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**PUBLIC VICES IN PUBLIC PLACES:  
CHALLENGES IN CORPORATE GOVERNANCE  
DEVELOPMENT IN CHINA**

by

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**PRIVATE VICES IN PUBLIC PLACES:  
CHALLENGES IN CORPORATE GOVERNANCE DEVELOPMENT IN CHINA**

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"Even in misfortune there is fortune".

-- An old Chinese adage.

## I. INTRODUCTION

The "agency problem" inherent in the separation of ownership and control of assets was recognised as far back as in the 18th century by Adam Smith in his *Wealth of Nations*, and studies such as Berle and Means (1932) and Lorsch (1989) showed the extent to which this separation had become manifest in U.S. firms. But the concept of corporate governance has only come into its own in the past twenty years, deriving its analytical framework from theoretical developments in financial, industrial and institutional economics and its policy implications from empirical studies seeking to explain the microfoundations of international economic competitiveness. Until very recently, however, these studies were almost exclusively concerned with corporate governance in mature market economies with highly developed markets for the external financing of corporates. Yet the problem of corporate governance is arguably even more serious, and even more of an imperative, in transition and emerging economies.

The recessionary transformation in the transition economies of the Former Soviet Union (FSU) and Central and East Europe (CEE) has been unprecedented in modern history. The output collapse there has been greater and more prolonged than the Great Depression of 1929-32; a decade on, transition economies displaying evidence of nascent recovery are still the exception rather than the rule. A major factor behind the painfully slow process of recovery in these economies has been their weak microfoundations despite -- or because of -- mass privatisation which failed to address the problem of corporate governance. The resulting patterns of ownership and insider control of privatised state-owned enterprises (SOEs) have proved detrimental to restructuring and recapitalisation<sup>1</sup>. In the few economies (e.g. Poland and Hungary) where output has begun to recover, growth has derived mainly from the *de novo* firms while the large privatised SOE sector remains largely moribund. Clearly, the shortage of capital remains a severe impediment to recovery: the shift from repressed inflation to high open inflation wiped out real balances and the value of much domestic assets. Although capital shortage is a real problem, extensive capital flight and currency substitution suggest that there is probably more capital around than official statistics show. The major constraint to economic recovery are difficulties in mobilizing capital for corporate financing. The underdevelopment of efficient financial markets in transition economies inhibit financial intermediation between savers and investors, but ultimately the problem lies in the weak corporate governance of firms.

The imperative of good corporate governance in emerging or developing economies had also begun to be recognised in the mid-1990s, primarily because weak corporate governance was seen as undermining their ability to attract external sources of capital in increasingly

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<sup>1</sup> Recent studies [references to be added] of a number of transition economies, however, show that there are no significant differences in the performance of insider-controlled and outsider-controlled firms but foreign invested firms tend to perform better.

competitive international financial markets attendant upon globalisation. But it was the Asian financial crisis in 1997, followed by the Brazilian and Russian financial crises, that provided the "definitive" evidence for the corporate governance imperative in developing countries. In the case of Asia, for example, it was widely argued (by the multilateral financial institutions, at least) that defective corporate governance lay behind the corporate and financial malpractices responsible for the crisis. (That this argument has now become the received wisdom despite the fact that rigorous empirical evidence for such conjectures is almost completely absent, or that the corporate governance of the international financial institutions who invested massive amounts in the region has yet to be scrutinised, is another story<sup>2</sup>).

Corporate governance development has consequently become a major policy priority in many transition and developing economies, with most initiatives modelled after measures recommended in or adopted by the mature market economies that have been pioneers in corporate governance development -- mainly Anglo-Saxon countries, such as the United Kingdom and the United States, characterized by the primacy of equity market financing of corporates, widespread share ownership, highly developed institutional investors and the so-called outsider model of corporate governance. Transition and developing countries, however, are often distinguished by a number of structural, systemic, policy and institutional features which pose peculiar problems in corporate governance development. These features may not necessarily invalidate the first principles and axioms of good corporate governance as developed in the mature western economies, but they are likely to dictate differences in emphasis and nuances, and certainly in the "entry points" and modalities of corporate governance enforcement. These peculiarities include the following interrelated stylized features.

First, the **public policy** or national economic developmental aspects of corporate governance are more pronounced in transition and developing countries than in more developed ones. Corporate governance has both a narrow and a broad meaning or objective. In its narrow conception and at the level of the firm, corporate governance is concerned with the protection of the interests of shareholders and other stakeholders, with shareholder value the objective or benchmark of corporate governance in one of its more narrow conceptions. But since governance and performance of firms determine the efficiency and competitiveness of a country's corporate sector, financial stability, and ultimately the development of the national economy, corporate governance is also a public policy issue. This broader conception and aim of corporate governance -- creating robust microfoundations of macroeconomic stability and growth -- is particularly relevant in transition and developing economies faced with the challenge of establishing efficient, market-based economic institutions.

Second, transition and most developing economies have **corporate landscape morphologies** significantly different from those of advanced market economies. They typically have large and inefficient public sectors. Their corporate landscapes and industrial structures are dominated either by large SOEs or by large founder family-owned and controlled firms. The

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<sup>2</sup> Although there are numerous works on corporate governance in Japan, there have been very few studies of corporate governance of Asian emerging economies. The number of such studies have increased following the Asian financial crisis, such as those by [references]. The ADB and the World Bank also undertook a number of studies as part of the APEC corporate governance development initiative. But most of these studies focused mainly on the legal framework for corporate governance and do not examine actual practices.

problem in these economies is not so much insider control (so advocated by Shleifer and Vishny (1997)) per se as it is one of which type of insider and/or excessive ownership concentration. Debt market, not equity market, financing is the principal source of external capital for firms, and capital markets are typically underdeveloped. Typical, also, are pervasive internal financial "markets" operating within large cross-held conglomerates (such as in Korea, the Philippines, Hong Kong, etc.). These morphologies mean that corporate governance development measures focused primarily on publicly listed companies -- typical in mature economies -- would be barking up the wrong tree.

Third, transition economies and developing countries to varying degrees are defined by relatively **underdeveloped policy and institutional environments** within which firms operate. Legal and regulatory frameworks are typically rudimentary with poor contract enforcement. Accounting, auditing and disclosure standards are inadequate for the level of transparency and monitoring necessary for good corporate governance. Product market competition vital for imposing commercial discipline on firms tends to be weak due to oligarchic industrial structures. Insider controlled firms (former SOE management in transition economies and founder family in developing economies), with senior appointments often made on the basis of political or kinship ties, mean that managerial job markets are underdeveloped and senior managerial jobs are not contestable. Above all else, debt market discipline is weak due to uncompetitive (and often state dominated) banking systems while equity markets and institutional investors are too small to serve as a market for corporate control and for evaluating firm performance through investors' entry and exit.

Fourth, the **role of the state** is still often pervasive in transition and developing economies. As noted earlier, in many transition and developing economies state ownership still dominates. In many such economies, extensive state regulation (e.g. "bureaucratically administered economic systems" in the parlance of comparative systems) and state patronage operate to create an unholy nexus of government, big banks and major firms that gives rise to serious and widespread moral hazard problems. Even more important is the **duality of corporate and political governance**: i.e. the impact of political governance on corporate governance and the consistency between them. It is worth recalling that the term "corporate governance" did not exist twenty years ago and the concept was borrowed from politics. Corporate governance is merely an analogue of political governance: "shareholder democracy", with agents (management  $\Leftrightarrow$  political leaders) elected by and accountable to principals (shareholders  $\Leftrightarrow$  the public) and the firm (government) operated in a transparent fashion in the principals' best interest. As such, corporate governance (politics of the boardroom) tends to mimic political governance or processes and it is difficult to imagine a situation where democratic values and processes can be fully instilled or practised within a firm when the overall polity precludes and negates participatory pluralism<sup>3</sup>. Corporate governance development in such societies will need to take explicit account of the political parameters.

These *differentia specifica* of transition and developing economies, although often noted, tend to be ignored when it comes to prescriptions of corporate governance development. The "no one size fits all" caveat is often made, but then normative measures proceed, for

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<sup>3</sup> Of course the relationship is asymmetric: firms can easily be undemocratically governed within a democratic policy, but an undemocratic polity inhibits the nurturing of democratic corporate governance.

example, to recommend implicitly or explicitly a shift towards equity markets in conformity with Anglo-Saxon economic prototypes as a means of corporate governance development -- a case of the mountain going to Mohammed rather than the other way round<sup>4</sup>.

The challenge of corporate governance development is undoubtedly more formidable in transition and developing countries because of policy and institutional environments less conducive to the enforcement of corporate governance. But I would argue that, by the same token, addressing these challenges provide these economies with unique and historic opportunities for corporate governance development less available to the advanced economies<sup>5</sup>. Like putty-clay fixed capital which lose their malleability, institutions (social, economic and political) once established or "institutionalised", are very difficult to reforms: witness the irony of the Washington Consensus-based shock therapy or big bang transition strategies when the U.S. itself has been unable to reform its health care system despite decades of attempts. Transition and developing countries enjoy "advantages of backwardness" where economic and legal institutions are concerned. Many of these economies are engaged -- or need to engage -- in a whole host of micro and macro reforms, in particular public sector reform or privatisation and financial market development as well as development of the legal and regulatory regime. As such, they have an opportunity to design *ex ante* and configure, purposively and simultaneously, ownership patterns, the corporate landscape and the financial architecture most conducive to effective corporate governance. As an old Chinese adage puts it, "there is fortune in misfortune".

What follows in this paper is an examination of corporate governance in China: the nature of the problematic, actual corporate governance practices, the factors impacting on actual practices and the policy options which might be considered in improving corporate governance. The objectives are twofold: firstly, to describe and analyse corporate governance in China, and secondly, to use China as a case study to illustrate some of the points made above. China is at once both a transition and a developing economy where the macroeconomic and broader developmental issues in corporate governance are pronounced. But among transition and developing economies it is also an outlier. Unlike other transition economies (with the exception of Vietnam), it has adopted a gradualistic transition strategy which so far has precluded mass privatisation, with poor performing SOEs still heavily predominant in the real sector while its financial sector remains fundamentally unreformed and administratively-based. Unlike other developing countries (with few exceptions), it has a very high -- indeed one of the world's highest -- savings rate at about 40 percent of GDP, and a huge money balance (M2/nominal GDP ratio in excess of 120 percent) desperately seeking more efficient financial intermediation into more illiquid and productive assets. The supply (sources of external corporate financing) and demand (corporate restructuring and recapitalisation) for corporate

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<sup>4</sup> However, some more recent national and international guidelines on best practice in corporate governance have tried to take greater and explicit account of the peculiarities of developing countries. For example, The Commonwealth Association for Corporate Governance (CACG) Guidelines (1999) take more account of the wide diversity and emerging market features of the Commonwealth countries and adopt a wider or more "inclusive" approach to cover state-owned enterprises and the interests of stakeholders other than shareholders.

<sup>5</sup> And many advanced or developed economies are equally in dire need of corporate governance development!

governance could not be better matched. China therefore presents somewhat of an extreme case in terms of both the imperative of corporate governance and the potential for corporate governance afforded by its advantages of (institutional) backwardness.

## II. THE MACROECONOMIC IMPACT OF WEAK MICROFOUNDATIONS

The imperative for strengthening corporate governance in China is evident from the adverse impact of profound weaknesses in the system's microfoundations on macroeconomic stability and growth.

China's growth rates has been amongst the highest in the world since market-oriented policy and systemic reforms began in 1978, outperforming the East Asian NIEs in the 1990s. Real GDP grew by 9.8 percent in the period 1979-97, but a downturn in both domestic and external demand had led to a deceleration of growth to 7.8 percent in 1998 and 8.0 percent in 1999. This impressive growth performance has been accompanied and facilitated by significant institutional changes which have made China one of the most marketised and open among transition economies. Although ideological and political factors precluded ownership reform of the SOE sector, significant property rights reform (e.g. privatisation) has taken place through the back door as a result of the lifting of controls on the growth of the non-state sector (Lin 1995). The explosive growth of township and village enterprises (TVEs), in particular, has been the main engine of China's industrial development since 1984 and has led the non-state sector to outgrow and overwhelm the SOE sector. By the late-1990s, the non-state sector accounted for about 75 percent of total industrial output, and the formal state sector accounted for only an estimated one-third of GDP -- a ratio approximating those of Britain, France and Italy in the late 1970s<sup>6</sup>. Growth of the TVEs and foreign-invested enterprises, together with gradual but sustained trade liberalisation which allowed entry of non-state entities into certain industries previously monopolised by SOEs, have resulted in intense competition in a number of product markets and have seriously undermined the profitability and viability of SOEs.

China's "open door" policy has also transformed the country from one of most closed economies in the late 1970s to one of the most open in the 1990s<sup>7</sup>. With total foreign trade growing by annual average of about 17 percent in 1979-97, China's foreign trade/GDP ratio based on official exchange rates increased from 9.8 percent in 1978 to about 34 percent in 1998 -- an openness exceeding that of Japan's<sup>8</sup>. The growing openness of the Chinese economy has witnessed an increasing reliance on foreign capital. From 1978 to end-October 1998, the

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<sup>6</sup>It is difficult for reasons of statistical coverage, ambiguous ownership categories and price distortions to determine with any high degree of precision the relative sizes of the state and non-state sectors. The formal state sector in 1998 accounted for about 25 percent of total industrial output; the manufacturing sector accounts for about 46 percent of GDP, while much of the other sectors (agriculture, services, etc.) are under collective ownership. Thus, the state sector accounts for about a third of GDP.

<sup>7</sup> In terms of trade volume, China has dramatically its position from the world's 32nd largest trading nation in 1978 to the 10th largest in 1997.

<sup>8</sup> Calculated more realistically in terms of PPPs or RERs, China trade/GDP ratio would be considerably less, perhaps in the low to mid-20 percentage range.

amount of contracted and utilized foreign direct investments (FDIs) totalled \$560.6 billion and \$257.8 billion respectively. In 1994-98 China was the world's second largest recipient of FDIs after the United States, with FDIs of \$45.5 billion in 1998. Over 300 of the world's largest 500 multinationals have invested in the country. It has sustained significant and growing current account surpluses in recent years of around \$40 billion annually, and has the world's second largest foreign exchange reserves of over \$150 billion at mid-year 1998.

Vigorous output growth over the past twenty years, however, should not obscure the fact that the fundamental objective of reforms -- the establishment of an efficient and competitive market-based economic mechanism to facilitate robust and sustainable growth over the long-term -- has yet to be fully realised. The ability of China to exploit and realise its full economic potential remains hampered by persistent macroeconomic instability and profound economic inefficiencies. Although important productivity gains were made in the early 1980s when growth was consumption-led and of an intensive nature, they appear to be petering out since 1984 when growth resumed an extensive character, driven primarily by very high levels of industrial investments<sup>9</sup>. These high rates of investment were underwritten by equally high levels of domestic savings (about 38-40 percent), yielding a net positive resource balance. But high levels of industrial investment, combined with macroeconomic allocative inefficiencies as well as inefficiencies in the use of resources at the micro level, have generated periodic bouts of overheating and inflationary pressures undermining macroeconomic stability. Since 1978, there have been at least three such stop-go cycles as the authorities switch between alternative policy regimes in the absence of effective macroeconomic instruments for fine-tuning.

China's "corporate sector" -- including both state-owned enterprises (SOEs) and corporatised firms -- is characterised by serious shortcomings of low economic efficiency, ambiguous property rights, weak corporate governance and generally poor financial discipline. These systemic and behavioural weaknesses, most pronounced in SOEs, have an increasingly adverse impact on macroeconomic balances as well as on the financial system. SOEs continue to dominate China's economic landscape despite their declining share of output. Although the state's share of industrial output has declined to about 25 percent in recent years, it still remains the single most important sector in the national economy in terms of its share of total fixed assets, manufacturing employment and claims on investment resources. [Latest data to be added]. But loss subsidies and preferential policy lending to support inefficient SOEs crowd out other potentially more profitable investments in other economic sectors, thus inhibiting the realisation of China's true GDP potential.

Recent official Government pronouncements have admitted that about one-third of all SOEs are loss-makers, another third either breaking even or with implicit losses and a third profitable. Official statistics put industrial SOEs' losses at 1.1 percent of GDP (China Statistical Yearbook 1998), but our estimates show losses of SOEs (including non-industrial SOEs) amounting to about six percent of GDP in 1997 (see Table 1). Given the huge stock of productive assets embodied in SOEs and the large volume of capital which continues to be administratively and preferentially allocated to them each year, their poor performance represents a massive under-utilization of scarce resources and a high opportunity costs of potential GDP growth forgone. For example, China's GDP could, *ceteris paribus*, be six

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<sup>9</sup>For the 1980s as a whole, the GDI/GDP and fixed investment/GDP ratios averaged 35.9 percent and 27.2 percent respectively.



percentage points higher if SOE losses were eliminated and probably be over six percentage points higher if resources were deployed for more efficient use by the non-state sector.

The poor performance of SOEs generates a number of structural weaknesses which impact adversely directly and indirectly on macroeconomic stability. First, the fiscal burden of subsidies to loss-making SOEs are significantly greater than that indicated by a relatively low open budgetary deficit of 2 to 3 percent. Policy loans to support loss-making and generally poor-performing SOEs have accounted for the preponderant share of a rising consolidated government deficit (CGD, defined as the open deficit plus part of central bank lending for policy objectives) which is estimated to have averaged 5.5 and 7 percent of GDP in recent years [1999 data to be added].

Second, SOEs are sustained by large volumes of preferential policy lending, primarily through the state banking system but also through local government controlled non-bank financial institutions (NBFIs such as international trust and investment companies or ITICs). As our discussion below will show, Chinese industrial SOEs have extremely high debt-asset ratios with a large proportion of debts unrepayable; a large number of SOEs have negative equity. The large amount of non-performing loans in the balance sheet of the banking sector (and dubious investments by ITICs) has led to crisis levels of fragility and systemic risks of the financial system in general and the banking system in particular.

Thirdly, soft-budget constraints and other systemic defects of SOEs generate tremendous investment hunger which poses almost uncontrollable flow demands in the system and thus serious difficulties in macroeconomic management. Important changes in the relative importance of economic agents and in the GDP structure of sectoral balances, evidenced most clearly by the dominant role now played by households in domestic savings, have meant that excessive intermediation between the household and corporate (SOE) sectors through the state banking system poses serious difficulties for the control of money supply and credit. Broad money (M2) in China, at about 120 percent of nominal GDP, is extraordinarily high and difficult to control (Cyril Lin 1995). In part this problem stems from the underdevelopment of the financial market and undiversified savings instruments in China which leave households with little or no portfolio choice except bank deposits and, since 1991, equity investments. The failure to develop financial markets and to commercialise the banking system is itself due primarily to the authorities' need to rely on, and hence preserve, existing defective banking arrangements to support SOEs.

Fourth, shortcomings in the fiscal incentive structure which result in serious under-financing of infrastructure and basic industries are also in large measures attributable to ambiguities in the property rights of SOEs. Under conditions of ambiguous property rights associated with state ownership, implicit property rights and explicit control rights have effectively been assumed by local governments who seek to invest primarily in consumer goods industries SOEs where a larger proportion of their profit and tax remittances accrue to local treasuries. Yet while local authorities exercise rights over residual claims of SOEs under their jurisdiction, residual risks are borne by society as a whole when losses are met through the national monetary, banking and fiscal systems.

A critical and potentially explosive problem -- and one which tends to be neglected or underestimated in policy discussions -- arising from the existing pattern of financial intermediation in China is that household savings represent ownership claims for which there

are at present no real physical counterparts. Intermediation by state banks who direct household savings to poor performing or loss-making SOEs are effectively taking unacceptable risks with household assets which they may not be able to surrender. Yet state banks have few options but to continue supporting the SOEs. So long as the fundamental nature and behaviour of SOEs remain unreformed, reforms in other areas, especially in public finances, monetary policy and banking, will remain severely hamstrung.

### III. THE CORPORATE GOVERNANCE PROBLEMATIC IN CHINA

The problems of corporate governance in China are therefore indivisible from those of the reform of SOEs which still dominate the country's industrial and financial system. The problem of governance in SOEs has long been recognised by the government although it was not articulated as such. Historically, it has been conceptualised in terms of "state vs enterprise relations": how to enhance enterprise efficiency by striking a balance between state obligatory plans and enterprise self-initiative. It is worth recalling that this problematic was highlighted as early as in 1956 in Mao Zedong's speech on "The Ten Major Relationships". However, Mao's and other subsequent Chinese formulation of the SOEs governance problem failed -- or refused -- to address the underlying issue of property rights and state ownership.

There are intrinsic and fundamental problems of corporate governance in state-owned economic entities because of the ambiguity of property rights associated with state ownership. SOEs represent the classic case of the principal-agent problem. Under a system of ownership by the whole people (state ownership), property rights belong to everyone and to no one in particular. The state assumes the role as representative of the people and acts as the principal (owner) on behalf of the public in delegating day-to-day operational powers over enterprises to managers (agents). But the controlling authorities, e.g. central government line ministries and local governments, which exercise *de facto* ownership rights over SOEs in reality do not bear any residual risks over the control and use of an SOE's assets. Any residual claims (profits) or risks (losses) are socialised and simply passed on to the public at large<sup>10</sup>. There is therefore a divorce between the bearing of residual risk and the exercise of control. Systemic features of SOEs such as soft-budget constraints, the lack of independent financial accountability and the impossibility of bankruptcy, undermine the incentives and disciplinary mechanisms essential to corporate governance. We can identify three critical impediments to corporate governance in Chinese SOEs within such a regime.

Ambiguities of Property Rights, Principals and Agents. First, the core defect of such a system is that, under rigorous analysis, there are in reality no real owners nor indeed any real agents. The controlling authorities may exercise *de facto* ownership rights, but they are essentially **second-order agents** themselves of the true owners -- the public. Yet the public, as the owner who bears the ultimate residual risks through public finances (including "publicly-owned" assets of state-owned banks), have no effective rights or means for either monitoring SOEs performance or having an active voice in their governance. Such rights are vested in what we may term the **first-order agents**, in other words, the central government and parliament who are supposed to act as the custodian in the public interest. But then there is the classic problem of who monitors the monitor<sup>11</sup>? The system of state ownership therefore comprises a cascading

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<sup>10</sup> SOEs losses are covered either explicitly through budgetary subsidies or implicitly through policy loans from the state banking system.

<sup>11</sup> In reality, of course, the public has neither the means nor the incentive to monitor. This is

structure of agents who bears no residual risks, yet exercises effective *de facto* property and control rights over assets owned by no clear and identifiable principal. Such an arrangement poses serious moral hazard problems in both the economic and political domain.

Weak Managerial Incentives. Secondly, market-based managerial incentives do not operate in the governmental public administration (i.e. civil service) apparatus within which control and management of SOEs are exercised. In China, managerial job markets do not exist in the state sector and SOE managerial jobs are not contestable. The entire cascading structure of agents exercising property and control rights, from the head of state to the line ministries and local governments and down to the SOE manager, comprises government officials and bureaucrats on fixed and standardized public sector remunerations systems which are either weakly or not correlated to the performance of SOEs under their control. Thus, neither so-called principals (the multi-tiered state controlling authorities of SOEs) nor enterprise management have adequate incentives to ensure the most efficient use of assets under their control<sup>12</sup>. Equally serious is the absence of incentives for the controlling authorities to select the best SOE manager or to ensure that the enterprise is efficiently and profitably operated (Zhang Weiyang 1998). Appointments to managerial positions, both at the SOE and the controlling authorities' levels, are ultimately politically determined.

Incompatibility of Multiple Pseudo-Principals. Thirdly, the plethora of pseudo-principals -- or first and second order agents -- in China's multi-tiered SOEs control structure (central, provincial, municipal) gives rise to serious problems of conflicting objectives among the multiple controlling authorities. In a firm with multiple owners or shareholders, property (and non-property) and control rights are typically proportionate to the size of shareholding, with the largest shareholder assuming control subject to safeguards on the rights and interests of minority shareholders. But the lack of clearly quantitatively delineated "division" of property rights (shareholding) of SOEs among line ministries or local governments mean that each and every controlling authority duplicate the ownership functions of the central authorities. Yet central and local authorities often have conflicting definitions of what is in the public interest and how the SOE should be operated in the public interest. Local authorities are highly susceptible to the problem of "capture" where their interests are more aligned with those of the localities than those of the central authorities. The tensions between conflicting central vs local objectives and incentives in corporate governance of SOEs are an exact analogue of the well-known tensions in Chinese central vs local fiscal relationships.

Political and ideological factors precluded property rights reform in the state sector until 1992. SOEs reform during the 1980s sought instead to improve governance through the principle of "separation of government from management", aimed at improving firm performance by giving management greater autonomy and incentives to operate SOEs on a profit and commercially-oriented basis free(r) from political intervention. This approach, particularly in its contract responsibility system variant introduced in the late 1980s, succeeded

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a classic case of free-riding in monitoring and governance under extreme dispersion of share ownership.

<sup>12</sup> SOE management have incentive systems geared to performance, but there are strict limits on both the amounts and the uses of performance-related payments which reduce the marginal effectiveness of incentives. See our discussion below on managerial incentives.

somewhat in enhancing the profit and market-orientation of SOEs management although state intervention remained pervasive<sup>13</sup>. Another major policy initiative was the formation of enterprise groups which networked together vertically and horizontally linked SOEs to promote rationalisation of production structure, technological development and intra-group cross-financing. One of its key objectives was to create large conglomerates, modelled after the Korean chaebols, with the scale economies, resources and critical mass to compete internationally.

These measures, however, failed to address fundamentally the problem of SOEs economic inefficiency and losses. Prohibition of any tampering with property rights during the formation of enterprise groups precluded any substantive change in corporate forms or governance of enterprises within a group<sup>14</sup>. Nor did the contract responsibility system improve the system of corporate governance in SOEs. The contract system introduced quantitative changes (ratios of profit sharing, greater autonomy within state determined broad control figures over wage bills and investments, etc.) rather than qualitative changes in the nature and methodology of the basic ownership and control relationship between the state and firms.

Initiatives to explicitly address the corporate governance problem began in 1992 when the authorities sought to clarify property rights of SOEs through corporatisation (*gongsihua*), e.g. the conversion of SOEs into western-type corporate entities predominantly in the form of limited liability companies and joint-stock companies. Corporatisation was a measure in the larger policy of converting SOEs into "modern company systems"<sup>15</sup>. Another measure was the "operational mechanism transformation" (OMT) of SOEs: essentially an extension of earlier measures to give SOEs greater operational autonomy in fourteen defined areas of decision making. These measures laid the foundation of the landmark "Decision on the Problems of Establishing a Socialist Market Economy", adopted by the 14th Congress of the Communist Party of China in October 1993, which for the first time since reforms began in 1978 stated that the objective of reforms was the establishment of a modern "socialist market economy" with "Chinese characteristics", i.e. a competitive market system characterized by the predominance of public ownership.

It may be argued that while the policy of separation of government from management underpinning the SOEs reforms and corporatisation measures may appear as a sensible solution

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<sup>13</sup> The contract responsibility system gave SOEs additional managerial autonomy in return for an agreed schedule of tax and profit remittances over a three to five year period. See Groves et al (1994), Lin (1993, 1995), Naughton (1995) for studies of the SOEs contract responsibility system.

<sup>14</sup> Enterprise groups were basically the formation of strategic alliances, with partners usually retaining their original independent accounting and SOE identities. The formation of enterprise groups arguably increased their monopolistic position and undermined competition vital to corporate governance.

<sup>15</sup> A modern enterprise system was defined as one characterised by clarified property rights, clearly delineated rights and responsibilities, financial independence and accountability, separation of government from enterprise management and scientific commercially-oriented management.

to excessive state intervention, it is in fact logically flawed from the perspective of agency theory. The increasing separation of government from management equates to an increasing separation of principal from agent: i.e. increasing separation of ownership and control with informational asymmetries exacerbated. As such, the corporate governance problem could become more serious. A survey conducted by this author (Lin 1994) lends empirical support to this argument. The survey showed that greater managerial autonomy enjoyed was enjoyed by firms although both SOEs and corporatised firms continued to be subjected to state intervention<sup>16</sup>. But the survey concluded that corporate governance did not improve, and in a number of instances it deteriorated because increased autonomy, greater informational asymmetries and monitoring problems allowed management, sometimes in collusion with its controlling authorities, to form an insider group operating in its own interests. Indeed, since the introduction of the OMT and corporatisation measures in the early 1990s, the performance of SOEs and the Chinese "corporate" sector as a whole have worsened. Losses of SOEs have in fact accelerated with adverse impacts on macroeconomic stability. Official data (China Statistical Yearbook 1998) show that profits of industrial SOEs halved from 81.7 billion Yuan in 1993 to 42.8 billion Yuan in 1997; or as a share of GDP, it fell from 2.4 percent of GDP to 0.6 percent. Losses doubled from 45.3 billion Yuan to 83.1 billion Yuan (1.1 percent of GDP). A different estimate (Lin 1999) puts total SOEs losses at around 6 percent of GDP in 1997 (see Table 1 above).

The problem of worsening SOEs performance lay behind Jiang Zemin's speech, at the 15th Congress of the Chinese Communist Party in the fall of 1997, which announced the policy of significant ownership diversification of the state sector through complete or partial divestiture of small and medium-size SOEs. But Jiang's speech also reiterated that public ownership would continue to remain dominant in the Chinese economy. Similarly, a Decision of the 4th Plenum of the 15th Party Congress (September 1999), and the State Planning and Development Commission's (SPDC) January 2000 statement elaborating on this Decision, reaffirmed that while state ownership would be reduced in a number of sectors, it would remain dominant in industries of strategic importance such as infrastructure, key producer goods, etc. Few specific practical measures for divestiture have in fact been formulated. Nevertheless, there is anecdotal evidence to show that privatisation and closures of poor performing small and medium-sized SOEs are proceeding at the local levels.

#### **IV. PURPOSE AND DETERMINANTS OF CORPORATE GOVERNANCE**

As a newly emergent issue whose policy importance has far outgrown the robustness of its conceptual underpinnings, corporate governance has become all things to all men (women). Before examining actual corporate governance practices and the main factors conditioning these practices in China, therefore, it would be useful first to summarize some of the ambiguities concerning the understanding and determinants of corporate governance.

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<sup>16</sup> For example, enterprises still remained subjected to state controls over labour (total wage bills, hiring and firing of workers), investment and production structure (approvals of "above-norm" investments and major changes in product lines), cash flow allocations (investments, welfare expenditures, dividend payments), disposals of assets and changes in capital structure.

Corporate governance may be about many things, but the essence of corporate governance is about how owners (principals) of firms can ensure that the firm's assets (and the returns generated by those assets) are used efficiently and in their best interests by managers (agents) delegated with powers to operate those assets<sup>17</sup>. This problem is intrinsic to any arrangement where owners themselves do not undertake the management function directly. The corporate governance problem arises due to the following:

**Separation of ownership and control rights**, leading to a divorce between residual risk bearing by principals (owners) and control by agents (management). The governance problem increases as firms rely more on external financing because the distance between security holders (shareholders, creditors and other claimants) and firm management increases;

**Informational asymmetry** where principals have less knowledgeable about the actual strategy, operations and performance of firms than agents in day-to-day control; and

**Incomplete or state-contingent contracts** which provides potential moral hazards for management to dissemble and deceive owners, and to operate the firm in their (managers') own interest at expense of owners.

In such a regime, the prerequisite for effective corporate governance involves:

**Alignment of risk-bearing and control:** (e.g. rights of shareholders in appointing management, approval of strategy and cash-flow) founded on a clear property rights structure and enforceable laws/regulations;

**Monitoring and oversight** of management and firm's performance based on transparency, regular and reliable disclosures, and internal checks and balances; and

**Incentives:** managerial incentives to enhance effort and align interests of management with those of owners'.

It is generally accepted the governance problem entails a tension between accountability and managerial initiative: i.e. between the need for directors or management to be accountable to shareholders on one hand and the need for management to have the discretion to maximize profits. An apt analogy (with apologies to the Cadbury Report) is in terms of unleashing the tiger (management) into the jungle of the market to seek and exploit opportunities while ensuring that the tiger brings home the meat without consuming it all himself, or that it does not

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<sup>17</sup> Others formulate the governance problematic in terms of the optimal form of security (debt vs equity) which best safeguard security holders. Economists generally adopt the agency theory (principal-agent problem) to depict the governance problem while management specialists tend to conceive it in terms of "trusteeship" and "stewardship" (of board members on behalf of owners). Some even challenge the notions of a basic ill-intent in management or of an inherent adversarial and confrontational relationship implicit or explicit in many economic formulations. Lawyer tends to focus more narrowly on legal protection of the property and non-property rights of shareholders, ignoring the incentives issue.

eat up the owner in the process.

To address the corporate governance problem in practice, owners (and stakeholders) need to devise a **governance system** comprising effective mechanisms of **control, oversight** and **monitoring** over management and of **incentives** for management to behave in the owners' interest. The devil, however, is in the details. It is the practical design of such a system that the problems of corporate governance become, if not quite a nightmare, complex. Corporate governance arrangements are typically codified in the company charter or articles of association containing core provisions stipulated by the legal and regulatory framework. But these provisions, such as safeguards on proprietary and economic rights of owners (to vote, to receive returns, to exit, to have access to information, etc.), are often stated in highly general terms so as to be in many instances meaningless in practice. As is the case in the U.S., this generality is intentional, based on the philosophy that owners and firms should be given as much discretion to conduct business as they see fit subject to some very basic safeguards on protection of owners and on compliance with laws against fraud and malpractice. For example, as required by corporate law, the company charters in many countries specify the duties of board directors in terms of "in the best interests of the firm (and its shareholders)". But "best interests" is a big and vague package of things, and can mean everything or nothing. Very detailed safeguards and provisions written into charters or company law, on the other hand, risks circumscribing not only the freedom of shareholders to determine the nature of the contract between them and management, but also that of management in exercising initiative. In general, safeguards and provisions for effective corporate governance are inadequate in both company law and company charters of most countries (including the mature economies). It is the details that make or break a corporate governance system in practice.

An effective system depends on a number a number of variables which constitute the design parameters. The most critical of these include the **scope of accountability** and the desirable **purpose and benefits** which determine the **specific objectives** or **measures and criteria** of whether governance is good or bad.

Accountability. The nature of the corporate governance problem as stated above in terms of management's responsibilities to shareholders can be varied to widen the scope of a firm's and management accountability. It is sometimes argued that in addition to owners or shareholders, management should also be accountable to other stakeholders such as employees, creditors, major suppliers and customers with a direct stake on the well-being of the firm. The scope of accountability can be broadened even further to include those with an indirect stake, i.e. "society" as a whole. The concept of "societal responsibility" in the governance of firms has been increasingly advocated, and is actually written into statutes in Germany. There are good arguments for broadening the scope of accountability to include stakeholders, other than shareholders, most directly affected by the activities of the firm. The prescribed scope of accountability of managers (and hence of firms) have important practical implications for issues relating to specific objectives and board representation, as will be noted below.

Purpose and Benefits. Closely related to the question of "to whom should the board be accountable" is the issue of the advantages of corporate governance. As noted earlier, a narrow conception regards corporate governance as safeguarding the interests of shareholders (and other security claimants). This seems pretty much to be the dominant view among firms and institutional investors in Anglo-Saxon countries. Good corporate governance in this context involves mainly enhanced capacity for shareholders to perform oversight and monitoring

functions through, for example, approving (or setting) strategic and financial objectives, management selection, decisions on directors remuneration, profit distribution, board representation, etc.

A broader conception includes the narrow conception described above but in addition considers the efficiency aspects from the perspective of national economic vitality. The merits and demerits of any corporate governance system should therefore be evaluated not only in terms of adequacy of shareholders' interests but should include its capacity to raise financing (which may or may not be in the interests of existing shareholders), productivity and competitiveness which contribute to the dynamism of the economy overall. Capacity in these areas obviously benefits shareholders ultimately. But where achieving these capacities require major restructuring and investments which may depress share prices or returns (shareholder value) in the short-term, the adoption of this broader conception (by shareholders) would promote longer-term strategic positioning. This broader conception also emphasizes the importance of ownership patterns and financing modalities (debt vs equity) in corporate governance, with some [references] attributing various advantages to the German-Japanese model of concentrated ownership, insider control and (relationship) bank financing. Regardless of the validity of these claims, the broad conception is more relevant if corporate governance (and firm performance) is posited to be a public policy issue of national importance. In this case, corporate governance should be, and is usually, situated within the overall context of structural adjustment and corporate restructuring.

Objectives, Measures and Criteria. The broader the scope of accountability or the more numerous the parties that management is deemed to be accountable, the wider the range of objectives and criteria that the governance of a firm will have to meet. If management is posited to be accountable only and exclusively to its owners, then the measure and objective of corporate governance is equally narrow: e.g., shareholders' interest as expressed by some financial return indicator -- e.g. "shareholder value" or Tobin's  $q$ . But if accountability is extended to "society" in general, then the objectives may well, for example, include (as has been suggested by some) environmental protection, consumer protection, affirmative action in racial equality, etc.

There are a number of hazards in having too broad a range of objectives of corporate governance as a result of extensive accountability. First, it would be technically impossible to design an internally consistent set of "targets" or objectives which can be met equally. And once these objectives are prioritized, those on the bottom on the list might just as well not be on the list. Secondly, the firm as a profit or shareholder value maximising economic entity would be assuming non-commercial obligations which are properly the competence of government or other bodies. The enforcement of broader social objectives might best be left to regulatory mechanisms, with good corporate governance being one that complies. Finally, the inclusion of explicit non-commercial or non-economic objectives could well become a Trojan Horse for political interference and motives.

The broad conception of corporate governance would imply going beyond using shareholder value as the sole objective or criteria of satisfactory governance<sup>18</sup>. The choice of a

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<sup>18</sup> Consider, for example, a profitable firm, delivering high shareholder value to its investors, but engaged in activities considered by some as socially and ethically irresponsible: such as, say, environmentally damaging or arms sales to repressive regimes. In the shareholder model, the



judicious blend of indicators of firm performance and prospects, in this case, depends on either the myopia or "vision" of stakeholders, especially institutional investors, in making investment decisions. Even so, a long-term view requires considerable effort and skills in monitoring and analysis.

Determinants of Corporate Governance. The core organisation of a system of corporate governance involves a firm's three constituent decision-making bodies: the shareholders' annual general meeting (AGM), the board of directors and management. Companies throughout the world are based on this generic organisational prototype. It is often assumed that this architecture represents the corporate governance of a firm. In reality it does no such thing. It only provides a skeletal structure upon which corporate governance could be exercised, and the effectiveness -- indeed the very existence of -- corporate governance depends entirely on how the skeletal structure is fleshed out. How it is fleshed out depends on:

- (a) **Statutory provisions**, particularly those relating to the definition and exercise of shareholders' rights, oversight mechanisms and disclosure, contained in the legal and other (especially financial and securities) regulatory framework of the country or jurisdiction and replicated -- and further developed -- in the charter of the company.
- (b) **Monitoring, compliance and enforceability** of these legal and other statutory requirements.

However, how governance works in practice, and more crucially how effective it is, depends on a host of internal characteristics (ownership and capital structure) and external factors which act as enforcement mechanisms, of which the most important are:

- (c) **Ownership concentration or dispersal**, which determines whether a firm is tightly controlled by a group of insiders (e.g. majority shareholders) or by a large number of widely dispersed small shareholders governing largely through markets (e.g. share price movements), and the balance of powers and interests between majority/insiders and minority/outside shareholders.
- (d) **Board attributes**, such as the composition, representativeness, independence and qualification of board members, as well as the existence of sub-committees (headed by non-executive or independent directors) on audit, nomination and remuneration, to ensure that it can be an effective oversight body on behalf of stakeholders.
- (e) **Supporting checks and balances**, such as independent share registrars, company secretaries, internal financial controls and accurate and timely information accessible to board members.
- (f) **Accounting standards** (including auditing) and conventions which determine the type, detail and quality of information disclosed to ensure transparency.

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firm may be said to have good corporate governance (in delivering high shareholder value), but in the stakeholder model, it can be said to be badly governed.

- (g) **Product market competitiveness** to instill commercial discipline on management.
- (h) **Efficiency and competitiveness of financial markets**, providing financial discipline and incentives, especially equity markets where shareholders can exercise their "vote" in governance through entry and exit, and which provides a market for corporate control as well as monitoring functions performed by institutional investors.
- (i) **Competitiveness of managerial job markets** which make managerial jobs "contestable" and thereby elicit managerial effort.
- (j) **Cultural and historical factors**, which, amongst other things, strongly influences business organisation, practices as well as the passivity or activism of shareholders in governance.

Thus, both internal and external enforcement mechanisms impact on corporate governance. International experience suggests a number of basic, key lessons or pointers on when and how good corporate governance is achieved or not achieved. These include the following:

- (a) **There is no single best model of corporate governance.** The effectiveness of any model depends on the peculiarities of ownership patterns, the legal framework, business practices and culture of the country. Although the insider model (e.g. German-Japanese) was previously often argued to be superior to the outsider model (e.g. Anglo-Saxon) in terms of yielding better long-term company performance, empirical evidence of the 1990s (e.g. Japan and the transition economies) has proved either inconclusive or even contrary.
- (b) **Corporate governance is a dynamic and evolving system.** Its effectiveness changes over time in line with the development of the economy and society.
- (c) **The devil is in the details.** As discussed above, details make or break a system of corporate governance.
- (e) **The system is only as good as the stakeholders want it to be.** No amount of legislation can enforce a good system. At the end of the day, it is up to shareholders (stakeholders) to want to protect their rights and exercise their rights that governance can come into play. It is, ultimately, a self-enforcing system.

## V. CORPORATE GOVERNANCE PRACTICES IN CHINA

The relaxation of controls since 1978 on the development of the non-state sector (comprising collectives such as the township and village enterprises or TVEs, individually-owned entities and foreign invested firms), as well the corporatisation process since 1992, have resulted in a highly diversified and complicated corporate landscape in China. Data on the composition of China's corporate landscape in 1994 and at end-1997 are given in Tables 2 and 3 and Figure 1. Financial data on the various enterprise and corporate forms are given in Table 4. The corporate governance of TVEs differs from that in SOEs, as summarized in Box 1, although it would be

premature to infer any causal relationship between the corporate governance and more dynamic economic performance of TVEs. Moreover, the performance of the non-state sector and TVEs has begun to deteriorate in the 1990s [data to be added].

In developing the company law framework for the corporatisation process, Chinese legislators defined the legal basis of enterprises both by the nature of their liabilities and by investors (owners). A summary description of how different corporate forms are defined in China and their legal basis is given in Appendix 1.

China's Company Law prescribes a corporate governance system for joint stock limited liability companies (JSCs) through an organisational structure comprising three main constituent bodies: the shareholders' general meeting (or annual general meeting); the board of (executive) directors; and the board of supervisors<sup>19</sup>. The statutory framework for corporate governance in China is described in Appendix 2. This corporate governance structure is modelled after the German two-tier system of an executive board and an oversight supervisory board, with mandatory employees' representation on the supervisory board. On paper, China's Company Law provides for a comparatively strong and -- in theory -- effective system of corporate governance of JSCs. The evidence available appears to suggest that despite fairly stringent legal requirements for institutional arrangements within the firm conducive to good corporate governance, actual practices in corporate governance in Chinese companies deviate considerably from what would be considered best practice in the West as well as from the spirit of Chinese statutory requirements and intentions. Actual corporate governance practice in Chinese limited JSCs tend to be characterised by the following features<sup>20</sup>.

Excessive Powers of the CEO and Insider Control. A system of "one-man rule" by an all-powerful CEO (*zhongjingli* or general manager) dominates the control and management of Chinese firms. Both Company Law and company charters stipulate that CEOs are to be elected by the shareholders' meeting. This is formally adhered to, but in practice the process often involves the controlling shareholder (typically the state) appointing the board chairman and CEO and notifying other shareholders accordingly, with the appointment rubber-stamped by the shareholders' meeting. Other board members are appointed by other major shareholders in proportion to their shareholding, but discussed beforehand with the controlling shareholder and sometimes with the workers' representative council. One or two board vacancies are sometimes left to minority and outside shareholders to elect at the shareholders' meeting through open ballot. Cumulative voting procedures, however, are rarely adopted.

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<sup>19</sup> For LLCs with "comparatively few" shareholders and "comparatively small" scale of activities, Company Law allows them to have a single executive director rather than a board of directors; they are also able to dispense with the formation of a supervisory board.

<sup>20</sup> This depiction of actual corporate governance practices is based on interviews and surveys conducted by the author in China in December 1998. Interviews were conducted with officials at various governmental organisations (including the China Securities Regulatory Commission, the Shanghai and Shenzhen stock exchanges, the System Reform Office of the State Council and the State Economic and Trade Commission), SOEs, LLCs, listed companies, law firms and securities, investment, management consultancy and accounting companies. The assistance of Zhong Hongjun (Beijing University) and Zha Song in conducting these interviews and surveys is gratefully acknowledged.

The CEO is first and foremost an agent of the controlling shareholder and follows the latter's instructions. The board, however, does act as a forum for balancing the interests of the different major shareholders. Major strategic decisions are agreed upon beforehand among the key shareholders, often outside the formal shareholders' meeting or the boardroom. Some companies have appointed "independent" non-executive members to the board although they are superfluous given a supervisory board. There is hardly any evidence of supervisory boards or non-executive board members performing substantive oversight functions over the executive board and senior management<sup>21</sup>. Often, non-executive directors and supervisory board members are "captured": they become part of the group of insiders and identify with their interests. It is doubtful whether the supervisory board has any effective role in representing the interests of employees and other stakeholders. The interests of employees are safeguarded primarily by Party representatives within the firm in consultations with the controlling shareholders. It is important to note in this regard that Party involvement, both in employee relations and in other operational matters of the company, represents an additional and potentially powerful -- and peculiarly Chinese -- voice in the corporate governance of Chinese firms.

Inadequate Safeguards for Outsiders. The near-absolute control exercised by a controlling shareholder, and what may be regarded as "collusion" between the controlling and other large shareholders, represent an "insider system" of corporate ownership, governance and control. The company is run largely by and in the interests of the insiders to the potential detriment of outsiders and other stakeholders. There is strong anecdotal evidence that in many Chinese listed companies, insiders operate without much regard for the spirit and intent of company charters and often abuse their powers to infringe upon both the interests of the company and shareholders. A review of the annual reports of companies listed in the Shanghai Stock Exchange shows that over 40 companies, or about 10 percent of listed companies in the Shanghai market, have been or are involved in major litigations involving over 750 million Yuan. Most of these cases are concerned with the negligence, improper behaviour and deliberate fraud on the part of senior management.

Minority shareholders and other stakeholders are often regarded not as fellow stakeholders with equal rights and interests to be respected and protected, but as speculators expecting to free ride on the company's performance. These outsiders are expected to be passive and not to "interfere" in the company's "internal affairs" (its governance), and indeed outsiders tend to accept this convention and behave accordingly. This also translates into a common perception that there is no necessity -- even an undesirability -- for transparency and disclosures of a firm's operations and performance to outsiders and stakeholders.

Weak Managerial Incentives. There appears to be little or no correlation between the money incomes of senior management and company profitability, and between senior management incomes and company size. The determinants of the relative size of senior management's money incomes are the geographic location and ownership characteristic of the

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<sup>21</sup> Membership of the Supervisory Board typically comprises retired company (or enterprises) officials and employee representatives. Non-executive directors are usually honorary appointments of distinguished personalities made by the controlling shareholder for public relations purposes to lend prestige to the firm or to provide political and commercial connections.

company. Senior management's money incomes of companies located in the coastal region tend to be higher than those located in the inland regions. Moreover, if a listed company was formerly an SOE or if its controlling shareholder is an SOE, then senior management money incomes tend to be lower than those in listed companies without SOE affiliation<sup>22</sup>.

Despite restrictions on income differentials, many companies do not disclose annual salaries of their general managers. But money incomes form only a proportion of the total income of management and employees in China: a significant proportion of total income accrues in non-monetary form such as access to highly subsidized social provisions (housing, health care, etc.) and other fringe benefits. These benefits are usually automatically associated with a given position and are invariant to company performance. Since benefits are a hidden "black box" not publicly disclosed, it is impossible for shareholders other than the controlling shareholder to ascertain the true extent of managerial remuneration.

Many board directors and CEOs, and sometimes even supervisory board members, of Chinese listed companies hold shares in their companies. But shareholding is probably an powerful incentive mechanism in only the few truly private sector listed companies where senior managers, who are often also the controlling shareholders, hold sufficiently large shareholdings for share prices to matter. A reason why sizable share holdings by senior management is not prevalent in China is a provision in the "Standard Opinions on Limited Joint-Stock Companies" (May 1992) which prohibits JSCs from issuing more than ten percent of stocks as employee shares when they go for a public offering. Subsequently, the "Notice on the Cessation of Employee Share Issuance" (November 1998) promulgated by the CSRC prohibited any issuance of employee shares when a limited JSC makes a public offering<sup>23</sup>. The Securities Law (29 December 1998), like Company Law, does not contain any provision for share options in listed companies.

Inadequate Transparency and Disclosures. Financial disclosure requirements for listed companies are described in Appendix 3. In practice the role and effectiveness of internal audits are circumscribed by the excessive powers of the CEO who has the authority and means to influence the reports of internal auditors and the financial officer. The role of the external auditor is therefore particularly important. Certified public accountants (CPAs) are obliged under the "Independent Auditing Standards for Certified Public Accountants" to express an opinion based on their audits. But as in western countries, external auditors "qualify" their audits and can only perform audits largely on the basis of information provided by the company. Nevertheless, the role of external auditors in China have been important in flagging areas of concern to shareholders. In 1997, external auditors expressed reservations or negative opinions on the annual reports of 93 listed companies (Jinrong Xiaoxi, 20 November 1998). The role of the China Securities Regulatory Commission (CSRC), who is empowered to inspect and

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<sup>22</sup> This is in part a result of a ruling by the Ministry of Labour prohibiting senior officials of SOEs from having money incomes more than three times the average incomes of employees. Although this ruling in theory applies only to SOEs, it appears to be widely enforced in corporatised state-owned or state-controlled economic entities such as JSCs.

<sup>23</sup> The reasoning behind this prohibition was that employee shares was originally conceived and intended as a form of welfare provision for employees, but most employees quickly sold out their shares to exploit the usual large gap between issuing and market prices of shares.

supervise listed companies, is also important in enforcing transparency and protecting shareholders' interests. Since 1998, there have been at least 8 known cases of punishments imposed by the CSRC. Most of these cases concern illegal share price manipulation and financial malpractices, usually involving fraudulent accounting and financial statements.

It is widely believed that false accounting and financial misreporting are pervasive among Chinese SOEs and companies. The China National Audit Office (CNAO) stated in December 1998 that "cooked books", embezzlement, fraud and "irregularities" in financial management are widespread among Chinese firms. Its scrutiny of 110 trust and investment companies, 88 securities companies and life and property business subsidiaries of the People's Insurance Company of China (PICC) in 1998 led it to conclude that the financial management of many of these firms were "chaotic and inaccurate" with many securities companies engaged in misappropriation of clients' money and illegal fund raising<sup>24</sup>. The extent and scale of financial mismanagement appears to be particularly serious in NBFIs such as the international trust and investment companies (ITICs). An example is the high-profile suspension in October 1998 of one of the country's largest, and previously regarded as one of the most successful, ITICs -- the Guangdong International Trust and Investment Company (GITIC)<sup>25</sup>. Like other ITICs, GITIC had used capital raised domestically and overseas for questionable and risky investments, including in loss-making SOEs. Most other ITICs are widely believed to be carrying portfolios of similarly dubious investments and loans, with liabilities far in excess of assets. [Additional data on asset-stripping]

[To be added: Section on corporate governance practices in TVEs, individually-owned firms, joint-venture firms]

[To be added: Section on ownership patterns, capital structure, AGM voting procedures, internal control structure, executive and supervisory board configuration, managerial incentives and performance data from survey of companies listed on Shanghai stock exchange]

## **VI. FACTORS IMPACTING ON CORPORATE GOVERNANCE IN CHINA**

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

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<sup>24</sup> Its audit of Chinese grain companies revealed misappropriation and misuse of funds amounting to 60 billion RMB (US\$ 7.3 billion) and losses of 200 billion RMB (US\$ 24 billion).

<sup>25</sup> GITIC was subsequently closed in January 1999 by the central government in an effort to clean up the ITICs and other Chinese financial institutions. A government scrutiny revealed that GITIC had total debts of 36.17 billion RMB (\$4.37 billion) against assets of 21.47 billion RMB (\$2.6 billion).

peculiar cultural and political governance traditions.

Cultural Traditions and Political Governance. Actual Chinese corporate governance practice appears to be replicate Chinese social, cultural and political traditions. Endemic in Chinese culture, as a legacy of the Confucian heritage and reinforced by principles of Leninist democratic centralism in the People's Republic of China, is an ingrained tradition of recognizing the norm of an authoritarian leader within the organization or clan<sup>26</sup>. Prevalent also in Chinese culture is a tradition of insiders vs outsiders with a built-in convention of secrecy among insiders. Family or clan members, as "insiders", are expected to bear collective responsibility in promoting and safeguarding the interests of the unit. The interests of outsiders are either secondary or irrelevant. Conflicts within the unit are resolved not through the intervention of an external agency, but internally and confidentially through arbitration by the clan elder or recognised leader of the organizational unit<sup>27</sup>. Safeguarding the interests of the unit involves strictures on maintaining confidentiality on the internal affairs of the unit -- dirty linen are never washed in public, with disclosures regarded as a betrayal of the unit's interests. The actual practice of corporate governance in Chinese companies bears many of the hallmarks of the legacy of these cultural and political traditions. It explains, for example, patterns of authoritarian control of a firm by a controlling shareholder and the CEO, collusion among insiders and the lack of transparency and disclosures to outsiders on the actual workings and performance of the firm.

Equally important is the impact of political governance on corporate governance. It should be noted that the term governance was borrowed from politics. Corporate governance is an analogue of political governance: i.e. "shareholder democracy" in the boardroom and firms, with agents (political leaders or management) elected by and accountable to principals (citizens or stakeholders). Governance of corporates tends to mimic political governance. In a system where the system of political governance itself lacks accountability and transparency, as is the case in China, it is difficult and incongruous for corporate governance to be effective and institutionalised.

Weaknesses in Legal Enforcement. The market-oriented legal system, and the corporate and securities law framework in particular, in China has only been developed over the past two decades and is still relatively rudimentary and untested in many aspects. At the same time, as in many other Asian societies, there is a cultural aversion to resorting to litigation which is regarded as confrontational and aggressive, with a preference for informal resolution of conflicts. The lack of an independent judiciary in China, as well as a weak legal culture and enforcement system, easily undermines confidence in legal processes, especially in litigation against state controlled or owned firms. As in many other parts of the world, majority ownership and insider control of firms are often compelled by the need to avoid the vagaries of weak

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<sup>26</sup> Confucianism prescribes a strict hierarchial ordering among members of any organisational unit to maintain social order and harmony. Members of a collective or organisation are expected to recognize, respect and obey a leading authority -- e.g. the emperor and state officials in the political sphere, and the head of the clan or household in a family unit.

<sup>27</sup> Moreover, a decision once taken must be obeyed and can not be challenged, with any opposition *ex post* regarded as disloyal (and even traitorous) and disruptive.

property rights enforcement. This also explains why bankruptcy is not a credible threat acting to promote corporate governance. Enforcement of creditors rights through bankruptcy procedures in China is still ultimately a political decision. Bankruptcy has hitherto been used primarily as a means of writing off debts instead of protecting creditors. Although the government is now using bankruptcy increasingly as a threat to discipline firms, the decision to do so, as exemplified by the closure of the Guangdong International Trust and Investment Company discussed above, is that of the state's rather than of creditors seeking to enforce a debt contract.

Three factors account for the difficulties faced by Chinese shareholders in seeking legal recourse. First, the cost of lawsuits are high, particularly to small shareholders. In China, the plaintiff has to pre-pay the lawsuit fee to the court. Second, small shareholders and damaged parties are often ignorant of their legal rights and recourse. For most investors, the objective of legal proceedings is not only to enforce the termination of violations but to seek remedial damage compensation for losses incurred. Since a successful legal action results only in the enforced termination of violations and may not necessarily lead to damage compensation, shareholders would prefer to exit rather than undertake expensive legal action<sup>28</sup>. Third, there appears to be a reluctance on the part of the local People's Courts to accept cases concerned with what it regards as a company's "internal" disputes (disputes between shareholders, management or employees of a company), preferring to deal with cases between companies or involving outside parties<sup>29</sup>.

Competitiveness of Markets. An important external mechanism of corporate governance enforcement is the competitiveness of product markets which impose commercial discipline on managers of firms. A significant achievement of reforms in China since 1978 has been the undoubted development of competitive market forces into the economy. The growth of non-state enterprises and the TVEs in particular has resulted in SOEs facing intense product market competition in certain sectors (consumer goods and services)<sup>30</sup>. Product market competition in these sectors may be intense within a particular locality or province but are still hampered by a number of administrative barriers impeding full nationwide competition. Provinces and

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<sup>28</sup> The lawsuit fee is a percentage of the amount of the action or under dispute, and is in addition to other miscellaneous fees. If the defendant lack the funds to pay damages awarded, the court does not reimburse the plaintiff for his prepaid lawsuit fee. Small shareholders therefore face high transaction costs (legal fees, time and effort) in seeking legal action.

<sup>29</sup> Underlying this is the view that listed companies (typically large and important, with important political connections, which pre-qualify them for listing approval) are important to the local economy and are owned by local enterprises. Local People's Courts therefore find it awkward to accept claims of impropriety against these local listed companies.

<sup>30</sup> Indirect evidence of growing, and often intense, product market competition comes from two principal sources. One is the dramatic reduction in the profit remittances and increasing losses of SOEs due to the erosion of monopoly rents which they once enjoyed but have now been competed away by the TVEs. The second is the fact the recent downturn in domestic demand in the economy since 1996, which has precipitated a slowdown in GDP growth, has resulted in huge stockpiles of consumer goods at retail outlets nationwide. This in turn has led to a disinflation of 0.6 percent in 1998, with manufacturers and retailers engaging in massive price cuts in an increasingly competitive market.



municipalities tend to operate illegal and extra-legal non-tariff barriers preventing non-local firms from entry or access to local markets. The imposition of administrative barriers by local governments to inter-provincial trade has long been recognised as a major shortcoming by the central government who has proved unable to address effectively because of the political power of local governments.

In other sectors such as capital and strategic goods industries (steel, machine building, power, telecom, transport, etc.), however, near total state ownership and control have greatly restricted competition and the regulators (e.g. line ministries) are also the owners and operators. Competition in these sectors is gradually being introduced by allowing two or three state-owned operators to compete<sup>31</sup>. But the dominance of a handful of large state-owned firms dominating a particular market represents an oligarchic industrial structure. These large conglomerates enjoy massive market power, and it is possible that they operate as a cartel.

Weak Debt Market Discipline. Chinese firms rely on the debt market as its main source of external financing. Table 5 and Figure 2 show the sources of funds for SOEs and for JSCs in 1997. For both JSCs and SOEs, loans and self-raised funds and domestic loans are the most important sources of financing, jointly accounting for about 75 percent of the total<sup>32</sup>. Since most working capital of SOEs are met through bank lending, industrial SOEs have a very high current liabilities to current assets ratio of 103.4 percent (Zhang Weiyong 1998). A study of 302,000 SOEs shows that short-term and long-term debt accounted for respectively 66 percent and 34 percent of total debt in 1995. Much of the short-term debt is used by SOEs to finance long-term investments, leaving the SOEs incapable of servicing their debts. The ratio of current assets to current liabilities for industrial SOEs was only 92.4 percent in 1996.

Investments are generally financed out of "self-raised funds" and bank lending. But loans from state banks and state-owned non-bank financial institutions (NBFIs) have increasingly become a major source of investment financing. Self-raised funds is a category difficult to break down in detail. This item generally refers to funds not borrowed from banks or provided by central government appropriations and typically comprises retained profits, depreciation reserves, extra-budgetary funding from local governments and, in a small number of cases, bond and "share" issues to employees. One study (Wu Xiaoling 1997) estimates that about half of self-raised funds are actually covert bank loans such as relending and loans channelled via NBFIs or other enterprises. If this is true, then roughly 50 percent or more of SOEs' fixed asset investments are sourced directly or indirectly from the debt market. Moreover, a significant proportion of long-term fixed investments are financed through short-term bank loans, as indicated by an unusually high ratio of short-term assets to short-term liabilities of 96.7 percent for industrial SOEs (Zhang Weiyong 1998).

The Chinese banking system, although considerably reformed in a number of respects, is

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<sup>31</sup> For example, significantly improved quality of services and more competitive pricing have resulted from the introduction of multiple state-owned operators, such as in domestic civil aviation and telecommunications.

<sup>32</sup> Bond issues have been negligible, with only eight enterprises having issued bonds on the open market with a total value less than 0.5 percent of total stock market capitalization.

still not a real commercial banking system and nor does it constitute an efficient debt market (Yu Lianchun and Ju Yuan 1999). State-owned commercial banks, with significant volumes of policy lending, are to a large extent still essentially acting as cashiers for the state and can hardly play a useful role in corporate governance (Lin 1995). Chinese banks suffer from creditor passivity: bad and non-performing loans are often not written off a bank's balance sheet, but are recapitalised by additional loans to defaulting debtors in order to "protect" the bank's balance sheet and to maintain the viability of the borrower<sup>33</sup>. An indicator of the ineffectual role of the debt market is its accommodation of dangerously high and increasing levels of gearing in SOEs. The average debt/asset ratio of industrial SOEs increased from 18.7 percent in 1980 to 67.9 percent in 1994 and 65.1 percent in 1996 (Wu Xiaoling 1997). The average debt/asset ratio of 86,982 industrial SOEs in 1996 was 65.1 percent. These figures, moreover, are probably underestimates of the real debt burdens of SOEs. Various case studies suggest that actual debt/ratios are considerably above 65 percent, with many SOEs suffering from negative equity<sup>34</sup>.

Indeed, the banking sector itself displays all the hallmarks of weak corporate governance. This explains the increasingly serious problems of fragility and systemic risks in China's banking sector (Nicholas Lardy 1998). Estimates (Yu Yongding 1999, *Economist* 1999) of bad or non-performing loans in the state commercial banking system range between 20 percent to 25 percent of total outstanding bank loans, or between 20 percent to 26 percent of GDP.

Weak Equity Market Discipline. The problems of corporate governance are potential greatest in publicly traded companies or listed firms where (i) there is a larger and more dispersed number of shareholders; (ii) a long informational distance between investors and management poses difficulties in monitoring, transparency and shareholder activism; and (iii) their typically large size means that their performance could have pronounced adverse knock-on effects on other firms and on the financial system and the economy generally. The rapid growth in the number of listed firms in China in the 1990s therefore poses the most difficult challenge in corporate governance.

China's equity market is a relatively recent development but has grown rapidly, albeit in spurts, since 1992. Between 1991 and 1997, the number of companies listed domestically increased from 14 to 821 (China Statistical Yearbook 1998, Shanghai Stock Exchange Yearbook and Shenzhen Stock Exchange Yearbook various years). At end October 1998, the number of listed firms totalled 878: 430 on the Shanghai Stock Exchange, 405 on the Shenzhen

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<sup>33</sup> Bank passivity, and its inability to deal with distressed firms, derives fundamentally from the system of state ownership and the highly political process governing "commercial" relationships between state-owned banks and SOEs. Banks, as "agents" of the *de facto* owner (the state) obey instructions of the owner who also owns the debtors (SOEs). The "owner" is at once both the creditor and the debtor, and the debt transacted through the market is essentially an internal transfer between subsidiaries of a vast state economic machine.

<sup>34</sup> A survey of four major industrial municipalities (Changchun, Xian, Ningbo and Tangshan) by the Debt Restructuring Research Group (Wu Xiaoling 1998) shows that two-thirds of SOEs had debt/asset ratios of over 80 percent and over one-quarter had ratios in excess of 100 percent.

Stock Exchange and 43 on overseas markets (Hong Kong, New York and London). At end 1997, total market capitalization was 1,753 billion RMB (\$213.7 billion). The rate of securitisation as measured by the ratio of stock market capitalization to GDP has grown rapidly in China but is still considerably smaller than those of the Western and Asian economies. Table 6 shows that the ratio grew from 0.5 percent in 1991 to 23.4 percent in 1997.

Just like the state banking system which supports SOEs through the debt market, the securities market in China is essentially a state securities market conceived and operated primarily to support corporatised SOEs. State control over the equity market is exercised through three principal means. One is the state control over the pace of share issues and listing, and hence of expansion of the equity market. The listing of companies is a state controlled process based as much on political as on economic and commercial considerations. The central government decides on an annual quota of number of firms to be listed in each of the two exchanges, with the quota then distributed among the various provinces and eligible central government departments (e.g. ministries).

The second is state control over the types of share issues and their respective liquidity. The third is state domination of share ownership. These two features can be illustrated by examining the different class of shares, the pattern of share ownership in Chinese limited JSCs and the impact of illiquidity on the role of the equity market in corporate governance. Shares in China are classified by (a) shareholder's identity, and (b) their liquidity and/or listing location. The different classes of shares in each category are shown in Box 2. State domination of the equity market are evident from the extent of state ownership of listed JSCs. Chinese JSCs are characterised by highly concentrated shareholdings directly or indirectly held by government or quasi-government departments (e.g. state asset management companies).

At end 1997, 97 percent of companies listed in the Shanghai and Shenzhen market were either state-owned, state controlled or had significant state shareholding. About 75 percent of total shares were held directly or indirectly by the state. Of all the companies listed in the Shanghai stock exchange, only five did not have state or legal person shareholdings. Although the actual distribution of state and non-state shares in a given company differs, a generally accepted stylized fact is that state, legal persons and individually-owned (private) shares each account for about one-third of total shares subscribed in most publicly traded companies. This means that non-freely tradable shares, comprising state shares and legal person shares (which are predominantly ultimately owned or controlled by the state), amount on average to about 66 percent of a listed company's subscribed shares. At end-1997, the average share structure of all listed JSCs comprised 32 percent state shares, 30 percent legal person shares and 35 percent individually-owned or freely tradable shares. (The remaining 3 percent is presumably employee shares.)

The high degree of concentrated state ownership has restricted the capacity of China's equity market to perform a financial disciplinary role in the corporate governance of listed firms. The predominance of state ownership of listed JSCs in the form of non-liquid, non-freely tradable state and legal person shares translates into a stock market in which only a small percentage of a firm's share issue is publicly traded and hence exposed to equity market discipline. Table 7 shows that non-freely tradable state and legal person shares together account for 64 percent and 65 percent of total shares issued on the Shanghai and Shenzhen market respectively. Table 8, which gives a different but more detailed breakdown of the share structure of the Shanghai and Shenzhen stock markets, shows that A shares, the main instrument

of equity trading, account for only 27 percent of total shares issued in China stock markets. In the Shanghai and Shenzhen market together, total freely tradable (or negotiable) shares, comprising A and B shares, represent only 32 percent of total shares issued.

Thus, nearly 70 percent of total shares issued in China's stock are not freely traded or exposed to equity market discipline. This means that there is a weak -- if not the absence altogether of a -- market for corporate control, and listed companies are not exposed to any disciplinary incentives arising from takeover threats. Concentrated state holdings and the overwhelming proportion of (state-owned) shares not openly traded greatly restricts market-determined share price movements, and hence and the role of share prices in disciplining the management and behaviour of firms. Indeed, it is questionable whether share prices represent an accurate market valuation of firms. In this context, "shareholder value" as understood in the West is difficult to measure and in China it may not be a particularly meaningful item to maximize in determining the objectives of corporate governance<sup>35</sup>.

The disadvantages of state ownership have been transposed to the capital market and are even more pronounced when the equity market comprises largely state-owned and controlled listed companies because there is an inherent and often unresolvable conflict between the role of the state as administrator and regulator and its role as a commercial entrepreneur and market player. State domination of listed companies also present problems of asymmetric objectives and in the bearing of residual risks. There is a divide between an ordinary, small shareholder who regards a listed company as a commercial vehicle and invests for purely commercial reasons, and a state majority or controlling shareholder -- essentially an administrator or politician -- who assigns and operates the listed company with a variety of non-commercial objectives. The former bears full residual risk but the latter does not.

## **VII. CHALLENGES AND OPTIONS IN CORPORATE GOVERNANCE DEVELOPMENT IN CHINA**

The immediate imperative for corporate governance in China today derives more from its implication for macroeconomic performance and broader developmental prospects than from the need to safeguard shareholders interests or to facilitate external financing of firms. Although the number of JSCs have grown rapidly, their ownership is concentrated in the hands of the state and shareholders are still relatively few. Moreover, defective corporate governance of SOEs and state-controlled corporates has not inhibited their ability to raise financing because of policies to support SOEs regardless of their performance; defective corporate governance merely accommodates and contributes to inefficient use of resources and assets. With huge household money balances chasing few equity investment opportunities given the thinness of

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<sup>35</sup> The state's main objective in its management of assets in listed companies is to increase value of assets rather than maximise returns on investment through higher dividends and share prices. Its role in corporate governance is thus largely limited to ensuring that state assets are not eroded through illegal and extralegal means, and that its agents (management) obey instructions to deliver pre-determined minimum dividend payments. The recognition of this fact leads co-investors to focus on dividend payments to the exclusion and neglect of other aspects of corporate governance. Consequently, the amount of annual dividends payable to shareholders is the most important objective for management.

China's capital markets, even listed companies with weak corporate governance find it easy to raise equity market financing -- witness the asset price inflation when China first opened its two stock exchanges in the early 1990s.

China's large and inefficient SOE sector represents a weak microfoundation for stable and sustainable growth in the longer term. As such, the immediate imperative in corporate governance in China is compelled primarily by the need to alleviate the adverse impacts of an inefficient "corporate sector" (including both SOEs and corporatised firms) on macroeconomic balances. The direct and amplified impacts on macroeconomic performance and developmental prospects render corporate governance development far more critical than in the developed countries.

The inefficiencies of SOEs may be attributable to defective corporate governance and the ambiguity of property rights inherent in state ownership which militate against effective corporate governance. China has been engaged in initiatives -- implicitly and explicitly -- to improve corporate governance since market reforms began in 1978. What is distinctive about China's experience hitherto, however, is that unlike in other transition economies these initiatives are being made largely *without* fundamental property rights reform or privatisation. Indeed, the Chinese authorities have sought to improve corporate governance of SOEs as an alternative to, and as a means of avoiding, privatisation. The most important measure has been the clarification of property rights through corporatisation. Corporatisation has become the generic solution not only for improving the performance of SOEs, but also as a means for the external financing of firms through a rapidly growing equity market.

The process of corporatisation has largely involved a reallocation of formal control rights among a small number of state (governmental) institutions and SOEs without any substantive change in the essential nature of ownership and control by the state. Whereas previously a pre-corporatised SOE was subject to a single controlling (state) authority, be it a central or local government department, its post-corporatised status as a JSC now involves *de facto* ownership by a small number of state departments or SOEs who constitute the majority shareholders. A rationale behind encouraging the multiplicity of shareholding of JSCs among various state bodies was the belief that, aside from the benefits of capital raising, multiple "ownership" would sever the direct and exclusive link between an SOE and its controlling authority. A JSC with multiple owners would then be subject to the check and balance of various owners with a common objective of maximising their investment returns, allowing it to be operated as a commercial concern immune from political intervention rather than as an appendage of a particular state administrative organisation.

The outturn of China's corporatisation programme has failed to achieve the desired improvement in corporate governance. The overwhelming majority of JSCs and listed companies are owned by a variety of state institutions, such as state asset management companies, other state-owned or controlled corporates and SOEs, who suffer from weak corporate governance practices themselves. From this point of view, the ambiguity of property rights has not been resolved; they have merely been transposed. Consequently, the defective corporate governance practices of these state-owned governmental and economic entities have merely been mapped on to state-owned JSCs rather than alleviated. Where JSCs and listed companies do comply substantively with statutory requirements on providing a voice to outside and minority shareholders at AGMs and have greater transparency, they undoubtedly represent an improvement over the governance of SOEs. But they still fall far short of what is desirable.

More importantly, the process of corporatisation since 1992 has been correlated with a noticeable deterioration in the performance of China's corporate sector.

The Policy Framework. Four on-going "regime shifts" are increasingly making corporate governance development more urgent and perhaps more feasible. They are certainly compelling policy reforms which provide a window of opportunity for corporate governance development. First, the fragility of the banking system is now recognised to be untenable. Banking and other financial sector reform measures are beginning to translate into more stringent commercially-based credit screening and loan approval processes which are making it harder for SOEs and corporatised firms to obtain credit and loans. It appears that the authorities are now more amenable to reform of property rights of the SOE sector through partial and full divestiture of a significant number of SOEs. SOEs reform will accelerate reforms in areas such as social safety nets, pensions, housing, etc., which provide entry points for the development of institutional investors that could promote corporate governance.

Second, the performance of the non-state sector -- the engine of industrial growth over the past fifteen years -- has begun to deteriorate. Although SOEs reform has hitherto dominated the policy agenda, the need for restructuring and recapitalisation of firms in the non-state sector will become increasingly prominent in the near future. Firms in these sectors will therefore need to adopt improved corporate governance.

Third, China's accession to WTO membership will commit the authorities to extensive market liberalisation within a six year time frame. The ability of domestic SOEs and non-state firms to withstand foreign entrants will depend on fundamental improvements in corporate governance to enhance performance and competitiveness.

And fourth, major initiatives during the past few years in other parts of the world to improve corporate governance will render China less competitive in attracting capital unless it too catches up and adopt internationally acceptable standards of corporate governance.

Ownership Diversification. Given China's extraordinarily diversified corporate landscape, a question that arises is: which types of firms should corporate governance initiatives in China be targeted at? SOEs? Listed companies? As our discussion earlier has shown, listed companies are typically state-owned although their sources of external financing may differ somewhat. For both types of firms, ownership diversification is desirable.

It appears that a factor impeding the political decision to privatise in China is the authorities' fears of the dangers of distorted privatisation, resulting in large and corrupt insider-dominated private firms (such as the oligarchies in Russia). But these dangers tend to arise from weak corporate governance practices accommodated by weak legal systems and political governance. This factor is not a good argument against privatisation, because where conditions for corruption and malpractices exist, large corrupt firms are just as likely -- if not more so -- to occur in the state sector as they are in the private sector. Clearly, good corporate governance -- one that is accountable and transparent -- is one of the best safeguard against abuses and malpractice, either in state-owned firms or in privately-owned firms. Unfortunately, best practice in corporate governance in state-owned firms are much more difficult to enforce because of ambiguity in property rights and the close links with politicians.

Even if divestiture of small and medium SOEs proceed, the more important medium and

large SOEs will remain under state ownership. The cynic would argue that attempts to improve corporate governance in SOEs are pointless since good corporate governance of an SOE is an oxymoron. Such cynicism aside, the second-best solution for corporate governance development of state majority owned or controlled corporates should involve measures aimed at optimizing their ownership and control structures. This is, ultimately, the critical factor in improving corporate governance in China in view of the predominance of SOEs in China's real sector.

Concentrated ownership and insider control in themselves are not necessarily undesirable or detrimental to corporate governance. On the contrary, the literature on corporate governance contains many arguments in favour of concentrated ownership and the insider model<sup>36</sup>. But there are insiders and there are insiders -- different types of insiders and owners will have radically different corporate governance. Moreover, the advantages of the insider system have to be balanced against the need: (i) to safeguard the interests of minority, outside shareholders and stakeholders; and (ii) to have appropriate internal checks and balances to ensure that sound strategic decisions are made and companies operated efficiently. In situations where legal and market institutions are still relatively underdeveloped and the playing field may not be level, and where the external mechanisms of corporate governance are subsequently relatively weak and ineffectual, these internal safeguards are particularly important. The paucity of such internal safeguards in founder family controlled firms in East Asia was clearly a major factor behind their dubious investment decisions that led to the financial crisis. These safeguards are weak in Chinese firms, with for example, little or no provisions for minority representation and cumulative voting or against related party transactions.

If good corporate governance of state-owned firms are to be realised, then the safeguards will have to be much more stringent: clear commercial objectives, clearer and more explicit accountability (to the public through public representation on the boards and to parliament), clearer and more explicit mandates and incentives schemes for management and greater transparency. These might be more easily attained through professional, commercially-based asset management bodies. Because of the inherent problems of corporate governance in state-owned firms, and of the inherent public scepticism about state-owned firms, corporate governance needs to be -- and to be seen as -- better than in private sector corporates: because of the inherent moral hazards and conflict of interests, the state needs to be more virtuous than Caesar's wife.

Optimizing the ownership and governance structure in China requires ownership deconcentration through further divestiture of a significant proportion of state holdings in JSCs and listed companies, with the state retaining golden shares. The current practice of delegating management to state-owned asset management companies does not address the fundamental ownership, control and governance defects inherent in state ownership. Management of shares retained by the state should be delegated -- if not entirely, then at least a sizeable proportion -- to non-state commercially-oriented asset and fund management companies with effective corporate governance structures. This would also help promote the development of institutional investors, shareholder activism and efficient financial intermediation consistent with the stated

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<sup>36</sup> Concentrated ownership is often posited to offer advantages of better corporate performance in the long-term due to activism in corporate governance and more effective monitoring by a small group of strategic and knowledgeable investors with a long-term interest in the firm.

goals of financial market development.

Despite its failure hitherto in strengthening corporate governance practices, the corporatisation programme has nevertheless created a much improved legal and institutional basis upon which more generic measures for strengthening corporate governance can be introduced for listed companies and larger JSCs.

Strengthening the Policy and Institutional Environment. In the light of the corporate governance weaknesses analysed above, the first set of measures should seek to strengthen the internal (firm-level) mechanisms of corporate governance through enforcement of existing laws and regulations which, if actually complied with, would significantly improve corporate governance. This could include: the formulation of a code of best practice in corporate governance; public information campaigns to increase popular awareness of rights and responsibilities of shareholders as well as of board directors and management; and the monitoring of compliance by firms with the best practice code and with existing legislations.

The second set of measures should be aimed at improving the overall policy and institutional environment within which firms operate. This would include: fine-tuning of the legal (company, securities and bankruptcy) and regulatory framework; adoption of better accounting and auditing standards, disclosure requirements; enhancing market competitiveness through the introduction of a competition policy; and further financial market reforms which could allow the debt and equity markets to act as effective enforcement and disciplinary mechanisms of corporate governance.

The key issues which need to be addressed in the legal framework to enhance corporate governance are not substantively different from those in mature market economies. These include: (a) what types of financials (banks and NBFIs) can own shares of companies; (b) restrictions on size of holdings and disclosure requirements on gaining large or controlling shareholding; (c) protection of minority and outside shareholders; (d) classes of shares and the principle of one share one vote; (e) rules for the convening of annual general (or extraordinary) meetings, size of quorum and majority voting procedures at such meetings; (f) rules on and disclosures of related party transactions; (g) clear mandates for independent or outside directors or supervisory boards; and (h) disclosure requirements in the form of regular, externally audited, full and intelligible company reports and financial statements.

Equally important, however, is financial market reforms. The present debt market is a pseudo-commercial banking system owned by the state and used by the state largely to support mainly poor-performing public sector firms. The Chinese banking system is itself characterised by even weaker corporate governance practices where not only its assets have been used for risky and dubious lending, but where the interests of the investors or owners of assets (e.g. household depositors) are not safeguarded or represented. The equity market, in turn, is unable to perform any effective role in corporate governance because the majority percentage of shares of most listed firms are state-owned and can not and are not publicly traded. Market activity is limited to transactions of privately-owned shares which form only a small proportion of a firm's total share issue. This means that the stock market can not function as a market for corporate control, and nor does share price movements function as meaningful signals of investor's confidence or as "votes" in corporate governance. Indeed, the majority (and non-publicly tradable) state shareholdings of a listed company constitute an unfair and uncompetitive practice which gives its shareholder (the state) a disproportionately, unjustly large and non-contestable



power in corporate governance.

In the course of financial sector reform, it is important to stress the imperative of strong corporate governance in financial institutions. This is especially true of banks, asset managers, pension funds, etc., where their "assets" (liabilities) are not their own but belong to enterprises and households. In both the US and the UK, some of the worst cases of corporate mismanagement and weak corporate governance have been in financial institutions, especially investment banks and NBFIs. There have been numerous initiatives to improve corporate governance of pension funds in both the US and the UK, and in fact pension fund managers have played a leading role in corporate governance development generally. But it is conspicuous that no similar attempts have been made to improve the corporate governance of banks and investment funds. It is debatable whether stronger banking supervision and financial regulations alone are adequate without addressing the issue of corporate governance of these institutions directly.

The very process of privatisation can also serve as a powerful instrument for promoting or kick-starting the financial market if the process itself relies on particular type of financial institutions (banks, institutional investors and NBFIs such as pension funds and insurance companies) and instruments (e.g. investment funds and debt-for-equity swaps). A degree of concentrated ownership in banks or investment funds would facilitate monitoring and an active voice in corporate governance, with these investors acting as "agents of change" in the restructuring process. In Poland, for example, the authorities have established investment funds which essentially contract out, through competitive bids, state asset management to professional managers. Similarly, the ways in which large SOEs are unbundled and privatised could address the problem of industrial concentration and monopolies (typical of many command economies) and thereby increase the competitiveness of markets so vital to corporate governance and efficiency.

Initiatives in China to improve corporate governance will also have to address two issues which on which there appears to be no consensus in other countries. One relates to managerial incentives or remuneration. Excessive pay of company directors is a highly controversial issue in both the United States and the United Kingdom, and it is this issue more than any other which has fuelled the corporate governance debate. Although various codes of best practice have stipulated mechanisms of oversight over executive pay, such as independent remuneration committees comprising non-executive (independent) directors, no code that this author is aware of has been able to develop clear and transparent formulae for determining directors' pay. Performance-related remuneration packages of directors in most large firms are too complicated for ordinary shareholders to understand and monitor.

The second issue concerns the enforcement of codes of best practice. The number of such codes may be multiplying monthly, but a shortcoming in the majority of cases is the relatively weak means of enforcement -- or indeed any mention of how best practice can best be enforced. Almost all codes are voluntary. Even when they are made part of listing requirements -- the usual approach -- no sanctions apply if companies fail to comply fully. The principle underlying voluntary codes is that the diversity of firms, in terms of their ownership structures, sector-specific risk, methods of raising external finance, etc., require giving them flexibility in the ways first principles of good corporate governance can be tailored and practically implemented. While this is indeed a valid principle, it also provides firms with moral hazards and opportunities not to comply with the spirit of and codes of best practice. The general view

is that compliance with best practice is best left to shareholders and markets to ensure.

The problem with this approach in China, and presumably in many other transition and developing economies, is the underdevelopment of what can euphemistically be termed a "modern market-based business culture". At the risk of being banal, it is salutary to remember that corporate governance is ultimately about human behaviour conditioned both by economic calculus and by cultural traditions. The development of corporate governance therefore involves the cultivation of a particular business culture and values which can only be a prolonged process. Clearly a more pro-active policy of corporate governance is necessary, with markets, the state and the international economy acting as agents for such cultural transformation. But it is in the development of China's backward markets and market institutions which in the long term is likely to be the most powerful agent of change.

### **Box 1: The Counterexample of TVEs.**

The phenomenal growth performance of township and village enterprises (TVEs) provides a counterexample of how an improved system of corporate governance can result in greater economic efficiency and dynamism in China. In terms of property and control rights, TVEs are usually jointly owned by local (township and village) governments and by individual former commune members. Local government ownership tends to be vested in the local government's "development corporation" (*kaifa gongsi*). There is a wide variation among TVEs in the distribution of ownership between local governments and individuals, with some TVEs majority owned by the local government and others almost completely owned by individuals or by other firms. The equity participation of local governments confers important economic and political advantages for TVEs such as in securing preferential access to financing and other inputs, in clearances over bureaucratic and licensing hurdles, and in protection of local markets through non-tariff barriers.

The most distinctive features of TVEs in comparison with SOEs and other COEs, however, are threefold. First, ownership and property rights are unambiguous: they are owned by clearly defined (legal) persons such as local governments and individuals. This means that there are clearly identifiable residual claimants bearing residual risks. Second, they face hard budget constraints. Local governments, unlike the central government, can not engage in deficit financing (unless with the approval of the central government and met through central government transfers). As (partial) owners, local governments therefore face strong incentives to ensure that TVEs are efficient and profitable. Third, following from the previous two features, they have relatively better corporate governance structures in terms of clarified property rights, residual risk bearing, incentives and financial and market discipline. Although it is premature to make definitive judgements about causal relationships, the corporate governance structures of TVEs can at least be correlated with their better performance compared with SOEs. This does not mean that the corporate governance of TVEs are adequate. Anecdotal evidence suggests that many TVEs are insider controlled without adequate protection for and accountability to minority or outside shareholders, lack transparency, often fail to honour commercial contracts, etc. But the closer alignment of residual-risk bearing and control in TVEs results in a corporate governance structure which enhances incentives, firm performance and commercial objectives.

### **Box 2: Classes of Shares in Chinese Companies**

**State-owned Shares** refer to shareholdings of the central and local governments or by institutions and departments (including SOEs) designated by the State Council or by local governments. It was recently clarified that the ultimate owners of these shares is the State Council. This type of shares is not allowed to be publicly traded or exchanged except with the explicit approval of the state authorized investing institution or

department, such as the National Administrative Bureau of State-Owned Property (NABSOP) at the central government level and the state asset management bureaux of local governments. In the majority of publicly traded companies, the state is the majority or largest (controlling) shareholder.

**Legal-Person Shares** refer to shares owned by domestic institutions (enterprises or companies, or other economic entities enjoying legal person status). Broadly, a legal person in China is defined as a non-individual legal entity or institution. Official documents tend to refer to domestic institutions share companies, NBFIs and SOEs that have at least one non-state owner. (Banks are legally prohibited from owning shares in companies). Owners of legal person shares are usually firms or institutions which have acted as promoter of the invested company. If the legal person is an SOE or institution where the state has majority but less than 100 percent ownership, then the shares also called **State-owned Legal Person Shares**, which the CSRC defines as "legal persons shares" whereas NABSOP defines them as "state shares". Like state shares, legal person shares are not publicly tradable and are subject to the same restrictions applicable to state-owned Shares. Sales of legal person shares to foreign investors were allowed until May 1996 when such sales were suspended. Legal person shares here should be distinguished from legal person shares traded on the two automated quotation systems in Beijing, the Stock Trading Automated Quotation System (STAQ) and the National Exchange and Trading System (NETS). It should also be mentioned that cross listing is prohibited.

**Public Shares** refer to shares offered to and freely traded by the general public. Its is mainly held by individual public investors, staff and employees of companies who have not acted as the promoters, and institutional investors. Public shares are further classified according to their **liquidity and/or listing location**, as follows:

**"A" Shares**, (previously called "Renminbi-Denominated Common Shares" and since 1995 officially termed "domestic shares" in the State Council's "Regulation on Domestically-Listed Foreign Investment Shares of Limited Joint-Stock Companies") are issued in a registered form with nominal values in RMB. They can be subscribed and traded only in RMB, and are listed and freely traded in domestic stock exchanges. Only Chinese nationals or residents domiciled in China are qualified to purchase, own and trade these shares. No restrictions apply to holding periods, but there is a legal requirement that A shares should account for not less than 25 percent of total shares issued when a company goes for listing.

**"B" Shares (or "special shares")** (previously called "Renminbi-Denominated Special Shares" but termed "Domestically Listed Foreign Investment Shares" since 1995) are issued in registered form with nominal values in RMB, listed and traded in domestic exchanges, but subscribed and transacted in foreign currencies (in US dollars in Shanghai and in HK dollars in Shenzhen). Subscription and ownership of these shares are limited to: foreign natural and legal persons and other organizations; natural and legal persons and other organizations from Hong Kong, Macau and Taiwan; PRC citizens residing overseas; and other investors as may be authorized by the CSRC. Upon the approval of the CSRC, these shares or their derivatives (share option and foreign share certificates) may be circulated and transferred abroad.

**"H", "N", "L" and "S" Shares** refer to shares of Chinese companies listed, subscribed and traded in Hong Kong, New York, London and Singapore respectively, and with nominal values and trading in the respective local currencies of the country of listing.

**Employee shares** are shares offered to employees (staff and management) of a listed company, usually at a substantial discount. These share offerings are designed more as a benefit or incentive to workers rather than as means of raising capital. Employee shares are registered under the title of the labour union (workers' council) of the company. After an initial holding period of six to twelve months, the company may file an application with the CSRC to allow its employees to sell the shares on the open market.



**Table 1: Indicators of SOEs Performance**

Year	Original value of	Net value of	Total Loss of Lossing	Total	Total Pre-tax	GDP	Fiscal	Fiscal Deficit	Ratio of Loss to	Ratio of Loss to Fiscal	Ratio of Loss to
1978	319.34	222.57	4.206	50.88	79.07	362.41	113.226		1.160564	3.714695	
1979	346.67	237.86	3.638	56.28	86.44	403.82	114.638	13.541	0.900896	3.173468	26.8665534
1980	373.01	252.8	3.43	58.54	90.71	451.78	115.993	6.89	0.759219	2.957075	49.7822932
1981	403.23	270.93	4.596	57.97	92.33	486.24	447.579		0.945212	3.908861	
1982	437.5	291.4	4.757	59.77	97.22	529.47	424.233	4.765	0.898446	3.923849	269.5184436
1983	476.7	316.1	3.211	64.09	103.28	596.45	136.695	4.257	0.541073	2.349025	75.4287057
1984	517.0	339.55	2.661	70.62	115.28	717.1	164.286	5.816	0.371078	1.619736	45.7530949
1985	595.62	398.08	3.244	73.82	133.41	896.44	200.482		0.361876	1.6181	
1986	674.48	454.38	5.449	68.99	134.14	1020.22	212.201	8.29	0.5341	2.567848	65.7297949
1987	767.79	524.24	6.104	78.7	151.41	1196.25	219.935	6.283	0.510261	2.775365	97.1510425
1988	879.52	604.04	8.192	89.19	177.49	1492.83	235.724	13.397	0.548756	3.475251	61.1480182
1989	1016.084	703.32	18.019	74.301	177.314	1690.92	266.49	15.888	1.065633	6.761605	113.4126385
1990	1161.027	808.831	34.876	38.311	150.314	1854.79	293.71	14.649	1.880321	11.874298	238.0776845
1991	1355.675	950.719	36.7	40.217	166.115	2161.78	314.948	23.714	1.697675	11.652717	154.7609007
1992	1566.978	1089.265	36.927	53.51	194.412	2663.81	348.337	25.883	1.386248	10.600941	142.6689333
1993	1906.639	1330.437	45.264	81.726	245.47	3463.44	434.895	29.335	1.306909	10.40803	154.3003238
1994	2310.198	1567.752	48.259	82.901	287.625	4675.94	521.81	57.452	1.032071	9.248385	83.9988164
1995	3093.57	2136.389	63.957	66.56	287.42	5847.81	624.22	58.152	1.093691	10.245907	109.9824598
1996	3476.496	2386.07	79.068	41.264	273.713	6788.46	740.799	52.956	1.164741	10.673341	149.3088602
1997	3835.1	2588.3	83.095	42.783	290.722	7477.24	865.114	58.242	5.948614	9.605093	142.6719549

Source: China Statistical Yearbook, 1998.

**Table 2: Number of Industrial Enterprises by Ownership (1993-1997)**

	1993	1994	1995	1996	1997
Number of Industrial	9.916	10.0171	7.3415	7.9865	7.9229
SOEs	0.1047	0.1022	0.118	0.1138	0.0986
COEs	1.8036	1.863	1.475	1.5918	1.7723
Township Enterprises	0.2098	0.2177	0.2288	0.2023	*
Village Enterprises	0.7773	0.7887	0.6899	0.6784	0.6314
Cooperative Enterprises	0.6442	0.6892	0.3716	0.5186	0.7825
Individual-owned Enterprises	7.9712	8.0074	5.6882	6.2107	5.9747
Enterprises of Other Types of	0.00321	0.00445	0.00603	0.00702	0.00773
Gross Industrial Output Value	4840.2	7017.6	9189.4	9959.5	11373.3
% of Gross Industrial Output	100.0	100.0	100.0	100.0	100.0
SOEs	47.0	37.3	34.0	28.5	25.5
COEs	34.0	37.7	36.6	39.4	38.1
Township Enterprises	11.1	11.6	13.0	11.8	*
Village Enterprises	10.7	13.8	12.9	16.0	15.8
Cooperative Enterprises	2.7	3.7	2.3	3.4	4.1
Individual-owned Enterprises	8.0	10.1	12.9	15.5	17.9
Enterprises of Other Types	11.1	14.9	16.6	16.7	18.4

Note: a) The gross industrial output value is calculated at current prices.

b) The data of the gross industrial output value in 1991-1994 were adjusted in accordance with the data of the Third Industrial Census, so that they were different from the data in the previous yearbooks.

c) The gross industrial output value in 1996 and 1997 was calculated in accordance with new stipulations.

d) \* Denotes the number is absent.

Source: China Statistical Yearbook 1998.

**Table 3:: Data on SOEs and Corporatised Entities, 1997**

<b>Domestic Enterprises</b>	
Category	Number
	2,078,348
State owned enterprises as legal persons	873,925
Collective owned enterprises	4,470,469
Collective owned as legal persons	2,356,841
Associated enterprises	113,310
Associated enterprises as legal persons	74,514
Joint stock enterprises	498,764
Joint stock enterprises as legal persons	400,366
Joint stock and cooperative enterprises	180,757
Joint stock and cooperative enterprises as legal persons	152,572
Other enterprises	17,429
Other enterprises as legal persons	10,369
Total of enterprises	7,357,077
Total of enterprises as legal persons	3,868,587
<b>Domestic Companies</b>	
Total	452,686
Limited companies	446,821
Wholly stated owned companies	8,734
Joint stock limited companies	5,865
Listed companies	370
Unlisted companies	5,495
<b>Enterprises with Foreign Investment</b>	
Total	235,681
Sino-foreign equity joint ventures	134,885
Sino-foreign cooperative joint ventures	33,413
Wholly foreign owned enterprise	67,197
Sino-foreign stock limited company	186
<b>Individual Owned Enterprises</b>	
Total	960,726
Sole proprietorships	387,534
Partnerships	130,668
Limited companies	442,524

**Table 4: Financial Data of Enterprises (Independent accounting units; bn Yuan), 1997**

	SOEs	COEs	SHEs	FEEs	EOCs	National Total
Number of Enterprises (unit)	74,388	319,438	12,322	19,861	23,020	449,229
Gross Industrial Output Value	2785.861	1977.158	492.999	821.591	602.74	6680.349
Total Capital	1389.722	439.827	208.153	395.961	265.879	2699.542
Total Assets	5910.761	1655.885	822.0	1027.005	786.384	10202.035
Circulating Funds	2295.798	891.799	394.24	480.858	370.176	4432.871
Fixed Assets	3141.458	631.168	342.537	432.334	343.109	489.0606
Liabilities	3831.502	1160.057	465.517	578.662	488.183	6523.921
Sales Revenue	2798.588	1647.205	459.288	757.957	543.998	6207.036
Sales Profit	392.368	188.696	68.662	82.069	59.866	791.661
Total Profits	42.783	45.843	28.549	31.167	17.881	166.223
Total Pre-tax Profits	290.722	118.824	54.642	62.821	36.379	563.388

Source: China Statistical Yearbook 1998.



**Table 5: Sources of Funds for SOEs and Shareholding Companies****Table 5a Corporate Investment Financing (financing sources of fixed asset investment, %) 1979-1996**

Year	State Appropriation	Domestic Loan	Foreign Funds	Fundraising	Others	Total
1979	79.0					
1980	52.0					
1981	48.5					
1982	36.6	16.2	1.9	45.3		100
1983	40.6	16.1	1.7	43.4		100
1984	39.0	15.4	2.2	39.2	4.2	100
1985	24.0	23.0	5.3	40.4	7.3	100
1986	22.2	22.7	6.5	38.4	10.2	100
1987	20.5	24.6	9.0	47.6		100
1988	14.7	24.2	9.0	40.5	11.7	100
1989	13.4	20.9	10.2	42.8	12.8	100
1990	13.2	23.6	9.1	42.1	11.9	100
1991	10.2	28.1	8.3	43.1	10.3	100
1992	6.3	30.4	8.0	46.6	8.7	100
1993	6.3	30.4	8.0	46.6	8.7	100
1994	5.0	25.7	7.2	51.0	11.6	100
1995	5.0	23.7	7.9	48.7	15.9	100
1996	4.6	23.6	6.7	50.9	14.4	100

Note: (1) investment of 1979-81 is that of capital construction; (2) fundraising in 1982, 1983 and 1987 includes "others".

Source: China Statistical Yearbook 1983, 1991, 1994, 1996 and 1997.

**Table 5b: Sources of Corporate Financing of SOEs and Joint-stock Companies, 1997 (%)**

Sources of Funds	SOEs	JSCs
State appropriation	5	0
Domestic loans	23	28
Foreign investment	5	9
Fundraising	53	45
Others	14	18

Source: China Statistical Yearbook (1998).

**Table 6: Securities Market Development in China****Table 6a Growth of Securities Market, 1991- 1997**

A. Number of listed corporations and shares from 1991 to 1997								
		1991	1992	1993	1994	1995	1996	1997
Shanghai	Corporation	8	29	106	171	188	293	383
	Shares	8	38	122	203	220	329	422
Shenzhen	Corporation	6	24	77	120	135	237	362
	Shares	6	33	95	142	161	270	399
B. Capitalisation								
Year	IPOs	Funds Raised (bn yuan)	Average funds raised per firm (bn yuan)	Equity capital of IPO firms (bn yuan)	Average equity capital per firm (bn yuan)			
1992	86	23.0	0.267	3.6	0.042			
1993	115	29.32	0.255	22.4	0.195			
1994	108	10.78	0.100	3.0	0.027			
1995	21	2.268	0.108	0.532	0.025			
1996	203	22.0	0.14	24.4	0.12			
1997	206	60.87	0.324	42.733	0.208			

**Table 6b: Securitisation Rate**

Year	GDP (bn yuan)	SD (bn yuan)	TMC (bn yuan)	R1 (%)	R2 (%)
1991	2161.78	911.03	10.919	0.505	1.199
1992	2663.81	1154.54	104.813	3.935	9.078
1993	3463.44	1520.35	354.152	10.23	23.29
1994	4675.94	2151.88	369.062	7.893	17.15
1995	5847.81	2966.23	347.427	5.938	11.71
1996	6859.38	3852.08	984.237	14.35	25.55
1997	7477.24	4627.98	1752.924	23.44	37.88

Note: SD and TMC refer to Urban and Rural savings deposits, total market capitalization, respectively; R1 and R2 refer to the ratio of TMC to GDP and the ratio of TMC to SD, respectively.

Source: China Statistical Yearbook 1998. SHSE&SZSE Yearbook 1998.

**Table 7: Distribution of Tradable and Non-tradable Shares, 1997**

A. Share-holding structure of corporations listed in Shanghai and Shenzhen Exchanges (billion shares)							
Items	Shanghai		Shenzhen				
	Number of listed shares	Percentage (%)	Number of listed shares	Percentage (%)			
State owned shares	15.339	55	12.822	56			
Legal person owned shares	2.404	9	2.046	9			
Staff shares	1.283	4	0.843	5			
Public shares	5.852	18	4.072	21			
Special shares	2.583	14	3.3	9			
Total	27.461	100	23.083	100			
B. Investors registered in SHSE (thousands)							
Items		1992	1993	1994	1995	1996	1997
Total							
	Total	111 2.3	4231.5	5748.9	6852	12078.7	17133.1
	Individuals	1105.3	4219.2	5725.7	6823.2	12041.1	17080.9
	Institutional investors	7.0	15.9	23.2	28.8	37.6	52.2
A shares							
	Total	1112.3	4224.9	5730.0	6825.0	12033.0	17067.7
	Individuals	1102.3	4210.9	5710	6820	12000	17021.9
	Institutional investors	7.0	14	20.0	25.0	33.0	45.9
B shares							
	Total		10.2	18.9	27.0	45.7	65.4
	Individuals		8.3	15.7	23.2	41.1	59.1
	Institutional investors		1.91	3.2	3.8	4.6	6.31

Source: Shanghai Securities Exchange, Statistic Yearbook 1998

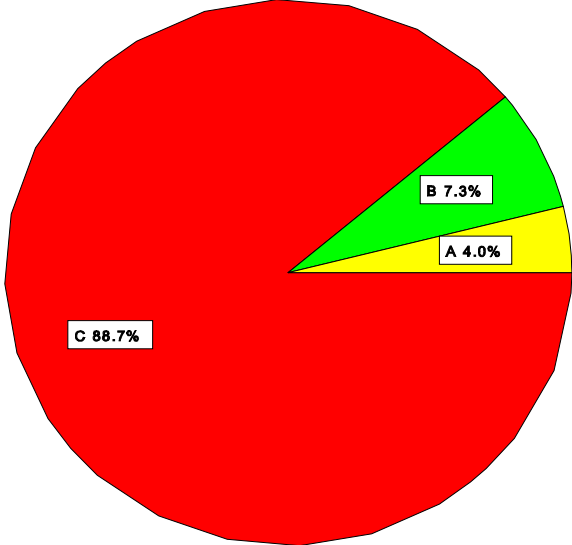
**Table 8: Shares Structure in China's Stock Exchanges (as of 12 December 1997)**

	Shanghai	Shenzhen	Total
Number of listed shares	422	399	821
A Shares	372	348	720
B Shares	50	51	101
Number of shares issued (million)	97537.49	79585.70	177123.19
A Shares	90776.32	73837.13	164613.45
B Shares	6761.17	5748.57	12509.74
Number of negotiable shares	28411.82	27432.12	55843.94
A Shares	21621.55	22460.61	44082.16
B Shares	6790.27	4971.51	11761.78
Negotiable share's rate (%)	29.1	34.5	32
A Shares	23.8	30.4	27
B Shares	100.4	86.5	93
Market capitalization (mln Yuan)	921806.64	831117.06	1752923.7
A Shares	903245.25	812174.04	1715419.29
B Shares	18561.39	18943.02	37504.41
Negotiable mkt cap (mln Yuan)	249488.09	269096.14	518584.23
A Shares	230820.36	252127.50	482947.86
B Shares	18667.73	16968.64	35636.37
Market volume (million shares)	121562.33	13443370.2	13564932.5
A Shares	116595.65	13052860.6	13169456.3
B Shares	4966.68	390509.6	395476.28
Traded amount (million yuan)	1376160.31	1695866.17	3072026.48
A Shares	1354868.02	1674497.10	3029365.12
B Shares	21292.29	21369.07	42661.36
Trading days	243	243	243
Ave. Price-to-earnings ratio (I)	38.65	39.86	39.255
Ave. Price-to-earnings ratio (II)	37.36	35.62	36.49

Source: Securities Market Weekly (the Monthly financial edition), 1998, 11.

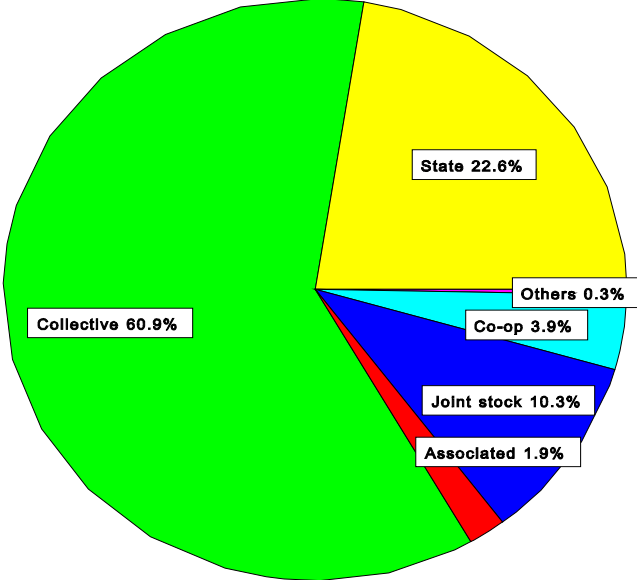
**Figure 1:Composition of China’s Corporate Landscape**

**Fig 1a. Enterprises registered as legal entities 1994**



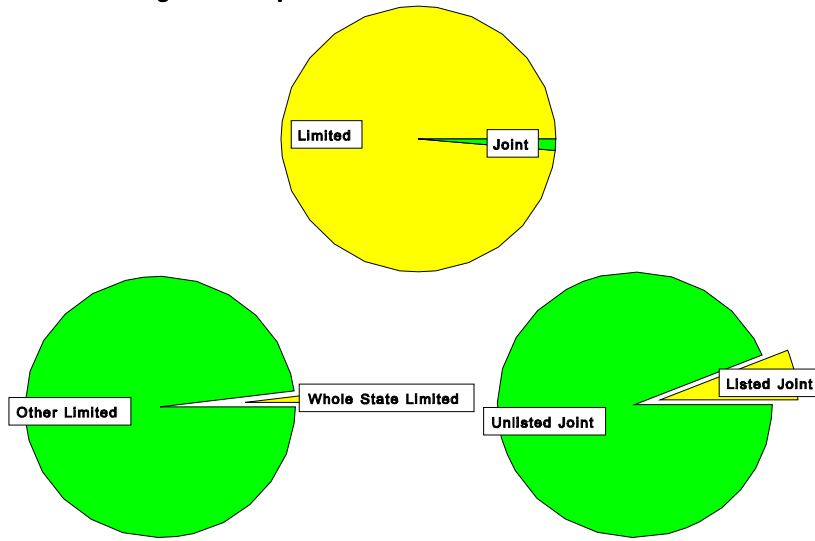
Note for Fig1a: The capital letter “A” refers to companies registered as companies. B are these private owned limited companies registered under Provisional Regulations On Privately Operated Enterprises. C includes state owned, collectively owned or jointly owned companies registered under other specifically applied laws.

**Fig1b. Enterprises registered as legal entities 1997**

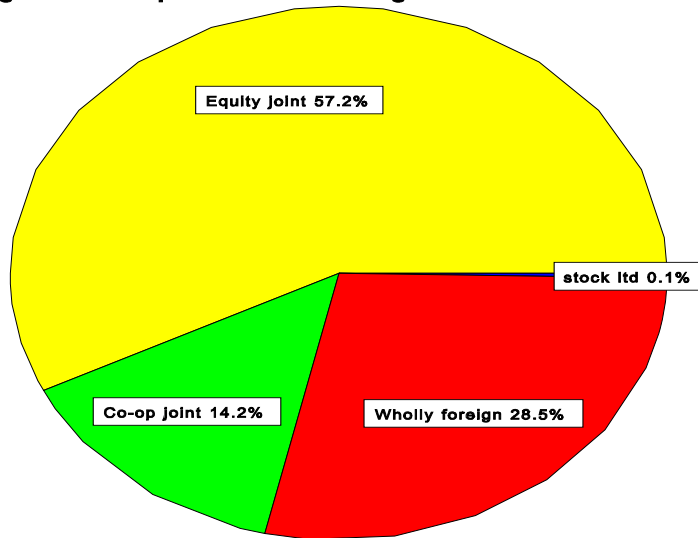


Note for Fig1b: The label “state” refers to the state-owned enterprises. “Collective” are those collective owned enterprises. “Associated” means the associated enterprises. The “Joint stock” label denotes joint stock enterprises. “Co-op” are the joint stock and cooperative enterprises. Finally, “others” refers to all other types of enterprises. All these enterprises are registered as legal persons.

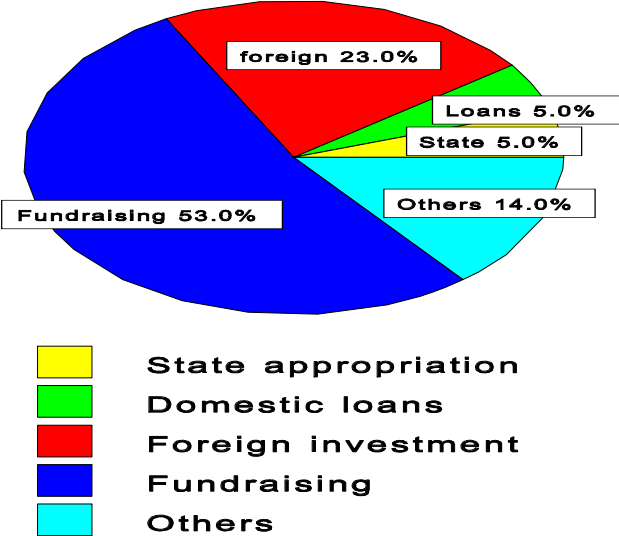
**Fig 1c Companies with domestic funds 1997**



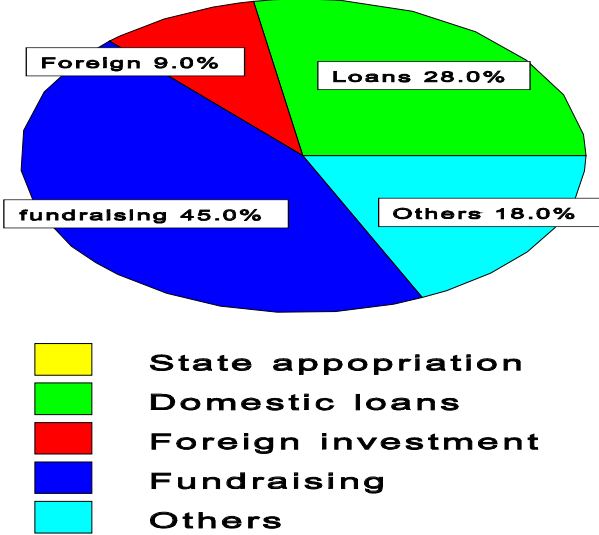
**Fig 1d Enterprises with foreign investment 1997**



**A. Funding sources of SOEs**



**B. Funding sources of SHEs**





## APPENDIX 1: CATEGORIES OF FIRMS IN CHINA

### Economic Entities by Ownership

SOEs. Prior to 1988, SOEs existed without a legal basis and were instead subject to the "**Regulations on the Work of Directors of Enterprises Under Whole People Ownership**" (1986) and the "**Regulations on Workers' Representative Meetings of Enterprises**" (1986) which laid out the principles and procedures for the organisation and operations of SOEs. These two regulations remain valid to this day. In 1986, the "**(Trial) Bankruptcy Law for Enterprises Under Whole People Ownership**" adopted. The legal basis for SOEs were established in 1988 with the promulgation of "**The Law on Enterprises Owned by the Whole People**" which defined SOEs as a legal person with the state as the sole (or majority) owner. Its liability is limited to the amount of assets authorized by the state. The 1988 Enterprise Law also outlined the main principles for SOE management. This was supplemented by the 1992 "**Regulations on Transforming the Operational Mechanism of (SOE) Enterprise Management**" which further enlarged operational autonomy of SOEs, including limited powers over disposal of assets through leasing, mortgaging and even outright sales. The "**Regulations on the Supervision and Management of Assets of SOEs**" (1994) required controlling authorities (government departments and authorities) to appoint supervisors clearly tasked with responsibilities for monitoring the use of assets of SOEs under their jurisdiction.

COEs. COEs are subject to the "**Law on Collectively-Owned Enterprises**" (1991). COEs are defined as a legal person with assets owned jointly by workers and other economic entities. The COE Law states that COEs are to be managed by a director appointed by the enterprise's workers' representative meeting (i.e. council) or the enterprise's "work council". The law also details the requirements and rules on the formation of COEs.

Individually-Owned (or Private) Enterprise. Private enterprises were stigmatized as "elements of capitalism" and were severely restricted in the pre-reform economy. Although their existence and growth were allowed after 1978, their legal status came only in 1988 when the National People's Congress passed an amendment to the Constitution of the PRC recognizing their "positive role" in the national economy and promulgated the "**Provisional Regulations on Private Enterprises**" (1988). The Regulations defined private enterprises as economic entities with eight or more employees and whose assets are owned by individuals. The Regulations further distinguished between three types of private enterprises: (a) **individually-funded enterprises** funded and managed by one person; (b) **partnerships** funded and managed, and profits shared and losses borne jointly, by two or more persons under a legal contractual agreement; and (c) **limited liability companies** in which the liability of investors to the company are limited to their respective contributions and the company's liabilities are limited to the extent of its assets. With progress in developing the commercial law system, partnerships and limited liability companies became subject respectively to the specific "**Law on Partnerships**" (1997) and the "**Company Law**" (1993).

Foreign Enterprises. Foreign enterprises includes joint ventures, sino-foreign cooperation enterprises and wholly foreign-owned enterprises. Each of the three types of enterprise is

respectively subject to the law promulgated for each of them. Where these foreign enterprises are incorporated as limited liability companies or limited joint-stock companies, they are also subject to Company Law (see below). But where the Company Law and the various specialized laws on foreign enterprises have different provisions, the latter takes precedence and applies.

### **Categories of Firms by Liabilities.**

Partnerships. The "Law on Partnerships" (1997) state that partners shall jointly invest, manage and share profits, bear losses, and that they must bear unlimited several and joint liability for the debts of the enterprise.

Companies. Companies in China's **Company Law (1993)** refer to **limited liability companies (LLCs)** and **limited joint-stock companies (JSCs)**. Both types are defined as enterprise legal persons with shareholders enjoy limited liability.

In an LLC, shareholders are liable towards the company to the extent of their respective capital contribution, and the company shall be liable for its debts to the extent of all its assets. An LLC is established by capital contributions made jointly by between two and fifty shareholders, with the registered capital not less than 100,000 Yuan for consultancy and services companies, not less than 300,000 Yuan for retailing companies and not less than 500,000 Yuan for manufacturing or wholesale companies.

In the case of a limited JSC, its establishment require a minimum of five individual "promoters" (or founding shareholders); but where an SOE is a promoter, then a minimum of only one promoter is required. A limited JSC's capital is divided into equal shares, with shareholders liable towards the company to the extent of their respective shareholdings and the company liable for debts to the extent of all its assets.

There is in China a special kind of LLCs called a **wholly state-owned company (SOC)**. SOCs are essentially SOEs in the guise of a modern corporation -- subject to Company Law rather than to the Enterprise Law. They are a LLC invested and established solely by an organisation, institution or department explicitly authorised by the state to make state-approved investments. This corporate form applies mainly to companies engaged in special lines of production or trade, such as infrastructure and other strategic industries, specifically designated by the State Council.

## APPENDIX 2: STATUTORY FRAMEWORK FOR CORPORATE GOVERNANCE IN CHINA

### A. Company Law

China's Company Law prescribes a system of corporate governance in terms of a system of checks and balances through an organisational structure comprising three main and distinct constituent bodies: the **shareholders' general meeting** (or annual general meeting); the **board of (executive) directors**; and the **board of supervisors**. Figure 2 depicts the typical organisational structure of governance and control in a Chinese limited JSC. For LLCs with "comparatively few" shareholders and "comparatively small" scale of activities, Company Law allows them to have a single executive director rather than a board of directors; they are also to dispense with the formation of a supervisory board.

This structure of corporate governance is heavily influenced by the German model which prescribes a two-tier structure of a board of director and of an oversight supervisory board, with mandatory employees' representation on the supervisory board.

#### 1. Shareholders' General Meeting (AGM)

Rights and Responsibilities. Company Law states that the Shareholders' General Meeting or the annual general meeting (AGM) is the highest authority within the company. It is empowered with the following rights and responsibilities:

- (a) Determination of company strategy and operational business and investment plans;
- (b) Appointment and dismissal of members of the board of directors and determination of matters relating to their remuneration;
- (c) Appointment and dismissal of representatives of shareholders as members of the supervisory board, and determination of matters relating to their remuneration;
- (d) Examination and approval of the company annual report (including operating budget for the next year) of the board of directors, and of the annual report of the supervisory board;
- (e) Examination and approval of the company's profit distribution and dividend policy and of plans for meeting any losses;
- (f) Approval of decisions on the increase or decrease in the company's registered capital, on the issuance of company bonds and on matters relating to mergers, de-merger, dissolution and liquidation.

Convening of Shareholders' Meeting. Shareholders' meetings are to be held once a year. An extraordinary shareholders' meeting should be convened within two months in the event of any of the following events:

- (i) The number of directors falling below that specified in the Company Law, or falling below two-thirds that specified in the company's charter;
- (ii) Unmet losses of the company amounting to one-third of the company total share capital;
- (iii) Request for an extraordinary meeting by shareholders holding ten or more percent of the company's shares;
- (iv) Whenever deemed necessary by the board of directors;
- (iv) Whenever called for by the supervisory board.

Shareholders are to be notified of a shareholders' meeting, and provided with the agenda of the meeting 30 days prior to the meeting. No resolution on matters not contained in the agenda may be approved in an extraordinary shareholders' meeting. Holders of non-registered shares are to be given notices of shareholders' meetings by way of notices given 45 days before the meeting. Meetings are to be convened by the board of directors and presided over by the chairman of the board. If the chairman is unable to preside or to perform his duties for whatever reasons, the meetings shall be chaired by the vice-chairman or another director designated by the chairman.

Voting Rights and Resolutions. Shareholders present at shareholders' meetings are entitled to one vote for each share held. (Hitherto, there are no provisions in Company Law for cumulative voting.) Resolutions of shareholders shall be approved with a simple majority of voting rights held by shareholders present. Resolutions on the merger, de-merger and dissolution of the company, and on amendments to the company charter, must be approved by shareholders holding at least two-thirds of the voting rights. Minutes of the meetings and resolutions are to be recorded, signed by directors attending the meetings, and kept together with a register of attending shareholders and of the power of attorney of attending proxies.

## **2. The Board of Directors**

The Company Law requires a limited JSC to have a board of directors comprising between five to nineteen members, with members elected (or dismissed) by the shareholders' meeting. The tenure of a board member is to be specified in the company charter but can not exceed three years. A director may serve consecutive tenures if re-elected.

Rights and responsibilities of board directors. The board is accountable to the shareholders' meeting and is empowered with the following rights and responsibilities:

- (a) Convene the shareholders' meeting, to whom it must report on the operations and performance of the company;
- (b) Implement resolutions and decisions adopted by the shareholders' meeting;
- (c) Draft proposed operational business and investment plans, and draw up final accounts and draft annual budgets, of the company;

- (d) Draft the profit distribution and dividends plan and plans for meeting any company losses;
- (e) Draft any plans for increasing or reducing the registered capital of the company, and for issuance of company bonds;
- (f) Draft any plans for mergers, de-mergers or dissolution of the company;
- (g) Decide on the company's internal organisation and management structure; and to formulate the company's management system;
- (h) Appoint or dismiss, and to decide on the remuneration of, the company's general manager; and upon the recommendation of the general manager appoint or dismiss and decide on the remuneration of the deputy manager and the officer responsible for financial affairs;

Board procedures. The board chairman is to be the legal representative of the company, and is to be elected by a simple majority of board directors. The Board may, where necessary, authorise the chairman to exercise some of the powers of the board when the board is not in session. Board meeting are to be held at least twice a year, with notices of such meetings given to all directors not less than ten days before the convening of the meeting.

Voting Rules. A board resolution can only be approved if more than half of the directors vote in its favour. A director may attend meetings in person; if he is unable to attend in person, he may give a proxy upon giving written authorization to other board directors.

Proxies. Proxy rules are contained in the CSRC's "**Guidance on the Company Charter of Listed Companies**" (6 December 1997) which stipulate that company charters of listed companies should include provisions entitling shareholders to attend Shareholders Meeting in person or through proxies. A shareholders may commission a proxy for another person to attend and vote at the Shareholders' Meeting on his/her behalf. The proxy is required to submit the shareholder's power of attorney to the company and exercise voting rights within the scope of authorization by the shareholder.

Liabilities of board directors and senior management. Board directors and managers are to abide by the company charter and perform their duties diligently and faithfully, to protect the interests of the company and shareholders, and may not use their position, roles and powers for personal gain. A board director shall bear the liabilities for resolutions adopted by the board. If a board resolution is in violation of laws, administrative regulations and the company charter and which causes the company to suffer losses, the directors taking part in the said resolution shall be liable to the company for any damage incurred by the said resolution. However, if a director is proved to have expressed opposition to such a resolution when it was voted upon and his opposition is recorded in the minutes of the meeting, then the director is absolved from any liability associated with the resolution.

Eligibility of directors, supervisors, managers and senior officers. In addition to serving state

officials and functionaries, the following persons are disqualified from serving as members of the board of directors, board of supervisors, managers and other senior officers of the company:

- (a) Persons without or with restricted civil capacity;
- (b) Persons who, within the last five years, have been convicted of and penalised for offenses of corruption, bribery, trespass on another persons' property, misappropriation of property, disruption of social and economic order, and/or persons who have been deprived of political rights due to crimes committed, where less than five years have elapsed since the date of the completion of the implementation of the deprivation;
- (c) Persons who were formerly board directors, factory directors or managers of a company or enterprise which have been declared bankrupt and/or was liquidated as a result of management by such persons who were made personally liable for the company or enterprise, and where less than three years have elapsed since the date of the completion of the bankruptcy or liquidation of the company or enterprise;
- (d) Persons who were legal representatives of a company or enterprise which had its business license revoked due to a violation of law(s) and who were made personally liable for such revocation, and where less than three years have elapsed since the date of the revocation of the business or operating license;
- (e) Persons who have a "considerable" amount of overdue debts outstanding.

The Company CEO/President. The Chinese term for a general manager, *zhongjingli*, equates to the chief executive officer (or executive president or managing director) in a western company. The Company Law prescribes that the general manager is to be appointed or dismissed by the board of directors and is accountable to the board. The rights and responsibilities of the CEO are as follows:

- (a) Oversee the operation, management and production of the company, and to implement the resolutions of the board;
- (b) Implement the company's annual business and investment plans;
- (c) Formulate and implement the company's internal organisational and management structure and system, and the basic operational rules and regulations of the company;
- (d) Propose the appointment or dismissal of the company's deputy general manager(s) and (chief) financial officer;
- (e) Appoint or dismiss senior and other management staff other than those appointed or dismissed by the board of directors;
- (f) Perform any other functions or powers conferred by the board of directors or the company charter on the CEO.

### 3. The Supervisory Board

Board composition. The Company Law stipulates that the supervisory board of a limited joint-stock company shall comprise a minimum of three members, with a "convenor" (chairman) of the board elected among and by its members. The board shall comprise representatives of shareholders and a "proportionate" representation of the company's employees (staff and workers), with the specific proportion of employees representation to be decided by the company and stipulated in the company charter. The employees' representative(s) on the supervisory board is(are) to be democratically elected by the employees. The tenure of a supervisory board member is three years, which is renewable upon re-election and re-appointment by the shareholders' meeting. Members of the board of directors, managers and the chief financial officer are not allowed to serve as members of the supervisory board.

The Chinese legal requirement for a two-tier board structure, with a supervisory board distinct from an executive board, in limited JSCs is largely based on the German prototype. The two-tier structure (and the existence of a supervisory board) has evolved largely out of political and historical factors in post First World War Europe (especially Germany and the Netherlands) where a supervisory board, with explicit representation for stakeholders (such as employees), was regarded as a mechanism for avoiding industrial and social conflict through consultations between "capital and labour" as part of the social democratic political philosophy.

In principle, a distinct supervisory board with a clear mandate to perform regular oversight over company executives represents a potentially more powerful and effective system of monitoring and of accountability to shareholders: members of the supervisory board are different from those on the executive board, and the dangers of conflict of interest are alleviated. Moreover, the supervisory board in the German prototype is also an operational mechanism for the principle of "co-determination" where employees and other stakeholders are guaranteed representation on the supervisory board and thus have a voice in the governance of the firm. Thus, employees' representation on the supervisory boards in China is similarly statutory.

But a similar strong mechanism to enhance oversight over executives can be achieved in a single-tier structure, without the need for a separate supervisory board, through the appointment of independent non-executive members to the board of directors with clear mandates to perform oversight over executive board members and safeguard the interests of shareholders. In practice, neither a single-tier nor a two-tier board structure is automatically superior to the other. Weak or effective corporate governance is possible with either structure, depending on how faithfully either supervisory or independent executive board members fulfil their oversight functions. Nevertheless, a distinct supervisory board member, with a separate and stronger oversight mandate from shareholders, can often enhance corporate governance.

Rights and responsibilities of supervisory board members. These are as follows:

- (a) Review and examination of the company's finances;
- (b) Supervision and oversight of directors and managers to ensure that they have not violated any laws, regulations and the company charter in the course of execution of their duties, rights and responsibilities;

- (c) Require any director or manager to correct any act which is harmful to the company;
- (d) Propose, when members feel it is necessary, the convening of an extraordinary shareholders' meeting;
- (e) Perform any other functions and powers conferred upon it by the shareholders' meeting and/or the company charter.

Company Law states that supervisory board members owe a duty of fidelity and diligence to the company. The procedures and methods for meetings and voting are to be specified in the company charter.

#### **4. Company Secretary**

The Company Law does not make any stipulations for the formation of a number of important check-and-balance arrangements which are increasingly regarded in the western countries as essential to effective corporate governance. These include the **company secretary**, an **independent remuneration committee** and an **internal audit committee**. Some of these, however, are stipulated or recommended in additional commercial, securities and financial regulations and guidelines.

The "**Guidelines on Company Charters (Articles of Association) of Listed Companies**" (**Company Charter Guidelines**) promulgated on 16 December, 1997, by the China Securities Regulatory Commission (CSRC) and mandatory for companies listed in the Shanghai and Shenzhen Stock Exchanges (SHSE and SZSE respectively), requires listed companies to establish a "**secretary to the board of directors**". The role and functions of the secretary are comparable to the company secretaries in UK and UK-based company laws. The principal responsibilities of the secretary are as follows:

- (a) Deal with the daily affairs of board and accomplish tasks assigned by the board;
- (b) Draft and record company documentation such as reports, minutes, resolutions, summaries and notices of the board;
- (c) Coordinate the various meetings convened by the shareholders' meetings and the board, and undertake the public relations affairs (e.g. investors' relations) of the board and the company;
- (d) Prepare the draft annual company report;
- (e) Ensure that the company updates and maintains a complete set of records of its operations and organisation;
- (f) Manage and maintain the company's register of shareholders obtained from the central share registration and clearing company, and ensure that individuals and institutions eligible for obtaining relevant company records and documents are promptly



provided with such material.

Company Law in China provides only a partial subset of the legal requirements on corporate governance. Some Chinese legislators have commented on a number of important omissions issues in the Company Law, such as requirements on controlling affiliated transactions, a director's personal liability, competition between holding companies and their subsidiaries or holdings, etc. There appears to be a consensus view that many of these issues cannot and should not be automatically resolved by market processes, such that more statutory requirements are needed. Perceived gaps and omissions in the Company Law, however, have been filled to a certain extent through the corpus of Securities and other administrative regulations, and most recently by the Securities Law.

## **B. Accounting Framework and Financial Disclosures**

### **1. Accounting Standards**

Corporate legislation in most western countries require financial statements of a company to give a "true and fair view". But such legislations rarely provide little specific guidance on what is a "fair and true view". Legislations may also stipulate detailed disclosure requirements such as analysis of the capital and debt structure and information on directors' remuneration, but again they often do not provide specific guidance on how these numbers are to be calculated or compiled. Guidance on what constitutes a "fair and true view" and on the compilation of disclosure data have therefore to be sought in relevant financial and accounting standards such as the IAS which set out the principles to be followed in various areas of accounting.

Chinese accounting standards and conventions in the pre-reform period were copied from Soviet practices designed for centralised command planning. This accounting system was **funds-based** (identifying the purpose of fund allocated), **rule-based** (specifying account headings for recording the use of funds in various types of transactions) and **tax-based** (used to determine tax, profit and other remittances to the state). This system served primarily as an instrument for controlling and monitoring the use of funds allocated to an SOE by the planners, and was not intended nor useful for analyzing the financial position and viability of the SOE.

Accounting Reforms. Accounting reforms began in China in 1985 with the enactment of the **Accountancy Law (21 January 1985)** which established and defined the framework of modern accounting. The Law empowered the Ministry of Finance (MOF) to issue detailed accounting standards. In practice, however, a plethora of agencies, including the former Ministry of Commerce (and now the Industry and Commerce Administration Bureau) and the CSRC, issue accounting rules and regulations for various industries and enterprises belonging to different branches and ownership and corporate classification. These regulations and directives, often including detailed normative charts of accounts, model journal entries and required formats of financial statements, in a number of areas departed from international accounting standards and also led to geographic and sectoral differences in regulations.

The next major stage in accounting reforms was the introduction by the MOF in 1992 of various legislation which became the corpus of regulations governing accounting in Chinese firms.

These were: the "**Accounting Standards for Business Enterprises**" (ASBE), the "**Accounting Regulations for Joint-Stock Companies**"(ASJSC), the "**Accounting Regulations of the PRC for Foreign-Invested Enterprises**" (ASFIE) and the (GFPE). Although each of these legislations apply to different types of firms, they are broadly similar and are closer to IAS than previous accounting regulations. All these reforms, however, are accounting regulations rather than statements of accounting standards in the sense of the IAS or normative accounting standards issued in the western countries.

A key objective of the ABSE, which came into effect on 1st July 1993, was to reduce or eliminate inconsistencies in accounting between enterprises in different sectors (Anna Yip 1998). The ABSE also sought to move Chinese accounting standards closer to international conventions practised in most market economies, and allowed for only the debit-credit bookkeeping method to be used. The GPFE prescribed guidelines on financial management in enterprises including the accounting treatment of a number of items. The ABSE and the GPFE together provide the general framework for the format of financial statements to be provided by all enterprises and for consistency in treatments of similar or equivalent transactions across industries. To assist enterprises to adapt to these new standards, the Accounting Affairs Administration of MOF also issued twelve industry-specific accounting systems based on principles set out in the ABSE.

Accounting standards regulations, such as the ASJSC, are stricter for share companies or JSCs and strictest for listed companies. The ASJSC was recently supplemented by the introduction in January 1997 of the "**Detailed Accounting Standards**" (DAS) by the MOF. These regulations, relating to "**Disclosure of Related Party Relationships and Transactions**", "**Cashflow Statements**" and "**Post Balance Sheet Events**" are primarily applicable to listed companies and other enterprises such as SOEs are currently exempted from these requirements. JSCs, and listed companies in particular, are further subject to a wide array of regulations either in Company Law and other commercial, financial and securities legislations and administrative directives promulgated by agencies such as the MOF and the CSRC. The principal laws and regulations applicable to JSCs and listed companies are the "**Securities Law**" (28 December 1998) and the corpus of regulations issued prior to the Law, governing the issuance and trading of shares, "**Measures Against Fraud in Securities Market**" (1993), "**Implementation Rules on Information Disclosure for Companies Making Public Share Offerings**" (1993), the "**Standard Contents and Format of Public Disclosure For Companies Making Public Share Offerings**" (six issues) and the "**Law Against Financial Crimes**" (1995). Companies listed overseas are subject to the accounting regulations and disclosure requirements of the stock market in which they are seeking a public offering.

Internal and External Auditors. China's Company Law does not require companies to have an internal auditor although almost all medium and large companies have a chief financial officer and or chief accountant whose department or section usually contain an officer performing audit functions. The Law does require a company to establish rules and procedures in financial management and accounting in line with regulations and standards laid down by the MOF and other state agencies. Company Law and other legislation require a limited JSC to publish a financial year-end financial report which is to be externally audited and verified.

Enterprises and companies in China are also subject to two additional external audits. One is the inspection of state administrative and economic units such as SOEs and majority state-

owned companies, undertaken by the Party inspection and discipline bodies. These inspections, covering a wide range of matters from ideological and political affairs to economic and financial management, are sporadic but usually undertaken when there are suspicions of violations of Party and state regulations. The other is the more financially-oriented audit undertaken by a government authority, the China National Audit Office (CNAO), whose mandate is to fight misuse of public funds and corruption.

The CNAO's routine work is concerned with auditing the implementation of central and local government budgets and finances, but is authorized to examine the accounts of other institutions such as government administrative units and government-sponsored institutions and companies. It is also empowered to examine the finances of any institution in the country, but usually focus on SOEs and state controlled companies. Large-scale audit of financial institutions by the CNAO began in 1997 when it audited 110 trust and investment companies that resulted in the suspension and closure of a significant number of these companies. It is reported that the CNAO in 1999 will be auditing 162 major loss-making state firms in seven provinces.

## **2. Financial Disclosures**

Requirements for disclosures of financial and other relevant information in Chinese companies have, until recently, been far less stringent than in western countries. Public disclosure requirements hardly apply to, and are essentially irrelevant to, SOEs and most other types of companies. But the corpus of recent legislations described above have made public disclosure requirements in Chinese listed companies significantly closer to international practice. Listed companies are now required to disclose "publicly, adequately and on a timely basis" details of their financial position and business operations, and must publish financial and accounting reports once every six months in a fiscal year.

Annual Reports. The annual company and the externally audited financial report contained therein is required by law to be made available for inspection by shareholders at the company's registered address at least 20 days before a Shareholders' Annual Meeting. The financial report is required to include balance sheets, profit and loss statements, statement of financial changes, explanatory statements of the company's financial position and (proposed) profit distribution. A listed company is additionally required to disclose the company's financial practices and management and publicize a half-yearly financial report (usually contained in the interim report).

Disclosed information are to be contained in a listing reports, offering prospectuses, half-year (interim) and annual company reports, and other reports or announcements as necessitated by events such as shareholders' meetings, additional issues and M&A or takeovers. Three standards govern the extent and detail of disclosures depending on the type of reports: Standard No. 1 for prospectuses; Standard No. 2 for annual reports; and Standard No. 3 for interim reports. A summary of the required information to be contained in the three standards are given in Table 6.

Liabilities for Fraudulent Disclosures. The Company Law contains a number of provisions against improper or fraudulent disclosures. The Law (Article 212) stipulates that if a company provides to its shareholders and or the general public financial any accounting information

which is false or conceal major facts, then the personnel(s) directly responsible and or in directly in charge shall be fined between 10,000 RMB and 100,000 RMB. If the act constitutes a criminal offence, then criminal liability shall be pursued according to the law.

False reporting of registered capital, presenting of false or misleading information and documentation, or employing any other deceptions to conceal important facts in order to register or incorporate a company is prohibited by Company Law. A company falsely reporting its registered capital shall be fined a minimum of 5 percent and a maximum of 10 percent of the amount of registered capital falsely reported.

If an organization undertaking asset valuation, investment verification or other verification provides false or misleading information or supporting documentation, then its fee is illegal and shall be confiscated and a fine amounting to not less than the amount of its fee shall be imposed (Company Law Article 219). The relevant authorities in charge may also lawfully order the organisation to cease operations and may revoke the credentials and certification of the personnel(s) directly involved. Where such acts constitute a criminal offence, criminal proceedings will be pursued.

The "**Provisional Measures on the Prohibition of Fraudulent Conduct in Securities**" provides greater details about information disclosure requirements. This and other related supplementary regulations stipulate that if any statement made in connection with the issuance and trading of securities is false or misleading, or if it contains material omission, it shall be deemed a false statement and a punishable offence. The CSRC is the agency empowered to investigate and punish such acts. Penalties for contravening any of the provisions contained in these regulations include warnings, confiscation of illegal profits, fines and suspension or revocation of the relevant approval, qualification and licenses for engaging in securities business. Serious cases of violations would constitute a criminal offence.

According to Articles 160, 161 and 229 of the **Criminal Law** which came into effect in October 1997, any person making fraudulent statement(s) in a financial report or prospectus may be imprisoned for a minimum of five years.

### **Appendix 3: Summary of Financial Disclosure Requirements for Listed Companies**

#### Standard no. 1: Prospectuses

The content of the prospectus is required to include:

- a summary of all important information
- definitions of terms used
- an acknowledgement of responsibility for information in the prospectus and preliminary
- information on the offer and its jurisdictions
- a list of the parties involved in the issue
- a description of risk factors involved
- the use to which funds raised will be put
- an explanation of the company's dividend policy and the method of determining distributable profits
- a valuation of assets (by a PRC registered valuer)
- information on the issuing company
- the Articles of Association of the issuing company
- the directors and senior management of the company
- a summary of operating results for the past three years
- details of the share capital of the company
- a statement of the company's indebtedness
- a description of the company's major fixed assets
- details of the asset revaluation carried out on conversion of the company from a State-owned enterprise to a joint stock limited company
- financial information
- a profit forecast
- details of the company's commitments and contingent liabilities
- the future plans of the company

#### Standard no. 2: Annual reports

Annual reports should be available within 120 days of the year-end and include:

- a description of the company
  - a summary of its financial information
  - the Managing director's report
  - the company's financial statements
  - description of major events or transactions in the year under review details of related enterprises
- any other information of importance to the investor

#### Standard no. 3: Interim information

Interim information is required to be published within 60 days of the end of an interim period. It should include the following information:

- profit for the period before taxation
- taxation
- dividend per share
- earnings per share
- details of major shareholders
- a summary of the results and operations for the period
- any other information relevant to shareholders
- particulars of any share issue or repurchase
- a statement as to whether the financial information is audited or unaudited

## **REFERENCES**

[To be added]