed in the previous sections and in many other commonly conducted studies, SOA, ROE, and ROA are used as alternative performance measurements. I repeat the regressions in equations (1) and (2), and report the results as follows.

Table 6.11 Performance Indicators and CG Mechanisms with STS

Table 6.10 Tobin's Q and CG Mechanisms with LPS

Q	2000	2001	2002	2003	2004	2005	Pool
LPS	-0.33***	-0.33***	-0.29***	-0.24***	-0.29***	-0.02***	-0.22***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.37*	*0.00*
LPS^2	0.23***	0.22***	0.18***	0.11*	0.18***	0.09	0.14***
Sig (2 tailed)	*0.00*	*0.00*	*0.01*	*0.07*	*0.00*	*0.12*	*0.00*
LGS	0.21***	0.15***	0.13***	0.10***	0.10***	0.12***	0.15***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TOP10	0.20***	0.25***	0.23***	0.25***	0.20***	0.15***	0.21***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
FRS	0.06***	0.04**	0.04***	0.01	0.01	0.03**	0.03***
Sig (1 tailed)	*0.00*	*0.02*	*0.01*	*0.22*	*0.28*	*0.02*	*0.00*
MGS	-0.01	0.01	0.01	-0.01	0.00	-0.03**	0.00
Sig (1 tailed)	*0.38*	*0.28*	*0.37*	*0.34*	*0.41*	*0.03*	*0.42*
DIV	-0.05***	-0.07***	-0.04**	-0.03**	-0.05***	-0.08***	-0.06***
Sig (1 tailed)	*0.00*	*0.00*	*0.01*	*0.02*	*0.00*	*0.00*	*0.00*
AUD	-0.01	-0.01	0.03*	0.04***	0.04***	0.03*	0.02***
Sig (1 tailed)	*0.32*	*0.30*	*0.06*	*0.01*	*0.00*	*0.05*	*0.01*
Bsize	-0.01	0.01	0.00	0.01	0.00	0.05***	0.01*
Sig (1 tailed)	*0.34*	*0.30*	*0.43*	*0.36*	*0.48*	*0.01*	*0.05*
Bcom	-0.03*	0.00	-0.01	-0.01	-0.02	0.04**	0.06***
Sig (1 tailed)	*0.08*	*0.45*	*0.24*	*0.17*	*0.12*	*0.03*	*0.00*
Bmet	0.00	-0.03**	-0.02	-0.02	-0.02*	0.00	-0.02***
Sig (1 tailed)	*0.44*	*0.04*	*0.14*	*0.10*	*0.06*	*0.49*	*0.00*
SBsize	0.02	0.01	0.02	0.01	0.02	-0.02	0.00
Sig (1 tailed)	*0.16*	*0.30*	*0.10*	*0.30*	*0.13*	*0.15*	*0.26*
IND	0.01	0.02*	0.02*	0.03**	0.02*	-0.01	0.02***
Sig (1 tailed)	*0.21*	*0.09*	*0.08*	*0.04*	*0.08*	*0.19*	*0.00*
AGE	0.02	0.03*	0.02	0.03**	-0.01	0.17***	0.04***
Sig (1 tailed)	*0.19*	*0.07*	*0.16*	*0.02*	*0.27*	*0.00*	*0.00*
SIZE	-0.12***	-0.14***	-0.19***	-0.21***	-0.22***	-0.22***	-0.18***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	-0.67***	-0.70***	-0.67***	-0.70***	-0.71***	-0.76***	-0.71***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	0.04***	0.02*	0.04**	0.03**	0.04***	0.08***	0.04***
Sig (1 tailed)	*0.01*	*0.07*	*0.01*	*0.05*	*0.01*	*0.00*	*0.00*
GRO	-0.06***	-0.02	-0.07***	0.01	-0.03**	0.00	-0.03***
Sig (1 tailed)	*0.00*	*0.17*	*0.00*	*0.24*	*0.03*	*0.38*	*0.00*
Adjusted R^2	0.74	0.76	0.74	0.76	0.75	0.76	0.74
Durbin-Watson	1.95	1.90	1.85	1.86	1.84	1.85	1.84
F Statistics	135.12	169.99	166.36	197	196.2	220.35	1007.44

Panel A: SOA and CG Mechanisms with STS

SOA	2000	2001	2002	2003	2004	2005	Pool
STS	0.12	0.30***	0.26***	0.18**	0.16*	0.11	0.18***
Sig (1 tailed)	*0.16*	*0.01*	*0.01*	*0.04*	*0.07*	*0.15*	*0.00*
STS^2	-0.12	-0.36***	-0.34***	-0.22*	-0.19	-0.13	-0.22***
Sig (2 tailed)	*0.37*	*0.01*	*0.01*	*0.07*	*0.11*	*0.26*	*0.00*
LGS	0.09*	0.18***	0.17***	0.10**	0.11***	0.06*	0.11***
Sig (1 tailed)	*0.05*	*0.00*	*0.00*	*0.01*	*0.00*	*0.05*	*0.00*
TOP10	0.03	0.04	0.09**	0.08**	0.04	0.07**	0.06***
Sig (1 tailed)	*0.27*	*0.19*	*0.02*	*0.02*	*0.18*	*0.03*	*0.00*
FRS	0.05	-0.02	-0.01	0.02	0.02	-0.03	0.00
Sig (1 tailed)	*0.11*	*0.33*	*0.38*	*0.29*	*0.28*	*0.15*	*0.40*
MGS	0.07**	0.03	0.02	-0.02	0.00	-0.03	0.00
Sig (1 tailed)	*0.02*	*0.18*	*0.30*	*0.28*	*0.49*	*0.14*	*0.41*
DIV	0.06**	0.18***	0.17***	0.21***	0.21***	0.09***	0.15***
Sig (1 tailed)	*0.04*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AUD	0.02	0.04	-0.03	-0.03	-0.03	-0.03	-0.02*
Sig (1 tailed)	*0.31*	*0.12*	*0.16*	*0.16*	*0.21*	*0.17*	*0.09*
Bsize	0.04	0.07**	0.05*	0.03	0.01	0.05	0.05***
Sig (1 tailed)	*0.14*	*0.02*	*0.09*	*0.18*	*0.40*	*0.11*	*0.00*
Bcom	-0.03	0.01	0.01	0.08***	0.02	0.07**	0.15***
Sig (1 tailed)	*0.24*	*0.32*	*0.41*	*0.00*	*0.20*	*0.04*	*0.00*
Bmet	-0.11***	-0.03	-0.06**	-0.08***	-0.06**	-0.07**	-0.07***
Sig (1 tailed)	*0.00*	*0.19*	*0.02*	*0.00*	*0.01*	*0.01*	*0.00*
SBsize	0.07**	0.04*	0.04*	0.05*	0.06**	0.02	0.03**
Sig (1 tailed)	*0.03*	*0.08*	*0.08*	*0.05*	*0.03*	*0.22*	*0.02*
IND	-0.20***	-0.18***	-0.17***	-0.18***	-0.15***	-0.14***	-0.16***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AGE	0.00	0.04	0.11***	0.12***	0.10***	0.07**	0.06***
Sig (1 tailed)	*0.46*	*0.11*	*0.00*	*0.00*	*0.00*	*0.01*	*0.00*
SIZE	0.07**	0.01	0.05*	0.01	0.03	0.08***	0.05***
Sig (1 tailed)	*0.03*	*0.42*	*0.07*	*0.36*	*0.17*	*0.01*	*0.00*
LEV	0.08***	0.09***	0.15***	0.14***	0.14***	0.08***	0.12***
Sig (1 tailed)	*0.01*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	-0.01	-0.05*	-0.09***	-0.08***	-0.10***	-0.11***	-0.07***
Sig (1 tailed)	*0.38*	*0.07*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
GRO	0.22***	0.12***	0.14***	0.11***	0.06**	0.21***	0.13***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.02*	*0.00*	*0.00*
Adjusted R^2	0.13	0.11	0.14	0.13	0.10	0.11	0.13
Durbin-Watson	1.96	1.91	1.96	1.95	2.01	2.00	1.97
F Statistics	7.70	7.61	10.41	9.84	8.29	9.25	51.36

Panel C: ROA and CG Mechanisms with STS

ROA	2000	2001	2002	2003	2004	2005	Pool
STS	-0.11	0.01	0.04	-0.03	0.03	-0.01	-0.01
Sig (1 tailed)	*0.17*	*0.48*	*0.34*	*0.36*	*0.37*	*0.47*	*0.44*
STS^2	0.11	-0.04	-0.06	-0.02	-0.06	0.00	-0.01
Sig (2 tailed)	*0.40*	*0.76*	*0.62*	*0.87*	*0.55*	*0.99*	*0.75*
LGS	-0.02	-0.04	-0.02	0.00	0.00	-0.07**	-0.03**
Sig (1 tailed)	*0.33*	*0.19*	*0.36*	*0.49*	*0.47*	*0.02*	*0.03*
TOP10	0.02	0.10**	0.07*	0.09***	0.14***	0.11***	0.10***
Sig (1 tailed)	*0.33*	*0.01*	*0.05*	*0.01*	*0.00*	*0.00*	*0.00*
FRS	-0.04	-0.04*	-0.03	-0.06**	-0.07***	-0.09***	-0.06***
Sig (1 tailed)	*0.15*	*0.08*	*0.16*	*0.02*	*0.01*	*0.00*	*0.00*
MGS	0.04	0.01	0.00	-0.02	0.02	0.02	0.01
Sig (1 tailed)	*0.10*	*0.39*	*0.49*	*0.26*	*0.21*	*0.22*	*0.32*
DIV	0.28***	0.35***	0.30***	0.35***	0.39***	0.38***	0.36***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AUD	-0.05*	-0.04*	-0.01	0.01	0.02	0.01	-0.01
Sig (1 tailed)	*0.05*	*0.06*	*0.36*	*0.35*	*0.29*	*0.34*	*0.30*
Bsize	-0.04	0.00	0.01	0.01	-0.01	-0.03	-0.02**
Sig (1 tailed)	*0.13*	*0.48*	*0.38*	*0.36*	*0.35*	*0.20*	*0.04*
Bcom	0.00	0.06**	0.05*	0.04*	0.11***	-0.03	-0.03**
Sig (1 tailed)	*0.47*	*0.02*	*0.05*	*0.06*	*0.00*	*0.25*	*0.02*
Bmet	0.03	0.08***	0.00	-0.03*	-0.01	-0.02	-0.01
Sig (1 tailed)	*0.16*	*0.00*	*0.49*	*0.09*	*0.28*	*0.18*	*0.12*
SBsize	0.02	0.04*	0.00	0.02	-0.02	0.01	0.00
Sig (1 tailed)	*0.30*	*0.07*	*0.46*	*0.28*	*0.18*	*0.41*	*0.42*
IND	0.00	-0.03	0.02	0.06**	-0.01	0.01	0.01
Sig (1 tailed)	*0.46*	*0.17*	*0.22*	*0.01*	*0.36*	*0.33*	*0.14*
AGE	0.00	-0.01	0.02	0.03	0.07***	-0.03	0.02**
Sig (1 tailed)	*0.45*	*0.32*	*0.23*	*0.11*	*0.01*	*0.12*	*0.02*
SIZE	0.12***	0.11***	0.17***	0.15***	0.13***	0.19***	0.15***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	-0.28***	-0.20***	-0.20***	-0.18***	-0.17***	-0.19***	-0.20***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	-0.12***	0.00	0.01	0.04*	0.05**	0.05**	0.00
Sig (1 tailed)	*0.00*	*0.44*	*0.38*	*0.09*	*0.02*	*0.02*	*0.33*
GRO	0.19***	0.25***	0.27***	0.16***	0.13***	0.14***	0.18***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Adjusted R^2	0.24	0.29	0.28	0.28	0.30	0.31	0.28
Durbin-Watson	1.99	2.08	1.94	2.02	2.06	1.97	1.98
F Statistics	15.82	22.74	23.50	24.49	28.49	31.56	134.78

Panel B: ROE and CG Mechanisms with STS

ROE	2000	2001	2002	2003	2004	2005	Pool
STS	-0.03	0.04	0.14*	0.00	0.08	0.03	0.04
Sig (1 tailed)	*0.41*	*0.36*	*0.08*	*0.50*	*0.19*	*0.38*	*0.16*
STS^2	0.06	-0.08	-0.19*	-0.12	-0.16	-0.10	-0.10**
Sig (2 tailed)	*0.62*	*0.49*	*0.10*	*0.30*	*0.13*	*0.32*	*0.03*
LGS	-0.05	-0.09**	0.00	0.04	0.01	-0.02	-0.01
Sig (1 tailed)	*0.19*	*0.03*	*0.46*	*0.16*	*0.36*	*0.32*	*0.21*
TOP10	0.03	0.15***	0.09**	0.12***	0.14***	0.11***	0.11***
Sig (1 tailed)	*0.23*	*0.00*	*0.02*	*0.00*	*0.00*	*0.00*	*0.00*
FRS	-0.01	-0.07***	-0.02	-0.07**	-0.09***	-0.09***	-0.06***
Sig (1 tailed)	*0.39*	*0.01*	*0.22*	*0.02*	*0.00*	*0.00*	*0.00*
MGS	0.04	-0.01	0.01	-0.01	0.02	0.03	0.01
Sig (1 tailed)	*0.12*	*0.35*	*0.42*	*0.37*	*0.28*	*0.11*	*0.30*
DIV	0.19***	0.27***	0.22***	0.23***	0.29***	0.26***	0.25***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AUD	-0.05*	-0.03	-0.03	-0.01	0.00	-0.02	-0.02*
Sig (1 tailed)	*0.07*	*0.15*	*0.18*	*0.40*	*0.49*	*0.22*	*0.08*
Bsize	-0.07**	0.02	0.05*	0.03	0.00	0.01	-0.01
Sig (1 tailed)	*0.02*	*0.30*	*0.07*	*0.15*	*0.48*	*0.41*	*0.29*
Bcom	0.01	0.09***	0.04*	0.06**	0.09***	0.03	-0.02
Sig (1 tailed)	*0.33*	*0.00*	*0.08*	*0.02*	*0.00*	*0.20*	*0.11*
Bmet	-0.01	0.05**	-0.03	-0.05**	-0.04*	-0.07***	-0.04***
Sig (1 tailed)	*0.37*	*0.04*	*0.16*	*0.03*	*0.06*	*0.00*	*0.00*
SBsize	0.03	0.00	-0.02	0.01	0.00	0.01	0.00
Sig (1 tailed)	*0.17*	*0.49*	*0.20*	*0.37*	*0.44*	*0.32*	*0.43*
IND	-0.04	-0.06**	0.01	0.04*	0.02	0.03	0.00
Sig (1 tailed)	*0.12*	*0.02*	*0.32*	*0.09*	*0.24*	*0.12*	*0.34*
AGE	-0.01	0.00	0.03	0.02	-0.01	-0.04	0.01
Sig (1 tailed)	*0.34*	*0.49*	*0.15*	*0.23*	*0.37*	*0.11*	*0.28*
SIZE	0.21***	0.14***	0.25***	0.19***	0.22***	0.21***	0.21***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	-0.31***	-0.22***	-0.28***	-0.20***	-0.17***	-0.22***	-0.23***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	-0.06**	0.01	-0.08***	-0.01	0.00	0.01	-0.03***
Sig (1 tailed)	*0.02*	*0.34*	*0.00*	*0.41*	*0.47*	*0.33*	*0.01*
GRO	0.23***	0.24***	0.25***	0.18***	0.15***	0.16***	0.19***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Adjusted R^2	0.24	0.24	0.28	0.21	0.25	0.22	0.23
Durbin-Watson	1.94	2.04	1.93	2.04	2.07	1.89	1.97
F Statistics	15.47	17.97	23.47	17.38	22.63	20.56	107.59

We can see from the tables in 6.11 that the signs for STS are contradictory between Q and SOA as well as ROE. The quadratic variables have insignificant coefficients for most of the years. According to interviewees from the SDG group, Chinese officials attach more importance to ROE when considering listing and de-listing requirements, and therefore the figure is more likely subject to manipulation, especially with large SOEs. For example, they can change equity figure easily by obtaining "free capital" from the equity market by new or rights issues, because there is not much pressure of dividend from shareholders who are majorly state shares. Therefore, ROE might be a less attractive variable to be considered. It is also worth mentioning here that among the three alternative measurements, ROA has the highest adjusted R^2 of 28%.

For most of the years in the sample period, FRS and MGS have negative impact on firm performance, especially when proxied by ROE and ROA, while the impact is inconsequential due to their relatively small fraction.

Strangely enough, board size does not influence firm performance significantly, while increasing percentage of independent directors in some years negatively affect firm performance (especially when SOA is used). Theoretically, the independence of the board will increase supervision ability of the management (John & Senbet, 1998). However, most studies on the relationship between board independence and firm performance do not find any significant results (e.g., Hermalin & Weisbah, 1991; Mehran & Klein, 1998; and Bhagat & Black, 2001). From the case study, I can partly explain this. We know that independent directors in Chinese listed companies are not entirely independent, hence hindering their ability to carry out impartial supervision of management and operation of the business. Another fact is that some independent directors carry out too many duties at the same time (e.g., being business owner and/or independent director for many companies simultaneously) merely to gain material for personal resume and reputation, rather than having the time and incentive to actually participate in company supervision. This is evidenced by the statistical data that their attendance to board meetings is sometimes poor.

Frequency of board meetings has negative impact on firm performance, with contradictory result to original prediction. This corresponds to the comments from the case study interviewees in that boards tend to meet up when there are issues with the company operations and controls.

DIV is significantly and positively related to firm performance except for Q. This is consistent with the literature and our prediction. Jensen (1986) and Easterbrook (1984) both point out that dividend payment can relief agency problem. This argument is supported by La-Porta et al (1998), who suggest in counties with better investor protection, there is a higher likelihood for dividend payment and a better incentive to solve agency problem. Many studies in Chinese listed companies also generate the same result, e.g. Chen and Zhao (2000), Lv and Wang (2002), and Liu and Hu (2003). As far as numbers are concerned, this is quite obvious in that dividends are paid out from retained earnings, i.e. equity, and therefore increasing ROE. The more important motive is that the company that pays dividends wants to convey information to the market about its healthy operations and profitability.

If we look at AUD, the signs are almost consistently negative for SOA and ROE, as contradictory to hypotheses. According to the interviewees and many prior studies as discussed in the literature chapter, this is because the audit profession still lacks proper independence from their clients due to government influence and economic dependence, i.e. fee income. Therefore, when Big Four work as external auditors, the quality of their audit and hence the quality of financial statement disclosures and firm performances are less obvious and the only obvious impact is their higher audit fee charges that reduce performance. However, when ROA is used, the result is similar to that of Q.

Size of the company now has positive impact on returns, due to economy of scale and economy of scope, as suggested in the case. Some of the interviewees explained that large corporations can utilise group resources and network and therefore achieve economy of scale to save fixed costs and economy of scope to share distribution

channels etc. Another important factor is that large companies can gain some favour, in terms of financial and regulatory support, from local government because their performance is part of the evaluation of government operations. TAN is broadly negatively and GRO positively related to performances, which is in consistency with initial hypotheses, although there are some mix results.

When LPS is used, again VIF for the variables ranges from 1.02 to 3.19, which is way below the cut-off of 10, hence indicating unlikely multicollinearity. The only exception is LPS and LPS^2 because they are obviously highly related. However if I exclude LPS^2 from the regression, the results are very similar and the VIF for LPS is around 3. The results are presented in Table 6.12 below.

Table 6.12 Performance Indicators and CG Mechanisms with LPS

Panel A: SOA and CG Mechanisms with LPS

SOA	2000	2001	2002	2003	2004	2005	Pool
LPS	-0.12	0.05	-0.13	-0.16*	-0.07	0.06	-0.05
Sig (1 tailed)	*0.20*	*0.35*	*0.15*	*0.09*	*0.28*	*0.30*	*0.17*
LPS^2	0.10	-0.04	0.13	0.14	0.06	-0.09	0.04
Sig (2 tailed)	*0.44*	*0.74*	*0.26*	*0.21*	*0.62*	*0.43*	*0.41*
LGS	0.06	0.14***	0.10**	0.04	0.08**	0.05*	0.07***
Sig (1 tailed)	*0.16*	*0.00*	*0.03*	*0.16*	*0.04*	*0.09*	*0.00*
TOP10	0.03	0.00	0.05	0.06*	0.02	0.07**	0.05***
Sig (1 tailed)	*0.29*	*0.48*	*0.14*	*0.06*	*0.28*	*0.02*	*0.00*
FRS	0.05	0.00	0.01	0.03	0.03	-0.03	0.01
Sig (1 tailed)	*0.11*	*0.49*	*0.40*	*0.20*	*0.20*	*0.14*	*0.34*
MGS	0.07**	0.03	0.02	-0.01	0.00	-0.03	0.00
Sig (1 tailed)	*0.02*	*0.16*	*0.27*	*0.32*	*0.49*	*0.14*	*0.44*
DIV	0.06**	0.18***	0.17***	0.21***	0.21***	0.09***	0.15***
Sig (1 tailed)	*0.04*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AUD	0.02	0.04	-0.03	-0.03	-0.02	-0.03	-0.02
Sig (1 tailed)	*0.31*	*0.10*	*0.17*	*0.16*	*0.22*	*0.20*	*0.11*
Bsize	0.04	0.07**	0.05*	0.03	0.01	0.05	0.05***
Sig (1 tailed)	*0.15*	*0.02*	*0.09*	*0.19*	*0.39*	*0.11*	*0.00*
Bcom	-0.02	0.01	0.00	0.08***	0.02	0.08**	0.15***
Sig (1 tailed)	*0.25*	*0.36*	*0.49*	*0.00*	*0.21*	*0.04*	*0.00*
Bmet	-0.12***	-0.03	-0.07**	-0.08***	-0.06**	-0.07***	-0.07***
Sig (1 tailed)	*0.00*	*0.14*	*0.01*	*0.00*	*0.01*	*0.01*	*0.00*
SBsize	0.07**	0.05*	0.05*	0.05**	0.05**	0.02	0.03**
Sig (1 tailed)	*0.02*	*0.06*	*0.06*	*0.04*	*0.04*	*0.21*	*0.02*
IND	-0.20***	-0.19***	-0.17***	-0.17***	-0.15***	-0.14***	-0.16***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AGE	0.00	0.04	0.11***	0.12***	0.10***	0.07***	0.07***
Sig (1 tailed)	*0.47*	*0.12*	*0.00*	*0.00*	*0.00*	*0.01*	*0.00*
SIZE	0.07**	0.00	0.04	0.00	0.03	0.08***	0.04***
Sig (1 tailed)	*0.04*	*0.47*	*0.13*	*0.47*	*0.23*	*0.01*	*0.00*
LEV	0.09***	0.10***	0.15***	0.14***	0.14***	0.08***	0.12***
Sig (1 tailed)	*0.01*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	-0.01	-0.05*	-0.09***	-0.08***	-0.09***	-0.11***	-0.07***
Sig (1 tailed)	*0.38*	*0.07*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
GRO	0.22***	0.12***	0.14***	0.11***	0.06**	0.21***	0.13***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.02*	*0.00*	*0.00*
Adjusted R^2	0.13	0.10	0.13	0.12	0.10	0.11	0.12
Durbin-Watson	1.96	1.89	1.94	1.95	2.00	2.01	1.96
F Statistics	7.69	7.14	10.00	9.75	8.16	9.26	50.12

Panel B: ROE and CG Mechanisms with LPS

ROE	2000	2001	2002	2003	2004	2005	Pool
LPS	-0.09	0.15	0.02	0.04	0.05	0.11	0.04
Sig (1 tailed)	*0.24*	*0.11*	*0.43*	*0.37*	*0.34*	*0.15*	*0.22*
LPS^2	0.08	-0.12	0.00	0.06	-0.02	-0.10	-0.01
Sig (2 tailed)	*0.53*	*0.31*	*1.00*	*0.57*	*0.88*	*0.35*	*0.89*
LGS	-0.05	-0.08*	-0.01	0.02	-0.01	-0.03	-0.03**
Sig (1 tailed)	*0.20*	*0.06*	*0.38*	*0.29*	*0.36*	*0.17*	*0.03*
TOP10	0.05	0.13***	0.06*	0.06*	0.12***	0.09***	0.09***
Sig (1 tailed)	*0.15*	*0.00*	*0.07*	*0.06*	*0.00*	*0.00*	*0.00*
FRS	-0.02	-0.06**	-0.01	-0.04	-0.07***	-0.08***	-0.05***
Sig (1 tailed)	*0.33*	*0.02*	*0.35*	*0.12*	*0.01*	*0.00*	*0.00*
MGS	0.04	-0.01	0.01	0.00	0.02	0.03*	0.01
Sig (1 tailed)	*0.12*	*0.35*	*0.41*	*0.45*	*0.23*	*0.10*	*0.24*
DIV	0.19***	0.27***	0.22***	0.23***	0.29***	0.26***	0.25***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AUD	-0.05*	-0.03	-0.02	-0.01	0.00	-0.02	-0.02*
Sig (1 tailed)	*0.06*	*0.17*	*0.19*	*0.38*	*0.47*	*0.25*	*0.10*
Bsize	-0.07**	0.02	0.05*	0.03	0.00	0.01	-0.01
Sig (1 tailed)	*0.02*	*0.27*	*0.07*	*0.14*	*0.49*	*0.44*	*0.30*
Bcom	0.01	0.09***	0.04	0.06**	0.09***	0.03	-0.01
Sig (1 tailed)	*0.34*	*0.00*	*0.10*	*0.01*	*0.00*	*0.20*	*0.13*
Bmet	-0.01	0.05**	-0.03	-0.05**	-0.04*	-0.07***	-0.04***
Sig (1 tailed)	*0.36*	*0.04*	*0.15*	*0.03*	*0.06*	*0.00*	*0.00*
SBsize	0.03	0.00	-0.02	0.01	-0.01	0.01	0.00
Sig (1 tailed)	*0.16*	*0.49*	*0.23*	*0.38*	*0.39*	*0.32*	*0.47*
IND	-0.04	-0.06**	0.01	0.04*	0.02	0.03	0.01
Sig (1 tailed)	*0.12*	*0.02*	*0.32*	*0.07*	*0.22*	*0.14*	*0.32*
AGE	-0.01	0.00	0.03	0.02	-0.01	-0.04	0.01
Sig (1 tailed)	*0.33*	*0.49*	*0.16*	*0.23*	*0.38*	*0.11*	*0.28*
SIZE	0.21***	0.14***	0.24***	0.19***	0.21***	0.21***	0.20***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	-0.31***	-0.22***	-0.28***	-0.20***	-0.16***	-0.22***	-0.23***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	-0.06**	0.01	-0.08***	-0.01	0.00	0.01	-0.03***
Sig (1 tailed)	*0.02*	*0.36*	*0.00*	*0.41*	*0.46*	*0.39*	*0.01*
GRO	0.23***	0.24***	0.25***	0.18***	0.15***	0.16***	0.19***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Adjusted R^2	0.24	0.24	0.28	0.21	0.25	0.22	0.23
Durbin-Watson	1.94	2.04	1.93	2.05	2.07	1.90	1.97
F Statistics	15.47	18.04	23.28	17.50	22.34	20.24	106.96

Panel C: ROA and CG Mechanisms with LPS

ROA	2000	2001	2002	2003	2004	2005	Pool
LPS	0.05	0.24**	-0.01	-0.04	0.14*	0.17**	0.07*
Sig (1 tailed)	*0.35*	*0.02*	*0.48*	*0.36*	*0.10*	*0.04*	*0.06*
LPS^2	-0.06	-0.21*	0.02	0.09	-0.14	-0.21**	-0.07
Sig (2 tailed)	*0.65*	*0.07*	*0.85*	*0.41*	*0.17*	*0.03*	*0.12*
LGS	-0.01	-0.01	-0.02	-0.01	0.00	-0.06**	-0.03**
Sig (1 tailed)	*0.40*	*0.44*	*0.32*	*0.36*	*0.48*	*0.04*	*0.02*
TOP10	0.03	0.08**	0.05*	0.07**	0.14***	0.13***	0.09***
Sig (1 tailed)	*0.24*	*0.02*	*0.09*	*0.04*	*0.00*	*0.00*	*0.00*
FRS	-0.04	-0.04	-0.02	-0.05*	-0.06**	-0.10***	-0.06***
Sig (1 tailed)	*0.13*	*0.11*	*0.21*	*0.06*	*0.01*	*0.00*	*0.00*
MGS	0.04	0.01	0.00	-0.01	0.02	0.02	0.01
Sig (1 tailed)	*0.12*	*0.41*	*0.48*	*0.29*	*0.20*	*0.21*	*0.31*
DIV	0.28***	0.35***	0.30***	0.35***	0.39***	0.38***	0.36***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AUD	-0.05*	-0.04*	-0.01	0.01	0.02	0.01	0.00
Sig (1 tailed)	*0.06*	*0.07*	*0.36*	*0.37*	*0.27*	*0.33*	*0.34*
Bsize	-0.04	0.00	0.01	0.01	-0.01	-0.03	-0.02**
Sig (1 tailed)	*0.14*	*0.47*	*0.38*	*0.36*	*0.34*	*0.18*	*0.04*
Bcom	0.00	0.06**	0.05*	0.04*	0.11***	-0.02	-0.02**
Sig (1 tailed)	*0.44*	*0.02*	*0.06*	*0.06*	*0.00*	*0.25*	*0.02*
Bmet	0.03	0.08***	0.00	-0.03*	-0.01	-0.02	-0.01
Sig (1 tailed)	*0.16*	*0.00*	*0.50*	*0.10*	*0.30*	*0.18*	*0.12*
SBsize	0.01	0.04*	0.00	0.02	-0.03	0.00	0.00
Sig (1 tailed)	*0.36*	*0.08*	*0.44*	*0.28*	*0.14*	*0.43*	*0.50*
IND	0.00	-0.03	0.02	0.06***	-0.01	0.01	0.01
Sig (1 tailed)	*0.44*	*0.17*	*0.22*	*0.01*	*0.37*	*0.38*	*0.14*
AGE	0.00	-0.02	0.02	0.03	0.07***	-0.03	0.02**
Sig (1 tailed)	*0.45*	*0.31*	*0.23*	*0.11*	*0.01*	*0.15*	*0.02*
SIZE	0.12***	0.11***	0.17***	0.15***	0.13***	0.19***	0.15***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	-0.28***	-0.20***	-0.20***	-0.18***	-0.17***	-0.19***	-0.20***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	-0.12***	-0.01	0.01	0.04*	0.05**	0.05**	0.00
Sig (1 tailed)	*0.00*	*0.42*	*0.37*	*0.09*	*0.02*	*0.03*	*0.38*
GRO	0.19***	0.25***	0.27***	0.16***	0.13***	0.14***	0.18***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Adjusted R^2	0.24	0.29	0.28	0.28	0.30	0.32	0.28
Durbin-Watson	1.98	2.09	1.94	2.02	2.06	1.98	1.98
F Statistics	15.77	23.02	23.50	24.57	28.58	32.12	134.82

Panel A: ADM and CG Mechanisms with STS

ADM	2000	2001	2002	2003	2004	2005	Pool
STS	-0.26**	-0.26**	-0.47***	-0.03	-0.29***	-0.19**	-0.26***
Sig (1 tailed)	*0.02*	*0.01*	*0.00*	*0.39*	*0.00*	*0.04*	*0.00*
STS^2	0.27*	0.28**	0.48***	0.14	0.37***	0.20*	0.30***
Sig (2 tailed)	*0.06*	*0.03*	*0.00*	*0.26*	*0.00*	*0.07*	*0.00*
LGS	-0.12**	-0.09**	-0.06	-0.09**	-0.10***	0.00	-0.06***
Sig (1 tailed)	*0.02*	*0.04*	*0.12*	*0.04*	*0.01*	*0.45*	*0.00*
TOP10	0.09**	0.03	-0.07**	-0.04	-0.01	-0.07**	-0.03*
Sig (1 tailed)	*0.04*	*0.29*	*0.05*	*0.15*	*0.44*	*0.04*	*0.06*
FRS	-0.06*	-0.01	0.03	0.03	0.03	0.22***	0.04***
Sig (1 tailed)	*0.06*	*0.41*	*0.18*	*0.19*	*0.18*	*0.00*	*0.00*
MGS	-0.03	-0.01	-0.02	0.01	-0.01	-0.01	0.00
Sig (1 tailed)	*0.20*	*0.43*	*0.27*	*0.43*	*0.42*	*0.31*	*0.40*
DIV	-0.03	-0.07**	-0.01	-0.05*	-0.04*	0.00	-0.03***
Sig (1 tailed)	*0.20*	*0.02*	*0.34*	*0.06*	*0.08*	*0.49*	*0.01*
AUD	0.06*	0.04	0.04	0.03	0.04*	-0.02	0.03***
Sig (1 tailed)	*0.05*	*0.14*	*0.11*	*0.21*	*0.08*	*0.21*	*0.01*
Bsize	0.07**	0.00	-0.02	-0.03	-0.05*	-0.01	0.00
Sig (1 tailed)	*0.03*	*0.46*	*0.32*	*0.19*	*0.07*	*0.41*	*0.50*
Bcom	-0.01	-0.03	-0.03	-0.01	-0.11***	-0.04	-0.02
Sig (1 tailed)	*0.44*	*0.20*	*0.16*	*0.43*	*0.00*	*0.18*	*0.11*
Bmet	0.03	-0.03	0.09***	0.04*	0.02	0.01	0.05***
Sig (1 tailed)	*0.19*	*0.15*	*0.00*	*0.09*	*0.22*	*0.33*	*0.00*
SBsize	-0.07**	-0.07**	-0.03	-0.05*	0.00	0.01	-0.03**
Sig (1 tailed)	*0.02*	*0.01*	*0.16*	*0.05*	*0.44*	*0.34*	*0.02*
IND	-0.03	0.04*	0.01	-0.01	0.00	-0.04*	0.00
Sig (1 tailed)	*0.23*	*0.09*	*0.34*	*0.34*	*0.47*	*0.09*	*0.37*
AGE	0.11***	0.08***	0.05*	0.03	0.02	0.09***	0.05***
Sig (1 tailed)	*0.00*	*0.01*	*0.08*	*0.20*	*0.29*	*0.00*	*0.00*
SIZE	-0.23***	-0.20***	-0.22***	-0.17***	-0.21***	-0.25***	-0.22***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	0.06**	0.14***	0.11***	0.05*	0.04*	0.07**	0.08***
Sig (1 tailed)	*0.04*	*0.00*	*0.00*	*0.06*	*0.08*	*0.02*	*0.00*
TAN	0.08***	0.02	0.06**	0.02	0.01	-0.03	0.03***
Sig (1 tailed)	*0.01*	*0.31*	*0.02*	*0.21*	*0.34*	*0.17*	*0.00*
GRO	-0.14***	-0.17***	-0.19***	-0.13***	-0.12***	-0.16***	-0.14***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Adjusted R^2	0.11	0.10	0.12	0.05	0.07	0.10	0.08
Durbin-Watson	1.99	2.07	1.83	2.01	2.03	1.94	1.93
F Statistics	6.50	7.20	8.71	4.57	5.78	8.67	31.28

Here, SOA has similar results as Q while ROE and ROA generate results consistent with hypothesis, i.e. LPS positively impacts on firm performance. The results are significant for four out of the six years for ROA. A main explanation of this lies in the definition of LPS, which can be divided into stated owned legal person shares and corporate legal person shares. The former type of shares are held by government agencies such as central government ministries and commissions, national industrial companies, local government bureaus, local state assets management bureaus, and local state assets operating companies (Wang, 2003), and therefore they are essentially the same as state shares. We expect these shares will have the same impact on firm performance, while the corporate entity holding LPS works in monitoring firm operations. As for LGS, the results mostly show a positive relationship between these variables and performance indicators, while when ROE and ROA are used there are some negative relationships. TOP10 has consistent positive relationship with performance indicators across the years. This, as per the interviewees in the case study, is because sometimes concentrated ownerships and presence of block shareholders lead to better goal congruence and hence more efficient business decisions. The other finding from here is that ROE and ROA are more applicable in measuring performance than Q and SOA.

6.4.4 CG Mechanisms and Cost Indicators

When agency costs indicators are used, the effect of STS is also negative among the sample period, especially with ADM and ORC. When FCF is considered, for three out of the six years sampled, the impact of STS shows positive relationship as hypothesised although insignificant. FRS still has mixed results while MGS generally shows negative relationship with cost indicators, which is largely consistent with the literature and hypotheses. Generally AUD seems to reduce agency costs significantly, while board size etc does not have obvious conclusions. Details are shown in Table 6.13 below. Again adjusted R squared, Durbin-Watson, and F statistics values are presented at the bottom of each table.

Table 6.13 Cost Indicators and CG Mechanisms with STS

Panel B: ORC and CG Mechanisms with STS

ORC	2000	2001	2002	2003	2004	2005	Pool
STS	0.01	-0.10	-0.25***	-0.21**	-0.27***	-0.09	-0.14***
Sig (1 tailed)	*0.48*	*0.19*	*0.01*	*0.02*	*0.00*	*0.18*	*0.00*
STS^2	-0.01	0.08	0.21*	0.25**	0.31***	0.12	0.16***
Sig (2 tailed)	*0.93*	*0.54*	*0.08*	*0.03*	*0.01*	*0.28*	*0.00*
LGS	-0.07	-0.06	-0.11***	-0.13***	-0.08**	-0.02	-0.07***
Sig (1 tailed)	*0.11*	*0.11*	*0.01*	*0.00*	*0.02*	*0.26*	*0.00*
TOP10	-0.03	-0.01	0.05	0.03	0.00	0.01	0.00
Sig (1 tailed)	*0.29*	*0.38*	*0.12*	*0.19*	*0.48*	*0.39*	*0.41*
FRS	-0.06*	-0.05*	-0.03	0.02	0.04*	0.08***	0.01
Sig (1 tailed)	*0.07*	*0.08*	*0.17*	*0.28*	*0.08*	*0.00*	*0.20*
MGS	0.03	-0.01	-0.03	-0.01	-0.02	-0.02	-0.01
Sig (1 tailed)	*0.17*	*0.37*	*0.13*	*0.38*	*0.22*	*0.23*	*0.11*
DIV	0.03	-0.22***	-0.19***	-0.14***	-0.17***	-0.08***	-0.15***
Sig (1 tailed)	*0.18*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AUD	0.20***	-0.04	-0.05*	-0.04	0.00	0.01	-0.02*
Sig (1 tailed)	*0.00*	*0.12*	*0.06*	*0.11*	*0.46*	*0.32*	*0.06*
Bsize	-0.02	0.01	-0.03	-0.06**	-0.06**	-0.06*	0.00
Sig (1 tailed)	*0.33*	*0.42*	*0.14*	*0.03*	*0.02*	*0.07*	*0.38*
Bcom	-0.04	-0.02	0.00	-0.08***	-0.10***	-0.03	0.10***
Sig (1 tailed)	*0.12*	*0.29*	*0.47*	*0.00*	*0.00*	*0.24*	*0.00*
Bmet	0.00	0.02	0.06**	0.10***	0.05**	0.05**	0.09***
Sig (1 tailed)	*0.46*	*0.21*	*0.01*	*0.00*	*0.03*	*0.02*	*0.00*
SBsize	0.06**	0.01	0.02	0.00	0.03	-0.03	0.01
Sig (1 tailed)	*0.04*	*0.35*	*0.26*	*0.43*	*0.18*	*0.15*	*0.33*
IND	0.03	-0.02	-0.06**	-0.04	-0.04*	-0.06**	-0.04***
Sig (1 tailed)	*0.20*	*0.29*	*0.01*	*0.10*	*0.06*	*0.02*	*0.00*
AGE	-0.06*	0.03	0.04*	0.05*	0.07*	0.18	0.06*
Sig (1 tailed)	*0.06*	*0.19*	*0.09*	*0.05*	*0.01*	*0.00*	*0.00*
SIZE	0.02	-0.07**	-0.13***	-0.12***	-0.17***	-0.29***	-0.14***
Sig (1 tailed)	*0.30*	*0.02*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	0.03	0.18***	0.15***	0.16***	0.16***	0.22***	0.15***
Sig (1 tailed)	*0.22*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	0.07**	-0.19***	-0.15***	-0.17***	-0.16***	-0.07***	-0.12***
Sig (1 tailed)	*0.02*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
GRO	-0.04	-0.12***	-0.08***	-0.07***	-0.10***	-0.08***	-0.08***
Sig (1 tailed)	*0.13*	*0.00*	*0.00*	*0.01*	*0.00*	*0.00*	*0.00*
Adjusted R^2	0.03	0.19	0.20	0.18	0.19	0.18	0.16
Durbin-Watson	2.00	2.08	1.97	2.00	1.97	1.98	1.87
F Statistics	2.63	14.05	15.16	14.79	15.84	16.19	67.81

Panel C: FCF and CG Mechanisms with STS

FCF	2000	2001	2002	2003	2004	2005	Pool
STS	-0.02	-0.02	0.04	-0.23**	0.06	0.00	-0.03
Sig (1 tailed)	*0.45*	*0.44*	*0.36*	*0.02*	*0.29*	*0.49*	*0.28*
STS^2	0.06	0.05	0.02	0.28**	-0.01	0.08	0.08
Sig (2 tailed)	*0.68*	*0.71*	*0.88*	*0.02*	*0.93*	*0.49*	*0.11*
LGS	-0.11**	0.01	0.03	-0.01	-0.02	-0.08**	-0.03*
Sig (1 tailed)	*0.04*	*0.43*	*0.29*	*0.45*	*0.32*	*0.03*	*0.06*
TOP10	0.16***	0.09**	-0.01	0.05	0.00	0.06*	0.05***
Sig (1 tailed)	*0.00*	*0.03*	*0.41*	*0.12*	*0.49*	*0.08*	*0.00*
FRS	-0.05	-0.01	0.02	0.01	0.06**	-0.02	0.00
Sig (1 tailed)	*0.12*	*0.43*	*0.25*	*0.37*	*0.03*	*0.24*	*0.41*
MGS	0.01	0.00	0.01	0.00	0.02	0.01	0.00
Sig (1 tailed)	*0.35*	*0.45*	*0.43*	*0.48*	*0.28*	*0.33*	*0.37*
DIV	0.03	0.07**	0.05*	0.06**	0.04	0.05**	0.05***
Sig (1 tailed)	*0.19*	*0.02*	*0.06*	*0.03*	*0.10*	*0.05*	*0.00*
AUD	-0.07**	-0.02	0.02	-0.04	-0.05**	0.01	-0.02*
Sig (1 tailed)	*0.04*	*0.27*	*0.32*	*0.10*	*0.05*	*0.38*	*0.09*
Bsize	0.02	0.03	-0.02	-0.01	0.00	-0.03	0.01
Sig (1 tailed)	*0.32*	*0.15*	*0.32*	*0.43*	*0.49*	*0.24*	*0.21*
Bcom	0.04	0.03	-0.02	-0.06**	0.00	-0.04	0.04***
Sig (1 tailed)	*0.15*	*0.17*	*0.25*	*0.03*	*0.46*	*0.18*	*0.00*
Bmet	0.10***	-0.06**	-0.05*	-0.04*	0.00	0.03	-0.02**
Sig (1 tailed)	*0.00*	*0.04*	*0.07*	*0.08*	*0.44*	*0.19*	*0.04*
SBsize	-0.02	0.00	0.04	0.02	0.01	0.00	-0.01
Sig (1 tailed)	*0.31*	*0.47*	*0.14*	*0.23*	*0.43*	*0.47*	*0.35*
IND	-0.07**	-0.03	0.02	0.00	-0.06	-0.07***	-0.03***
Sig (1 tailed)	*0.03*	*0.16*	*0.23*	*0.46*	*0.03*	*0.01*	*0.01*
AGE	0.21***	0.15***	0.05*	0.19***	0.10***	0.13***	0.13***
Sig (1 tailed)	*0.00*	*0.00*	*0.06*	*0.00*	*0.00*	*0.00*	*0.00*
SIZE	-0.05	0.01	0.05*	0.00	0.05*	-0.06**	0.01
Sig (1 tailed)	*0.10*	*0.34*	*0.07*	*0.47*	*0.10*	*0.04*	*0.31*
LEV	-0.11***	-0.07**	-0.08***	-0.09***	-0.08***	0.01	-0.06***
Sig (1 tailed)	*0.00*	*0.02*	*0.01*	*0.00*	*0.01*	*0.35*	*0.00*
TAN	0.10***	0.08***	0.04	0.08***	0.02	0.03	0.05***
Sig (1 tailed)	*0.00*	*0.01*	*0.12*	*0.00*	*0.27*	*0.18*	*0.00*
GRO	-0.13***	0.09***	0.09***	0.09***	0.16***	0.00	0.06***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.46*	*0.00*
Adjusted R^2	0.08	0.04	0.02	0.05	0.04	0.01	0.03
Durbin-Watson	2.04	1.98	2.05	1.99	2.02	2.01	2.01
F Statistics	4.93	3.39	2.57	4.46	3.34	2.04	10.05

The impact of legal person ownership is more in line with the hypothesis, as well as MGS and FRS, although not quite significant. In terms of the boards, sizes of the boards have mixed results but in most years within the sample period larger boards, as well as percentage of independent directors, seem to reduce agency costs with the chosen proxies. This is consistent with the hypotheses.

Regulated industries also seem to have decreased costs, although the results are insignificant. AUD does not give consistent results for the predicted sign, especially when ADM is used, and the reason is as discussed earlier, although when ORC is used the impact is generally as predicted for four out of six years. For control variables, they have mostly given the predicted signs. The variables combined do not substantially explain the dependent variable, because adjusted R^2 of the models are fairly low (ADM 8%, ORC 16%, and FCF 3% for the pooled data), however we can see ORC is marginally better.

Table 6.14 Cost Indicators and CG Mechanisms with LPS

Panel B: ORC and CG Mechanisms with LPS

ORC	2000	2001	2002	2003	2004	2005	Pool
LPS	0.18	0.16*	0.00	-0.04	-0.16	-0.12	-0.05
Sig (1 tailed)	*0.11*	*0.10*	*0.49*	*0.35*	*0.08*	*0.12*	*0.16*
LPS^2	-0.15	-0.12	0.08	0.05	0.17	0.13	0.07
Sig (2 tailed)	*0.27*	*0.33*	*0.48*	*0.68*	*0.11*	*0.23*	*0.15*
LGS	-0.04	-0.02	-0.09**	-0.11***	-0.07*	-0.02	-0.05***
Sig (1 tailed)	*0.26*	*0.32*	*0.03*	*0.01*	*0.05*	*0.27*	*0.00*
TOP10	-0.04	-0.02	0.04	0.05*	0.01	0.01	0.01
Sig (1 tailed)	*0.23*	*0.30*	*0.20*	*0.08*	*0.38*	*0.36*	*0.31*
FRS	-0.06*	-0.04	-0.02	0.01	0.03	0.08***	0.01
Sig (1 tailed)	*0.08*	*0.12*	*0.27*	*0.40*	*0.14*	*0.00*	*0.24*
MGS	0.03	-0.01	-0.03	-0.01	-0.02	-0.02	-0.01
Sig (1 tailed)	*0.18*	*0.36*	*0.14*	*0.34*	*0.23*	*0.22*	*0.11*
DIV	0.03	-0.22***	-0.19***	-0.14***	-0.17***	-0.08***	-0.15***
Sig (1 tailed)	*0.19*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
AUD	0.20***	-0.04	-0.05**	-0.04*	0.00	0.01	-0.02**
Sig (1 tailed)	*0.00*	*0.12*	*0.04*	*0.10*	*0.50*	*0.35*	*0.04*
Bsize	-0.01	0.01	-0.04	-0.06**	-0.06**	-0.06*	-0.01
Sig (1 tailed)	*0.35*	*0.40*	*0.14*	*0.03*	*0.02*	*0.06*	*0.34*
Bcom	-0.04	-0.02	0.00	-0.08***	-0.09***	-0.03	0.10***
Sig (1 tailed)	*0.13*	*0.29*	*0.49*	*0.00*	*0.00*	*0.22*	*0.00*
Bmet	0.00	0.03	0.07**	0.10***	0.05**	0.05**	0.09***
Sig (1 tailed)	*0.49*	*0.17*	*0.01*	*0.00*	*0.02*	*0.02*	*0.00*
SBsize	0.06**	0.01	0.02	0.00	0.03	-0.03	0.01
Sig (1 tailed)	*0.04*	*0.38*	*0.28*	*0.44*	*0.15*	*0.15*	*0.32*
IND	0.03	-0.02	-0.06***	-0.04*	-0.04*	-0.05**	-0.04***
Sig (1 tailed)	*0.20*	*0.30*	*0.01*	*0.09*	*0.06*	*0.02*	*0.00*
AGE	-0.06*	0.03	0.04*	0.05*	0.06**	0.17***	0.05***
Sig (1 tailed)	*0.05*	*0.19*	*0.09*	*0.06*	*0.01*	*0.00*	*0.00*
SIZE	0.02	-0.06**	-0.12***	-0.11***	-0.16***	-0.29***	-0.14***
Sig (1 tailed)	*0.28*	*0.03*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	0.02	0.18***	0.14***	0.16***	0.15***	0.22***	0.15***
Sig (1 tailed)	*0.25*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
TAN	0.07**	-0.19***	-0.15***	-0.17***	-0.16***	-0.07***	-0.12***
Sig (1 tailed)	*0.02*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
GRO	-0.04	-0.12***	-0.08***	-0.07***	-0.09***	-0.08***	-0.08***
Sig (1 tailed)	*0.15*	*0.00*	*0.00*	*0.01*	*0.00*	*0.00*	*0.00*
Adjusted R^2	0.04	0.20	0.19	0.18	0.18	0.18	0.16
Durbin-Watson	2.00	2.07	1.97	2.01	1.97	1.99	1.88
F Statistics	2.72	14.14	15.11	14.48	15.51	16.20	67.39

Panel A: ADM and CG Mechanisms with LPS

ADM	2000	2001	2002	2003	2004	2005	Pool
LPS	-0.34***	-0.33***	-0.02	-0.08	-0.19	0.05	-0.11**
Sig (1 tailed)	*0.01*	*0.01*	*0.44*	*0.26*	*0.06*	*0.32*	*0.01*
LPS^2	0.38***	0.34***	0.08	0.01	0.17	-0.05	0.13***
Sig (2 tailed)	*0.00*	*0.01*	*0.47*	*0.94*	*0.15*	*0.64*	*0.01*
LGS	-0.14***	-0.11**	-0.01	-0.06*	-0.07**	0.02	-0.04**
Sig (1 tailed)	*0.01*	*0.02*	*0.43*	*0.09*	*0.05*	*0.31*	*0.02*
TOP10	0.10**	0.04	-0.06*	0.00	0.03	-0.05*	-0.01
Sig (1 tailed)	*0.03*	*0.18*	*0.09*	*0.48*	*0.26*	*0.08*	*0.24*
FRS	-0.06*	-0.01	0.03	0.00	0.01	0.21***	0.04***
Sig (1 tailed)	*0.08*	*0.37*	*0.20*	*0.45*	*0.40*	*0.00*	*0.00*
MGS	-0.03	0.00	-0.02	0.00	-0.01	-0.01	0.00
Sig (1 tailed)	*0.22*	*0.46*	*0.28*	*0.49*	*0.38*	*0.31*	*0.39*
DIV	-0.03	-0.07**	-0.01	-0.06**	-0.04*	0.00	-0.03**
Sig (1 tailed)	*0.23*	*0.02*	*0.33*	*0.05*	*0.09*	*0.48*	*0.01*
AUD	0.05*	0.03	0.03	0.03	0.04*	-0.03	0.03**
Sig (1 tailed)	*0.07*	*0.17*	*0.17*	*0.21*	*0.10*	*0.17*	*0.02*
Bsize	0.06*	0.00	-0.02	-0.03	-0.05*	-0.02	0.00
Sig (1 tailed)	*0.05*	*0.46*	*0.31*	*0.18*	*0.07*	*0.36*	*0.41*
Bcom	-0.01	-0.03	-0.02	-0.01	-0.11***	-0.04	-0.02
Sig (1 tailed)	*0.37*	*0.21*	*0.22*	*0.42*	*0.00*	*0.16*	*0.10*
Bmet	0.03	-0.03	0.09***	0.04*	0.02	0.01	0.06***
Sig (1 tailed)	*0.23*	*0.14*	*0.00*	*0.10*	*0.21*	*0.31*	*0.00*
SBsize	-0.07**	-0.07**	-0.04	-0.05*	0.00	0.01	-0.03**
Sig (1 tailed)	*0.02*	*0.01*	*0.12*	*0.06*	*0.49*	*0.37*	*0.02*
IND	-0.02	0.04*	0.01	-0.01	0.00	-0.04*	0.00
Sig (1 tailed)	*0.24*	*0.07*	*0.32*	*0.31*	*0.45*	*0.09*	*0.39*
AGE	0.12***	0.09***	0.05*	0.03	0.02	0.09***	0.05***
Sig (1 tailed)	*0.00*	*0.01*	*0.07*	*0.21*	*0.29*	*0.00*	*0.00*
SIZE	-0.23***	-0.19***	-0.20***	-0.17***	-0.20***	-0.24***	-0.21***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
LEV	0.07**	0.13***	0.10***	0.05*	0.04	0.06**	0.07***
Sig (1 tailed)	*0.03*	*0.00*	*0.00*	*0.06*	*0.11*	*0.02*	*0.00*
TAN	0.08**	0.02	0.06**	0.03	0.01	-0.03	0.03***
Sig (1 tailed)	*0.01*	*0.30*	*0.02*	*0.20*	*0.33*	*0.15*	*0.00*
GRO	-0.15***	-0.17***	-0.19***	-0.13***	-0.11***	-0.16***	-0.13***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*
Adjusted R^2	0.11	0.11	0.11	0.05	0.06	0.10	0.08
Durbin-Watson	1.98	2.08	1.83	2.01	2.02	1.94	1.92
F Statistics	6.82	7.36	7.86	4.47	5.32	8.48	29.71

Panel C: FCF and CG Mechanisms with LPS

FCF	2000	2001	2002	2003	2004	2005	Pool
LPS	-0.36***	0.01	-0.04	-0.18*	-0.13	-0.17*	-0.14***
Sig (1 tailed)	*0.01*	*0.47*	*0.37*	*0.07*	*0.14*	*0.08*	*0.00*
LPS^2	0.36***	-0.01	-0.01	0.18	0.08	0.11	0.10**
Sig (2 tailed)	*0.01*	*0.92*	*0.95*	*0.13*	*0.49*	*0.34*	*0.04*
LGS	-0.14***	0.03	0.03	0.01	-0.03	-0.07**	-0.03*
Sig (1 tailed)	*0.01*	*0.31*	*0.27*	*0.45*	*0.24*	*0.03*	*0.06*
TOP10	0.17***	0.10**	0.02	0.07**	0.02	0.08**	0.07***
Sig (1 tailed)	*0.00*	*0.02*	*0.37*	*0.05*	*0.32*	*0.02*	*0.00*
FRS	-0.05	-0.01	0.01	0.00**	0.05*	-0.04	-0.01
Sig (1 tailed)	*0.11*	*0.38*	*0.39*	*0.50*	*0.06*	*0.12*	*0.29*
MGS	0.02	0.00	0.00	0.00	0.01	0.01	0.00
Sig (1 tailed)	*0.32*	*0.47*	*0.44*	*0.48*	*0.35*	*0.35*	*0.42*
DIV	0.03	0.07**	0.05*	0.06**	0.04	0.05*	0.05***
Sig (1 tailed)	*0.17*	*0.03*	*0.06*	*0.03*	*0.11*	*0.06*	*0.00*
AUD	-0.07**	-0.02	0.02	-0.04*	-0.05**	0.01	-0.02*
Sig (1 tailed)	*0.03*	*0.26*	*0.32*	*0.08*	*0.05*	*0.40*	*0.07*
Bsize	0.01	0.03	-0.02	-0.01	0.00	-0.03	0.01
Sig (1 tailed)	*0.40*	*0.15*	*0.32*	*0.43*	*0.49*	*0.25*	*0.23*
Bcom	0.04	0.03	-0.02	-0.06**	0.00	-0.04	0.04***
Sig (1 tailed)	*0.16*	*0.18*	*0.26*	*0.03*	*0.46*	*0.17*	*0.00*
Bmet	0.09***	-0.06**	-0.05*	-0.04*	0.00	0.03	-0.02**
Sig (1 tailed)	*0.00*	*0.04*	*0.07*	*0.09*	*0.46*	*0.19*	*0.04*
SBsize	-0.01	0.00	0.04	0.02	0.01	0.00	0.00
Sig (1 tailed)	*0.41*	*0.48*	*0.14*	*0.23*	*0.41*	*0.46*	*0.40*
IND	-0.07**	-0.03	0.02	0.00	-0.06**	-0.07***	-0.03***
Sig (1 tailed)	*0.02*	*0.16*	*0.24*	*0.45*	*0.02*	*0.01*	*0.01*
AGE	0.22***	0.15***	0.05*	0.19***	0.11***	0.13***	0.13***
Sig (1 tailed)	*0.00*	*0.00*	*0.06*	*0.00*	*0.00*	*0.00*	*0.00*
SIZE	-0.04	0.02	0.05*	0.01	0.04	-0.06**	0.01
Sig (1 tailed)	*0.13*	*0.31*	*0.07*	*0.36*	*0.11*	*0.04*	*0.27*
LEV	-0.10***	-0.07**	-0.08***	-0.10***	-0.08***	0.01	-0.06***
Sig (1 tailed)	*0.00*	*0.02*	*0.01*	*0.00*	*0.01*	*0.35*	*0.00*
TAN	0.10***	0.08***	0.04	0.08***	0.02	0.03	0.06***
Sig (1 tailed)	*0.00*	*0.01*	*0.11*	*0.00*	*0.25*	*0.16*	*0.00*
GRO	-0.14***	0.09***	0.09***	0.09***	0.16***	0.00	0.06***
Sig (1 tailed)	*0.00*	*0.00*	*0.00*	*0.00*	*0.00*	*0.45*	*0.00*
Adjusted R^2	0.09	0.04	0.02	0.05	0.04	0.01	0.03
Durbin-Watson	2.03	1.98	2.05	1.99	2.02	2.01	2.01
F Statistics	5.31	3.37	2.58	4.29	3.38	1.95	10.08

When we look at DIV, dividend payment seems to reduce agency costs, especial with ADM and ORC being the proxies. The literature on the relation between dividends and agency costs is somewhat limited. Much of this literature focuses on Tobin's Q as a proxy for the quality of the firm's investment opportunity set and management's tendency to over-invest. However, recent studies of firms announcing dividend increases call into question the reliability of Q as a measure of the manager's inclination to invest in non-optimal projects. Yoon and Starks (1995) report that firms with low-Q exhibit greater mean external capital growth following dividend increases than high-Q firms. Denis, Denis, and Sarin (1994) report that both high-Q and low-Q firms increase capital expenditures following dividend increases, although they report a greater mean increase in capital expenditures for the high-Q firms.

Lippert, Nixon, and Pilotte (2000) use a somewhat different approach. They examine the relation between the price response to dividend increases and pay-performance sensitivity for evidence of dividends as a means to reduce agency costs.[44] Brunarski, Harman, and Kehr (2004) add to the literature on dividends and agency costs by exploring the hypothesis that dividends reduce agency costs. Using methods similar to Lippert, Nixon, and Pilotte (2000), they examine the relation between the stock price reaction to announcements of substantial dividend increases (dividend surprises) and three common measures of agency costs. If dividends decrease agency costs by either reducing the overinvestment problem, providing evidence of firm profits, or subjecting firms to external monitoring by the capital markets, then they expect shareholders of firms with low agency costs to benefit less from dividend surprises. According to the case study, dividend payment reduces the free cash flow that management can use for empire building or personal benefit pursuit, e.g. excess personal expenditures claimed for business use.

[44]Consistent with agency theory, they find that the stock-price reaction to dividend increases declines with pay-performance sensitivity and that the effect is concentrated in firms with low market-to-book ratios.

(3) $STS = \gamma_0 + \gamma_1 Q + \gamma_2 LIQ + \gamma_3 CON + \varepsilon$

(4) $Q = \delta_0 + \delta_1 STS + \delta_2 MGS + \delta_3 CON + \varepsilon$

In the first stage, STS is regressed against QH, SOAH, ROEH, ROAH, ADMH, FCFH, and ORCH, the predictors of firm performance and agency costs proxies from the first-stage regressions, as well as LIQ and other control variables. The coefficients for firm performance predictors are positive yet insignificant, which indicates that firm performance is not an important determinant of state ownership in Chinese listed companies. The coefficients for LIQ are negative and significant in all estimates because firms with less tradable shares have more state shareholdings, which is consistent with the Chinese capital market. In the second stage, Q, SOA, FCF, ROE, ROA, ADM and ORC are regressed against STSH, the predictor of STS from the first-stage regression, as well as other control variables. The coefficient for STSH for the pooled sample is similar to the results presented in previous sections.

Table 6.15 Robust Test Results with Q and STS

Variable	Coefficient		Variable	Coefficient	
Q	0.0198		STS	0.4323	
	(1.253)			(4.223)	***
LIQ	-0.3191		MGS	1.8983	
	(-8.171)	***		(5.480)	***
Adjusted R^2	0.0129		Adjusted R^2	0.0093	
F-Statistics	42.5271		F-Statistics	30.6574	

For presentation purpose, the results of constant and other control variables are not included in the table above. The result is similar with Wei et al (2005) in that endogeneity between state ownership and firm performance is less severe than in US firms. This is because when the government decides state ownership in the privatised firms, it may not take into account the performance of the firm. It is unlikely that the state increases or reduces its ownership based on firm performance (Wei et al, 2005). Both the above and prior studies all suggest that state ownership and firm

6.5 Robust Tests

The results may be biased if the variables on both sides of the equation are endogenously determined, especially when using cross-sectional results to make inferences about the causality of the relation (Wei et al, 2005). A group of studies suggests a link between ownership and financial performance. Chung and Pruitt (1996) use 3SLS simultaneous-equations model discussing CEO involvement, while Leech and Leahey (1991) use single OLS regressions on different accounting ratios. Only these two papers prove the linkage. Agrawal and Knoeber (1996) examine the use of seven mechanisms to control agency problems with both OLS regressions and simultaneous-equations system, and they emphasise the distinction between internal and external control mechanisms. Since these works normally fail to find any linkage, Kole (1996) conducts direct test of the causality direction and predict a relation from financial performance to ownership.

In many empirical works, there is a negative relationship between STS and Q. This can be explained by that higher state ownership causes higher agency costs and thus lower firm value. However, it can also be explained by that higher firm value induces the government to sell more state shares to private investors (Wei et al, 2005). Therefore, I need to test the endogeneity of ownership. Other than the mentioned control variables, state ownership is closely related to the number of tradable shares in listed firms, as firms with more tradable shareholdings are expected to have less state shareholdings. I can therefore include the proportion of tradable shares as a control over liquidity (LIQ) effect.

To test the robustness, a 2SLS procedure is used here to estimate the endogeneity, following Loderer and Martin (1997) and Wei et al (2005) and the mentioned previous studies. The following model consists of two equations (3) and (4) to determine Q and the fraction of STS, which are jointly dependent variables. The control variables are exogenous (instruments), so the system meets the order condition. In addition, it is identified because the number of variables missing from each other is greater than the total number of endogenous variables minus one. CON consists of the control variables SIZE, AGE, LEV, TAN, GRO, and IND, as defined in previous regressions.

performance are not simultaneously determined and hence the conclusions we draw from previous analysis are robust to model specifications.

Again, the results regarding foreign ownership and firm value may be biased if a bi-directional causality exists between foreign ownership and Q. It could be that foreign investors are attracted to better performing firms, thereby inducing a positive relation between foreign ownership and Q, rather than foreign ownership per se creating value through monitoring or insisting on good corporate governance (Wei, et al, 2005). To test this potential endogeneity between foreign ownership and firm value, the cross-sectional framework of Loderer and Martin (1997) and Wei et al (2005) is adopted and the model is specified as follows:

(5) $FRS = \lambda_0 + \lambda_1 Q + \lambda_2 REG + \lambda_3 CON + \varepsilon$

(6) $Q = \omega_0 + \omega_1 FRS + \omega_2 MGS + \omega_3 CON + \varepsilon$

The 2SLS technique requires the identification of exogenous variables that plausibly affect only firm value or foreign ownership, but not both. Following Wei et al (2005), the geo-economic dummy variable (REG) is used to account for economically more developed regions in China. The variable takes the value of 1 when the company is located in Beijing, Shanghai, Tianjin and the two most developed provinces of Guangdong and Zhejiang. The variables takes the value of 2 when the company is located in other coastal regions such as Liaoning, Jilin, Heilongjiang, Jiangsu, Fujian, Shandong, Hubei, and Hainan provinces, plus the Xinjiang Autonomous Region. All other regions belong to category 3, which represents less developed provinces. Since the start of economic reform, foreign investment has been attracted to the aforementioned coastal regions (Chadee & Qiu, 2001). Thus, it is sensible that REG only affects foreign ownership but not Q.

Table 6.17 Robust Test Results with Q and DIV

Variable	Coefficient		Variable	Coefficient	
Q	2.2371		DIV	1.7605	
	(1.5312)			(18.200)	***
LIQ	-1.7172		MGS	-2.4383	
	(-18.763)	***		(-4.015)	***
Adjusted R^2	0.3027		Adjusted R^2	0.1026	
F-Statistics	1378.0149		F-Statistics	363.6578	

As can be seen from the table above, dividend payment is negatively affected by the liquidity of the shareholding. This is consistent with the analysis in previously chapters in that state owned entities tend to retain more free cash flows for empire building etc. behaviours and hence expropriate minority interest.

As shown in the regression results tables, I repeated the analysis on a year by year basis to explore the possibility of model change over time. Also in the pooled dataset, YR dummies are used for robust testing due to the rapidly changing nature of the Chinese economy, which makes the model close to fixed effect panel regression.

Furthermore, I tried to use LGS and TOP10 as proxy for ownership concentration in separate models and find the results robust and the results remain broadly consistent with those shown in previous tables in this chapter.

6.6 Conclusion

This chapter investigates agency issues in Chinese listed companies and justifies the ways to measure agency costs. By using a sample of 6344 firm years from 2000 to 2005, I examine the ownership structures, board characteristics, external auditors, and dividend payments, and how they are related to firm performance and agency costs. I also directly use administration expenses, free cash flows, and other receivable accounts to proxy agency costs and I have obtained some significant and consistent results.

Table 6.16 Robust Test Results with Q and FRS

Variable	Coefficient		Variable	Coefficient	
Q	0.1453		STS	0.4323	
	(1.514)			(4.223)	***
REG	0.1207		MGS	1.8983	
	(2.165)	***		(5.480)	***
Adjusted R^2	0.0641		Adjusted R^2	0.0093	
F-Statistics	218.2286		F-Statistics	30.6574	

The coefficients for firm performance predictors are positive yet insignificant, which indicates that firm performance is not an important determinant of foreign ownership in Chinese listed companies. The coefficients for REG are positive and significant in most estimates because firms along coastal regions usually attract more foreign investments. The coefficient for FRS for the pooled sample is similar to the results presented in previous sections.

Finally, the results regarding dividend payment and firm value may be biased. It could be that bettering performing firms are able to pay more dividends, instead of dividend payment acting as a governance mechanism to improve firm performance. To test this potential endogeneity between dividend payment and firm value, the test model is specified as follows:

(7) $DIV = \phi_0 + \phi_1 Q + \phi_2 LIQ + \phi_3 CON + \varepsilon$

(8) $Q = \sigma_0 + \sigma_1 DIV + \sigma_2 MGS + \sigma_3 CON + \varepsilon$

The coefficients for firm performance predictors are positive yet insignificant, which indicates that firm performance is not an important determinant of dividend payment in Chinese listed companies. The coefficient for DIV for the pooled sample is similar to the results presented in previous sections.

acting as proxies for agency costs because it gives the most significant results, and in addition, ORC can illustrate Type II agency issues. This is because decisions on inter-company transactions are mostly made by large shareholder.

When we look at the actual results, firstly, I find that state ownership has conflicting effects on firm performance especially when cost indicators are used, while legal person ownership consistently has negative relationship with cost indicators, which is uncommon in previous studies about listed companies in the Chinese context. STS has not been significantly detrimental to firm performance from the results, as contradictory to the literature, although in general been negatively related when Q and ROA are used. However, when cost indicators are used, only ORC explains the impact of state ownership as expected for one of the sample years, i.e., increased central control results in increased RPTs and tunnelling and hence agency costs, suggesting ORC might be a useful proxy for agency costs in Chinese listed companies. On the other hand, concentrated ownership seems to have significant positive impact on firm performance, which is contradictory to our expectation.

From the case study, this is not bizarre because listed companies, especially those within large groups, can benefit from centralised shared services and supports. This will reduce wasted overheads and expenses regarding production and marketing. From Table 6.4 we can see average top 10 shareholdings stands at 61%, not overly concentrated but gives the shareholders enough incentive to get actively involved in the operation of the business. Block-holder theory, as discussed in the literature chapter, also explains the phenomenon. When we look at the quadratic variables, a clear convex relationship is revealed between the state and legal person ownerships and all the cost indicators, which also can be explained in a similar way.

MGS positively affects firm performance and hence reduces agency costs, which is consistent with the literature and our prediction, although none of the results is significant due to their minor fraction.FRS does not work the same way. As per the example of SDGE, foreign shareholders do not necessarily actively participate in the day to day operations of a business and therefore Type I agency costs exist i.e., costs to monitor managers for acting on behalf of shareholders.

Broadly speaking, the sizes of BOD and supervisory boards have positively affected firm performance and hence reduced agency costs. From pervious discussions this can be explained by the fact that bigger boards consist of more supervisors of diverse background and hence more adequate knowledge and experience to carry out their responsibility in supervising. This is what has happened in SDG in recent years. However, it is worth mentioning that the results are mixed when using different indicators. Independent directorship gives some significant results especially when performance indicators are used, while frequency of board meetings have completely opposing results to the hypothesis due to the reasons given in previous sections, i.e. boards meet up when performance is in bad shape.

The result for external auditors is quite interesting, as it seems to worsen firm performance but at the same time reduce agency costs. On the one hand, Big Four have more incentive to scrutinise the truth and fairness of company financial statements and corporate controls over financial reporting, in order to maintain reputation and avoid negligence. Those companies where their board appoints Big Four as auditors therefore are supposed to have better governance and less accounting manipulation or fraudulent activities, which then lead to reduced agency costs. On the other hand, Big Four have more capacity in providing additional non-audit services, which often are required by companies in difficulties, i.e. worse performance or deteriorating financials. Such services, e.g. tax and advisory work, normally result in higher costs incurred by the company receiving services and hence diminish firm performance.

Actually in the interview with CFO in the SDG group, he mentioned a survey he participated in about China's auditors, which suggested that most CFOs in China think that their auditors will change their audit opinion if offered more fees, no matter international renowned firms or local practitioners. About 25% of the respondents said that the level of integrity in China's auditing industry is unsatisfactory, with a few indicating open corruption in the profession, although Big Four response this was more a public perception rather than fact due to some scandals in the capital market. This was reflected by the fact that 62% of the CFOs cited integrity as one of the top criteria in choosing an accounting firm and hence choosing Big Four. Conversations

revealed that large SOEs, including SDG would want the auditor to submit to the company's opinion and therefore use local service providers.

The signs of leverage are almost completely the opposite of prediction. From the case study, we understand this is explicable because of the unique Chinese setting. Banks in China do not have the power to force repayment of debt due to government interference, especially with large SOEs. As in Shleifer and Vishny (1994), SOEs do not generally bear any responsibility and loss on debt. Under government intervention, they can borrow as much debt as they want for any investment projects and hence deteriorate firm performance and incur agency costs.

The size of the company clearly has positively relationship with firm performance and negative relationship with agency costs in most cases. This is in line with most studies in China as discussed in the previous chapter. More specifically, large companies such as SDG will attract more government as well as public attention, and have more established connections to utilise in obtaining resources in a more cost effective way.

Research is yet to be done to discover the reasons behind the different impacts for state ownerships. For example, many studies have currently distinguished two types of STS, namely those held by government agents and by corporate shareholders, where the latter seems to work similarly as LPS. However, given the aforementioned results about LPS, this distinction between state ownership does not seem to be necessary. Moreover, if we look at STS^2, the relationship is exactly the same as predicted, suggesting the relationships might be nonlinear.

In addition, I conduct some robust tests including time effect, measurement effect, and endogeneity effect, and find the results robust.

Chapter 7 Conclusion

7.1 Introduction

This chapter will summarise the main findings of the study, discuss theoretical and practical implications and contributions, highlight limitation of study, and suggest opportunities for further research.

7.2 Main Findings

As discussed in chapter 1, there are three main objectives of this study. In the following paragraphs, main findings will be presented in the same order to show whether and how they are achieved.

(1) The study aims at identifying agency issues in Chinese listed companies.

After a thorough literature review and in-depth case study, we can come to the conclusion that agency problem in China is mainly of Type II, i.e. conflicts between principals and principals. Traditional principal-agent conflicts as conceptualised by Jensen and Meckling (1976) are no longer applicable in emerging economies like China. Researchers have realised that in emerging economies, many firms experienced principal and principal conflicts, which were characterised by concentrated ownership and control (La Porta et al, 2002, Morck, et al, 2005, Wright et al, 2005).

In Chinese listed companies, the issue is reflected as expropriation of minority shareholders due to dominant state shareholdings. More specifically, largest shareholders, normally the state, have the right to appoint and dismiss senior management hence resulting in managers being affiliated with controlling

shareholders. The conflicts between dispersed shareholders and managers thus become conflicts between minority and controlling shareholders. As per the case study in chapter 5, controlling shareholders use their inside knowledge about listed subsidiaries to make business decisions, and sometimes appropriate public funding as their own freely (e.g. SDGI). This is because controlling shareholders normally have seats in the board of the listed subsidiaries. In this sense, the bigger the board, the more independence it has to make sound business decisions without controlling shareholder influence.

(2) The study also aims at developing some direct measurements of agency costs to be used in the Chinese settings.

New direct measurements of agency costs are used in the econometric model analysis. In consistence with the qualitative explanations, ORC seems to work most effectively as an agency cost proxy as it gives most significant results as predicted. As shown in Tables 6.15, ORC generates significant results for almost all independent variables, and more than ADM does. For FCF, the results are almost all insignificant for independent variables, suggesting this might not be a valid proxy after all. In summing up, ORC could be a more efficient variable than those previously used in similar studies such as ADM.

Additionally, ORC is most appropriate to represent Type II agency problems as mentioned in the previous chapters. The way it can serve as an agency cost indicator is due to RPTs. SOEs and their affiliated listed subsidiaries use RPTs to transfer capital and resources, which then need not report in the financial statements except for some narratives. Decisions are normally made between directors, or even worse from top down, i.e. government intervention. From this perspective, ORC acts well as a result of agency issues. In terms of performance indicators, both ROE and ROA work better than Q because they are more specific to the Chinese institutional background, as many previous studies also suggest.

make discretionary decisions. However, the cost was the losses of resource allocation efficiency, and of managerial incentives to improve production efficiency and technology efficiency, and a serious agency problem of bureaucrats.[46]

This study hence contribute important insights into the nature of agency issues in newly or partially privatised public listed companies emerging in China's transitional economy. For example, "hollowing out" listed companies by controlling shareholders such as the SDGI case, which, through related party transactions, often coerce listed companies to produce guarantee, tunnelling out the funds of listed companies or dividing up the property of listed companies by relying on their special status. This is supported from the econometric analysis in previous chapters.

The results of this study can highlight how different ownership structure in Chinese listed companies might influence agency costs. Besides, the study of a large emerging market such as China provides an opportunity for testing and refining theories on the corporate governance mechanisms that have been tested in developed economies. More particularly, dominance of state ownership can work positively with firm performance if backed up by a certain level of management ownership.

7.4 Methodological Contributions

Examples of expropriation of shareholders are abundant. Some of them are outright theft of corporate property, known as managerial theft (Shleifer & Vishny, 1997). For example, the manager can sell outputs or assets of the company s/he manages to companies owned by themselves or relatives, or pay themselves excessively high salary or bonus. More elaborate forms of expropriation of shareholders include managerial entrenchment, consumption of perks, empire-building and managerial

[46]Bureaucrats enjoy considerable freedom to expropriate public funds through various ways. One such way was to make investment in their hometown for private benefits, even if the return is much less. This misallocation is possible because it is impossible for the public to understand what the optimal routine is or it is too costly for them to stop the decision (Zhang, 1998).

(3) The study further aims at testing how a selection of corporate governance mechanisms affects agency costs in Chinese listed companies.

Relevant corporate governance mechanisms are identified to be more useful in China. One of the significant mechanisms is managerial ownership, although it has only a small proportion in total shareholdings of Chinese listed companies. This finding is important because traditional theories conclude firms in emerging economies are forced to rely on dominant ownership to keep potential managerial opportunism in check (Dharwadkar et al, 2000), and the result of this study actually showed that managerial ownership would have positive impact on company performance and reduce agency costs. Another significant finding is that introduction of the independent director system operated effectively after 2002 in mitigating agency issues, especially with the cost indicators. More importantly, corporate culture is brought up as an essential governance mechanism in this study, although current research is merely qualitative due to various reasons as mentioned in earlier chapter. Going forward this is an interesting field of study.

7.3 Theoretical Contributions

The essence of the agency problem is the informational asymmetry resulted from the separation of ownership and control. When shareholders delegate much of the control power over the company to the manager, they face two kinds of informational asymmetry that put them in disadvantage (Zhang, 2000). The existence of these two kinds of problems, better known as "adverse selection" and "moral hazard", makes it possible for the manager to divert from the objectives of shareholders and pursue his own interest using the resources of the company, as the interest of the manager typically differ from that of shareholders. The combination of residual income and residual control rights constitutes the essence of what economists call the ownership of the firm (Grossman & Hart, 1986).

As opposed from the traditional view, the most distinct feature of Chinese SOEs from capitalist firms is that, by definition, the role of principals in SOEs is played by the government rather than natural capitalists. The government appoints, motivates, and disciplines managers, and finances firms' projects. This has substantial implications for corporate governance of the enterprises. First, it implies that the investor of the firm is completely an outsider, and there exists no managerial ownership. As the owner is far away from the management team, and the manager has no stake in the firm, the agency problem of SOEs on the management side is potentially far more serious than of any capitalist firm where the CEO normally holds a considerable stake and is therefore an inside owner. Second, since the government is a pseudo-player rather than physical entity, principalship of the state has to be delegated to and exercised by governmental bureaucrats through a hierarchical structure (Zhang, 1993).[45] Governmental bureaucrats hold extremely concentrated control rights of the firm while they are not actual residual claimants, in a legal sense, because the residual belongs to the state. Therefore, control rights are separated from residual claim in the first place.

Moreover, these bureaucrats typically have goals that are different from social welfare, and are dictated by their own political and economic interests. This creates another agency problem, i.e. Type II agency problems, of how to motivate and monitor bureaucrats in order for them to behave like capitalists in selecting, disciplining, and motivating management. In any realistic sense, this second agency problem is far more serious than the first one, as discussed in previous chapters.

More particularly as the case study in SDG shows, the problem of SOEs is mainly that of the principal rather than that of agents, i.e. Type II agency problems. The benefit of central planning was that the agency problem of managerial theft and expropriation of funds at the firm level was tightly restricted since management had little freedom to

[45]Theoretically, "all people" are the principal (owner) of the firm, and the state is only a representative of all people (Zhang, 1993).

shirking. While outright theft may just be wealth redistribution from shareholders to the manager, more elaborate forms of expropriation often involve substantial efficiency loss in that what the manager gains is much less than what shareholders lose.

In either case, the company incurs an extra cost, which is known as the agency cost. Agency costs are a type of transaction cost, reflecting the fact that without cost, it is impossible for principals to ensure agents will act in the principals' interest. Agency costs include the costs of investigating and selecting appropriate agents, gaining information to set performance standards, monitoring agents, bonding payments by the agents, and residual losses.

Many works use Tobin's Q as a measurement of firm performance in the accounting and finance literature, and hence an inverse indicator of agency costs. In theory, the Q ratio identifies the juxtaposition of managerial efficiency of capital and the financial cost of capital. Scholars have simplified Q as sale to assets ratio. There are two alternative inverse indicators of agency costs in China. The first indicator for agency costs is ROA, which is defined as the ratio of before-tax profits over the book value of total assets (e.g., Xu et al., 2002). An alternative indicator of agency costs is the ratio of ROE, as a measure of profitability (e.g., Li & Cui, 2003). This indicator measures profitability from a different angle.

As far as cost indicators are concerned, FCF constitutes what management can freely use for non-ordinary activities and is used in many recent studies as agency costs indicator. In Jiang et al (2005), the researchers suggest the use of ORC as an indicator of tunnelling and conclude that companies with large ORC balances experience worse future operating performance and are much more likely to become candidate for delisting. In the same way, Cheung et al (2005) obtain data on firms undertaking RPT with SOEs, and analyse the characteristics of these transactions, and the corporate governance characteristics of the firms undertaking them.

As these studies are more qualitative, this study focuses on quantifying some direct measurements of agency costs. Administrative cost is always high among Chinese listed companies, and it can be divided into two parts. One part is the financial cost, including all kinds of interested payments and other finance related payments. The other part is personnel related, which can be viewed as agency costs, known as ADM.

This study also defines FCF and ORC in the Chinese context. By using all the aforementioned variables as in chapter 6, the study identifies the significance of different model specifications, which is the first comprehensive attempt in the literature. The various robust tests also have made the results more vigorous.

7.5 Implications

Apart from the contributions mentioned above, this research project also generates regulatory and practical implications in several aspects.

7.5.1 Regulatory Policy-Making

The current legal framework for corporate governance is based primarily on the following national laws and regulations: the Certified Accountant Law (1993), Audit Law (1994), Company Law (1994), People's Bank of China Law (1995), Commercial Bank Law (1995), Securities Law (1998), and Accounting Law (1999). They key regulatory bodies involved in the lawmaking process are CSRC, the State Economic and Trade Commission, the MOF, and the PBC. According to the Company Law, there are three tiers of control over a company's operations: the shareholders' general meeting, the boards of directors and supervisors, and management.

In theory, the general shareholders' meeting has final say over the key issues of the company, such as approval of the management strategy, the financial budget, and key investment plans, and the nomination of the boards of directors and supervisors. The board of directors makes key investment plans and the board of supervisors oversees

In the Chinese context, as the reform proceeds, incumbent bureaucrats find it more and more difficult to capture rents in their current positions, because of the disappearance of monopolistic profits and managerial discretion, while they find it better to do business with their remaining political capital of "Guanxi" (interpersonal connections) before it fully depreciates. Before they leave government office, they will grant full autonomy to the firms with which they will work. They will appoint themselves as chairpersons of the board, directors, or executives. Once they pocket some profits, they will buy into the firms. They can do this quietly because once the firms are corporatised, they can easily be sold bit by bit instead of as a whole.

The SOEs gradually change into private joint-stock companies. In this stage, it is possible for the government to become a bondholder who can be protected by private shareholders. Once incumbent bureaucrats become capitalists, they will have incentives to select high ability people for management; they themselves will voluntarily step down if unqualified. The separation of government from enterprises will be achieved accordingly. This is what was already happening with most SDG's not listed subsidiaries, beginning in early 2000s.

Greater diversification of the ownership of SOEs could provide an important opportunity for improving governance. Increasingly, enterprises are being partially divested to non-state interests through minority shareholding, mainly through Sino-foreign joint ventures and shares sold on stock exchanges in China and elsewhere. Diversifying ownership, however, is not enough, and, without the proper institutional framework of checks and balances, may compound insider control problems. The keys to success are to ensure that ownership diversification is carried out through transparent and competitive procedures and, more importantly, that it provides for investments on behalf of the state to be managed by independent professionals – custodians or trustees – whose remuneration is linked to performance. Reorienting China's SOEs toward the market will require reducing the state's involvement to passive minority ownership.

To complement this streamlining, a robust market for managers within a firm, across firms, across sectors, and across regions would be helpful. Increasing outsider participation by appointing non-state representatives to the enterprises' BOD is equally important. Board members should be selected from different regions and have diverse backgrounds. Cross-sectoral and cross-regional diversification of management and of shareholders is also important.

On the other hand, unless banks are privatised, they cannot be expected to play a constructive role in corporate governance of enterprises. This is because only private banks can have adequate incentives to select good managers and good projects for financing, and to enforce debts contracts through the bankruptcy mechanism. As long as banks are owned by the state and run by bureaucrats, and thus the state remains the ultimate rescuer of losing concerns, enterprises, even privately-owned, cannot be financially well-disciplined by the banks, and the fundamental problems of moral hazard and adverse selection cannot be solved as well as in a capitalist firm.[47]

7.5.3 Empirical Methodology

This study uses firm-level panel data for 2000-2005 to derive robust tests of formulated hypothesis on the corporate governance mechanisms. Some of the limitations in prior studies, such as the use of single-period data or out-dated data, are mitigated in this project. Before 2000, China adopted a quota allocation system by setting an annual limit on new share issues (Aharony et al, 2000). If an enterprise wanted to apply for initial public offering (IPO), it had to go through a rigorous and lengthy approval process covering such matters as the adequacy of business plans, managerial expertise and financial conditions. Hence, only a handful of applications

[47]Recently Geng (1998) proposed that, as a first step, China should separate the bank's deposit business from its lending business by allowing foreign banks to make direct loans to Chinese enterprises with inter-banks' financing from their Chinese counterparts who take deposit directly from households. However, it still faces the potential problem of possible collusion between foreign private banks and Chinese state banks.

were likely to be approved to make and IPO, thus making corporate listing qualifications relatively rare events (Aharony et al, 2000). In particular, independent director system was introduced in China in the year 2002. By comparing the three-year period before and after the adoption of the system with plenty available data, a more robust test of the research hypothesis can be performed. Moreover, by employing a two-stage analytical approach this study should be able to generate more informative insights into causality of agency issues than previous studies, as discussed in the literature review chapter.

Another important implication is the use of new variable ORC as an agency cost indicator, which inspires some new research projects. The methodology and results of this study can therefore act as a useful framework and benchmark for future research in China and other Asian countries, which have a similar economic structure and political history to China.

7.6 Limitations and Opportunities for Future Research

Like many other empirical studies, there are certainly some limitations in this research. A common one is the quality of data about Chinese listed companies, given the volatile stock markets in China. There are some limitations specific to this study, which at the same time would be interesting areas for future researchers.

Firstly, only major internal corporate governance mechanisms are discussed empirically due to lack of complete data source. Specifically, only ownership structure and board data is used for empirical study, including state shares, legal person shares, foreign and managerial shares, as well as board size, composition, and meeting frequencies. More and more studies have found institutional shares play an important role in corporate governance. Therefore, it would be interesting to explore how institutional ownership affects firm performance and agency costs, e.g. investment funds, securities companies, and insurance companies. Also sub

committees to the board seem to become increasingly important in modern corporate governance practices and their roles and impact on agency issues are an interesting topic to explore as well – maybe as one of the proxies as corporate culture.

Secondly, agency costs are measured in two ways: performance indicator and cost indicator, which are taken from the literature. Further justifications might be needed for such measurements, and there might be ways to look at other possible measurements for this main variable, especially in the Chinese setting. In fact, actual related party transactions data, rather than proxy by other receivable accounts, could be useful, as long as they are clearly classified in terms of transactions type. Scholars have already done several studies on the topic, which are however all restricted for explanatory power because of data restraint resulted from limited disclosure.

Thirdly, the case study is undertaken in the SDG group and its listed subsidiaries. As the method itself has limitations, the result cannot be generalised to show a picture of all Chinese enterprises. It is only an example illustrating what agency problems exist in typical SOEs and how corporate governance mechanisms affect agency costs. Further studies could be taken to link the mechanisms with other government or managerial behaviour in devising effective governance system for policy-making.

About dependency on state-owned banks:

1. A reported, your company has raised a large amount of debt – over 0.9 billion, while the operating income is negative during these years. Why did your company have such a high level of debt? Did your banks exercise any control, monitoring or influence on your company? Do you think the banks and other debt holders make efforts to monitor your company through the years, if yes, how? Why would this high level of debt cause concerns for the company and the government? Why was there a need to operate this debt-for-equity scheme? What was the consequence of the implementation of the scheme? Did it achieve the expected outcome?

2. During the process of changing your debts into shareholding, you also change the state shareholdings into debt, totalling around 0.6 billion. Why did you do that?

3. How do you maintain your operation and pay the employees except for selling your assets and lands bearing such heavy debt? Did you discuss corporate dependence on bank loans or the state on executive meetings?

About information asymmetry:

1. Do directors have good access to firm information and good communications with management?

2. Your company has invested in Water Paradise and Xiaomeisha Resort. Could you talk about the current situation of these two projects? How were these projects initiated? What decision processes were involved? Who was most influential in making the investment decisions? What benefits have these projects generated? Were they beneficial at the beginning? What are the downsides of these projects? Why would they become loss-making projects? How did you track the performance of each invested project? Do you have any further plans for such projects?

Appendix: Interview Questions

To the respondents:

Thank you very much for your willingness to carry out this interview for my PhD project. I am currently doing my PhD at Cardiff Business School in the UK. The objective of my doctoral research is to investigate agency issues in Chinese listed companies and evaluate the effectiveness of internal and external corporate governance mechanisms on reducing agency costs.

The following questions will therefore fall into three themes: agency issues, agency costs, and corporate governance mechanisms. Your frank response is important and will be much appreciated. Normally the interview conversation will be recorded only for accuracy in quotations. To preserve anonymity, interviewees will remain anonymous. Your data will be treated with full confidentiality and will not be identifiable as yours in my PhD thesis or any publications based on the thesis. If you are interested, I can send you the findings from my research.

Theme One: Agency Issues

In this part, there are two categories of questions. Category 1 is a series of questions on exploring evidence of agency problems and conflicts between government and managers, between shareholders and debt-holders, between large and small shareholders, and between shareholders and managers. Category 2 is about the ways in which these agency problems manifest, such as insider control, dividend policy, tunnelling and related party transactions. In the end, you can give your opinions on this theme in case any vital questions are missing.

Category One: Evidence of Agency Problems

About government interference:

1. Before April last year, your company was 100% state-owned. How did the management structure look like at that time? How did the government and the party exercise control over the company?

2. Did the Shenzhen government appoint your general manager? Who appoint other senior management? How were their work evaluated? How were their salaries and bonuses decided? What were their salaries and other remunerations? Do you feel that the level of managerial compensation provide a sufficient motivation for top managers to perform well?

3. What were the advantages and disadvantages of each of these major practices (appointment of the general manager by the government, low salaries, evaluation of managerial and firm performance by political criteria etc)?

4. Currently, which government or party departments have the strongest influence on your company? How do they exercise control or influence over the company (through personnel control, finance control, or organisational control)? How are the government/party departments interests represented in the company? Which aspects of your company are most affected by the government/party departments? Is the influence from government/party departments the same with your subsidiaries? Within the state-owned segment of your group, compliance is closely linked to CPC policies and regulations. What is your view of compliance as it relates to your subsidiaries?

About large shareholder control:

Do you perceive any appropriation of small shareholders by large shareholders? Do you perceive insider control in your firm? Is there any misuse of firm funds by the management representing controlling shareholder? What measurements do you take to alleviate the problem? Do you discuss such things in board meetings?

About empire building:

As reported, your company operates in more than 20 industries and have so many subsidiaries that even the top management has no idea how many exactly companies it controls. The statistical number of your subsidiaries reaches over 300 at maximum. What have caused the company so big and diversified? How do you view this situation? Do you consider this as empire building? What are the advantages and disadvantages of being big for the company, for senior management, and for shareholders? When deciding to enlarge the size of the firm who made the judgements?

About agency costs:

1. How much was your firm's average operational costs and administrative cost over the past years? How much was the average entertainment costs? What areas are the costs spent? Was it reasonable? Do you think it can be considered agency costs? What other sources do you think are the roots of agency costs?

2. In many cases, managers use company wealth for excess personal expenses or social events like banquets and drinks, overseas travelling, or even purchase of expensive cars for personal use. It is common that they neglect long-term developments and expropriate profit for rises in salaries and bonuses, or manipulating the retained profit by paying fewer dividends to state shares. Do you perceive such

situations in your company or your subsidiaries? Do you think it can be considered agency costs? What other sources do you think are the roots of agency costs?

Category Two: Ways to Manifest Agency Problems

About insider control:

According to the annual report for your listed subsidiaries, many of their directors hold positions in the parent company, which makes their operations dependent on the parent company. Do you agree with this? How close is your control over the operations and policies in the listed company? For example, you hold 72.45% of Tellus' total shareholdings, which is a high concentration. What advantages and disadvantages does this concentration have for the parent, subsidiaries and investors?

About dividend policy:

Dividend policy is set to protect minority shareholder or individual investors. However, in China, as large shareholder is usually the state and owns large portion of listed companies, do you think dividend payment is really in favour of minority shareholders of individual investors? What is the dividend policy of your listed subsidiaries? Did they pay dividend through their own wills or by obeying the regulations by CSRC? Did they pay dividend before or after issuing new shares? Do you think that through dividend payment the large shareholders actually expropriate the interest of minority shareholders? To what extent do you protect the rights of all of your shareholders, including your ability to prevent majority shareholders from diluting the value and interests of minority shareholders? How did the parent company influence dividend policy of subsidiaries? Why that influence? What was the outcome of the influence?

About fund switching:

What sort of performance measures do you use in deciding which projects receive funding? What procedures have you taken before investment decisions? Have you ever switched the usage of funding that is not disclosed in your annual reports?

About related party transactions:

1. How many related party transactions happened in the past year? Are you aware of every event of related party transactions? Do you discuss every event in board meetings? Do independent directors provide their opinions? How do you guarantee the fairness, openness, and objectiveness or the related party transactions? What was the purpose of the transactions? What was the process of initiating and implementing the transactions? Did they achieve the objectives?

2. In the annual reports of your listed companies, there is evidence that a large amount of their assets is occupied by the parent company. Among the three listed companies, SDG uses the capital of SDGI the most. At the end of 2003, with the request of CSRC, SDGI disclosed how large shareholders occupied the capital. The two largest shareholders used a huge amount of its capital, totalling in over 100 million, without any approval or relevant procedures. How could you explain the background of these two capital occupations?

(The required disclosure on related party transactions focuses mainly on the form and amount, while the economic objectives, operational considerations, or the consequent influences on performances of both parties are missing. The following questions will therefore emphasise on the missing information of some specific related party transactions.)

3.1. On 28/07/2001, SDG bought enterprises that actually are losing money at zero prices (e.g. Tellus Yueyang Real Estate, Longgang Tellus Real Estate, Tellus Yangchun Real Estate, Tellus Real Estate Huizhou Subsidiary, Dongguan Tangxia Zhenxing Plaza, Mechanical Equipment Import and Export Corporation, Tellus (Jinbian) Development, and Hong Kong Yujia Investment Co. & Ltd. SDG also paid the debts of these companies and projects at a total amount of 167 million, using 60% of the shareholding of Car Industry Trading Company and Huari and 45% of Zhongtian Industrial Co. & Ltd. In the year 2001, Tellus realized a profit of 5.1441 million and escaped from delisting temporarily. Was there any strategic concern behind the transaction? Was it aimed at preventing the Tellus from being de-listed? What other projects could the funds have been used for if not for the transaction?

3.2. There was a related party transaction on 03/09/2003 between SDG and your subsidiary Tellus in the form of asset displacement. The 60% shareholding of SDG Huari Car Company (Huari) was registered into Tellus, and the Chairperson of SDG Board of Directors held a concurrent post of chairperson in Huari. How was the transaction initiated? What was the principle objective of this transaction? Do directors on both parties agree on the transaction? Was there anyone not in favour of it and if yes what happened then?

3.3. On 10/01/2000, SDGI raised a cash capital of RMB 63867000 transfer all the shareholdings of Xinxingsuo Fibre-Optic Cable Communication Co. Ltd. held by SDG, resulting in 75% of the company's registration capital. How was this transaction initiated? Was there pressure about solving your cash flow problem? How did you discuss this transaction in executive meetings and reach the decision? Was there a voting process? Did all the members on the board of SDGI agree with this transaction? Did it solve any financial distress problems in your company?

Theme Two: Corporate Governance Mechanisms

In this part, I am going to investigate what corporate governance mechanisms actually exist in your company and your subsidiaries; how many external and internal mechanisms are; and how they affect agency problem and agency costs.

About general corporate governance practice:

1. What is your perception of corporate governance structure and mechanisms in your firm? How do you compare your firm's current corporate governance practices with those of one year ago? How do you compare corporate governance in the parent company with those in the subsidiaries? Are you familiar with your listed subsidiaries? Can you talk about the corporate governance in those three specific firms?

About the role of government:

1. By law, SOEs are governed by State-owned Assets Supervision and Administration Commission. Which government or party departments have the strongest influence on your company? How do they affect the company (through personnel control, through finance control, through organisational control)? How the government/party departments' interests are represented in the company? Which aspects of your company are most affected by the government departments?

2. Within the state-owned segment of your group, compliance is closely linked to CPC policies and regulations. What is your view of compliance as it relates to your subsidiaries?

About ownership structure:

Are you satisfied with current ownership structure of the firm? After the reform during last April, the state now has only 43.30%. How do you think the decrease in ownership concentration and state shareholding will affect your company's performance? Can you think of any advantages and disadvantages of the reform in your ownership structure?

About shareholder roles:

After the reform in last April, you now have Changcheng, Dongfang, and Xinda asset management companies as your shareholders. How did your first shareholder meeting go? How were the board of directors and supervisory board selected? Were the members appointed by the government or by all the shareholders? Did they present in your offices every day? Did they give opinions or interfere with your operations? Were there any changes on your management team? Have you now had, or plan to set up, any subcommittees, such as audit committee, strategy committee, or remuneration committee?

About the effect of the controlling shareholder:

In China, there are agency problems between the controlling shareholder and management and controlling shareholder with smaller shareholders. Do you think there are such problems in your company, e.g. do the controlling owners of this firm are keen to pursue their own interests over company value? Please could you give some examples for the problems mentioned? Why do you think could the problems happen in your firm? What do you perceive as the consequences of the problem? How do the board perceive, discuss or deal with these problems?

About shareholder protection:

1. To what extent do you protect the rights of all of your shareholders, including your ability to prevent majority shareholders from diluting the value and interests of minority shareholders? How?

2. To what extent do you provide independent oversight of management performance? To what extent do you hold management accountable to shareholders and other relevant stakeholders? How?

3. A major theme of corporate governance today involves the active participation of shareholders in a company's decision-making. How do the shareholders in your company make their concerns known? Do they send shareholder proposals to the company on an annual basis? Do you provide e-mail addresses for the chairs of each of the committees of the board, as well as for the board of directors as a whole? Do shareholders take advantage of that and communicate with directors via e-mail? What are the usual ways of communication between shareholders and your company? What is the volume of these communications, and from whom do they tend to come?

About the role of banks:

As you have huge loans from banks, do you think they make efforts to monitor this firm through the years? Do you discuss corporate dependence on bank loans on board meetings? When you decide to apply for bank loans or raise capital from capital market, the firm will incur additional expenses. How do you choose between the fund-raising methods? How do you come to the investment decision?

About board of directors:

1. How is corporate governance involved in the selection of the board of directors? Is your board predominantly an independent board? How many insiders are there on the board? Do they have same impacts on board decisions as outsiders? What measurements have you taken in preventing insider control?

2. Could you please talk about the composition of your previous board and senior executives? Were there any independent directors? How often did they meet every year? Do you think the performance of your company has been improved after the reform last year? Were there any big events in your company during the past year discussed in board meetings? Were they involved in evaluating the performance of general manager and other senior management? Are the board directors and supervisors closely involved in your business? Are there any formal decision-making procedures?

About independent directors:

Do you perceive any difference in corporate governance before and after the introduction of independent directors system? Do you believe independent directors of your company are truly independent from the general manager/chairperson or controlling shareholders? What are the reasons do you think prevent independent directors being independent?

About auditing and supervisory function:

1. To what extent do you understand the importance of audit committee? How is your supervisory board working in supervision and governance?

2. Your publicly listed companies are audited by external auditors. What is the case with the parent company? The State Council's National Audit Office sets the standards and can audit any of the state-owned enterprises at any time. Is your parent company audited on a regular basis? Did you ever get a qualified audit opinion from your external auditor over the years, and if yes, why? Did the management fight against it?

About financial disclosure:

To what extent do you disclose the accuracy and timeliness of your financial position, condition and prospects, and other non-financial information, and the ability of existing and prospective investors to access this information?

About the role of CSRC:

1. In order to improve the Chinese capital market, CSRC has strong regulations over listed companies, especially on compatibility, profitability, corporate governance, creditability, and transparency. How do you discuss and realize these aspects in your firm, for example in board meetings, information disclosures, independent directors?

2. CSRC has recently strengthened the regulation on misbehaviours of listed company operations, such as insider transactions, fake information disclosure. What measurements does your firm take in preventing such occasions? How do you view the fact that even CSRC issued many regulations, still there are listed companies neglecting the rules and committing financial faults?

About how to improve corporate governance:

1. What do you think are the strengths of corporate governance in your company?

2. What do you think are the weakness of corporate governance in your company? What improvements do you think can make corporate governance better?

Thank you for your time and help. It has been a great talk and the conversation is very helpful with my thesis writing. If possible, I would like to contact you again for small details concerning this interview or missing questions. Thank you very much again and wish you all the best in your future endeavours.

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own performance look good on the financial statements. Dahya et al. (2003) also indicate that many M&A are at least partly arranged, or even forced, by local governments.[24] It is thus not surprising that many mergers have mainly led to changes in names rather than actual restructuring. Therefore, China will not have an active market for corporate control until more non-state controlled enterprises are listed in the stock exchanges (Tam, 2002). For the reason stated, M&A as a corporate governance mechanism is not considered in this study.

Fama (1980) stresses the importance of the managerial labour market by arguing that the outside managerial labour market exerts many direct pressures on the firm to sort and compensate managers according to performance. Jensen and Ruback (1983) also recognise this pressure given the fact that when the incumbent management team performs poorly, its position is threatened by a takeover and subsequent replacement by another management team.

However, the role of competitive market for managerial manpower has not been available in China also. For listed companies with the state being a controlling shareholder, the pool of appointment to the positions of chief executives, most senior management, and a high proportion of directors on the board is restricted and subject to government influence or direct intervention (Tam, 1999).

Recent reforms of SOEs have improved the operations of a managerial labour market. Poorly performing firms are more likely to auction for a new manager, and accordingly managers are fired for poor performances. Managerial pay has been linked to sales and profits figures. Therefore, the managerial labour market is still immature as a governance mechanism in China, although economic reforms have helped develop an improved system of managerial resource allocation responsive to market forces. Therefore, this is also outside of scope of this study.

4.7 Summary

To sum up, there are three main problems with corporate governance mechanisms in China. (1) Problematic internal governance structure: the power structure is unreasonably set and lacks effective control and supervision on 'insiders'; shareholding structure is unreasonable - there is too large proportion of un-tradable shares and dominant shareholders; the BOD is

[24]They further state that market-led M&A are not effective because of the administrative and bureaucratic barriers created by the traditional macro-economic management system, which divides the economy into industries and geographic areas controlled by ministries and local government.