Corporate Governance: The International Journal of Business in Society

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Omid Sabbaghi is based at the College of Business Administration, University of Detroit Mercy, Detroit, Michigan, USA.

Abstract

Purpose – *This study aims to provide a review of corporate governance in China because effective and strong corporate governance is necessary for the efficient functioning and long-term sustainability of financial markets and corporations.*

Design/methodology/approach – *The author provides a literature review of corporate governance in China through themes such as the concentration of state ownership, the degree of independence among board directors, insider trading, quality of financial disclosures and the maturity of capital markets.*

Findings – *The author reviews empirical work surrounding key corporate governance variables and identifies avenues for future research. The author finds that corporate governance mechanisms exhibit implications for firm performance, fraud, capital retention, financial constraints, institutional investors, auditing and the quality of financial disclosures. In addition, the author reviews evidence documenting the importance of independent board directors in regulation and ethical conduct.*

Originality/value – *The literature review contributes to the growing literature on responsible corporate governance and provides further understanding of the importance of business ethics for promoting the integrity and long-term sustainability of China's capital markets and corporations and to ensure that company assets are used efficiently and productively in the best interests of investors and other stakeholders. This study offers insights to policy-makers interested in enhancing the quality of corporate governance within their nation. In addition, it provides a macro-level perspective for executives of multinational firms to consider if they are considering making a direct investment in China.*

Keywords *Corporate governance, Ownership*

Paper type *Literature review*

1. Introduction

Traditional research in corporate governance focuses on the system of principles, policies, procedures and clearly defined responsibilities and accountabilities used by stakeholders to eliminate or minimize conflicts. Corporate governance objectives include eliminating or mitigating conflicts of interest among stakeholders and ensuring that the assets of the company are used efficiently and productively in the best interests of investors and other stakeholders. An understanding of corporate governance practices in developing markets is important for a variety of reasons. For example, investors in emerging countries prefer companies with good corporate governance (Gill, 2001). Additionally, Stulz (2005) argues that understanding emerging market attributes are important for financial decision-making because there is the twin agency problem of state rulers and corporate insiders. A better understanding of corporate governance also helps to deter fraud in emerging markets (Li *et al.*, 2006). Recently, Shi *et al.* (2015) examine China-based stocks and present empirical evidence implying that good corporate governance of firms leads to their attractiveness as investment vehicles for both the short and long terms. In general, the quality of corporate governance exhibits direct implications for the risks, value and sustainability of a corporation: an ineffective system of corporate governance often results in major accounting, asset, liability and strategic policy risks to the company and its investors.

Received 10 December 2015
Revised 16 May 2016
Accepted 1 June 2016

Clarke (2004) argues that continuous improvements in corporate governance are necessary to achieve improvements in corporate performance and accountability. Thus for these reasons, among others, it is important to study the quality of corporate governance practices.

Corporate social responsibility and business ethics help to shape and define effective and strong corporate governance. In a recent study, Heath (2011) examines the traditional notion of shareholder dominance and argues that the same reasons which justify the priority of shareholder interests provide the ethical grounds for respecting other stakeholders' interest. In a related article, Cowton (2011) argues that the interests of creditors tend to be often neglected and that firms should adopt a wider stakeholder model in regards to their corporate governance. Weitzner and Peridis (2011) suggest that corporate governance be a part of a firm's strategy-making process and that incorporating ethical considerations early in the strategy process improves the ethical practices of management. In a related study, Clarke (2005) argues that a holistic approach to understanding corporate governance requires investigating the relationships between corporations and the economies and societies in which they exist. Collectively, these studies suggest that failures in corporate governance practices exhibit adverse implications for business and society.

The study reviews prior research and investigates salient themes in corporate governance for China. Specifically, the review provides several contributions to the existing literature. In Section 2, a literature survey on the key themes underlying China's corporate governance structures through different perspectives is provided. As Kang *et al.* (2008) point out, these macro-level themes include:

- concentration of state ownership;
- the degree of independence among board directors;
- insider trading;
- quality of financial disclosures; and
- maturity of capital markets.

These themes are currently important in the context of China's markets and its investors for a variety of reasons. For example, it is important to examine the concentration of state ownership because there is a greater emphasis on control and cash flow rights in state enterprises. High concentrations of state ownership also often lead to inefficient capital allocations and principal–principal (PP) conflicts. In addition, the concentration of state ownership yields implications for financial performance, asset utilization, the role of institutional investors, quality of financial reporting and audit, as well as the incidence of enforcements against fraud. Examining board independence is essential in explaining fraud, research and development (R&D) activities and compensation levels for management, and yields implications for pricing. Investigating the role of insider trading is vital because insider trading adversely affects investors and discourages investments in the stock market, thereby posing risks for the long-term health of China's financial markets. In addition, insider trading provides further light on securities regulation in China and whether there is inefficient enforcement of securities law. A review of the quality of financial disclosures in China is crucial because high quality financial reporting helps capital allocation efficiency. In addition to being a significant input for investors, regulators and other stakeholders, the quality of financial disclosures also motivates a review of governance mechanisms because internal corporate governance can lead to the selection of a low-quality auditor for a given firm. Finally, it is important to study the maturity of capital markets in China because immature markets restrict capital supply and exhibit the potential for preferential treatment in the banking sector. In addition, a review of China's capital markets helps to focus attention on the legal system for protecting investors in less mature markets, such as bondholders. In addition to examining the aforementioned themes, empirical evidence for related corporate governance variables is also reviewed. Section 3 provides directions for future research, whereas Section 4 offers concluding remarks.

2. Corporate governance in China

In recent years, there has been increasing attention on China's economic growth. Given China's increasing importance in the current world economy and the globalization trend, a better understanding of China's economy and related corporate governance issues provides important implications to China's regulators and benefits both domestic and international investors. Specifically, a better understanding of Chinese corporate governance practices is important in light of the country's economic and legislative reforms. In a historical analysis, Kang *et al.* (2008) outline four stages surrounding China's corporate governance development. These stages include:

1. the domination of state-owned enterprises (SOEs) from 1949 to 1983;
2. the beginning of the separation of government and enterprise from 1984 to 1993, marking the establishment of the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange;
3. the beginnings of the modern enterprise structure from 1994 to 2005 and the passage of the Company Law, delineating the rights and responsibilities for companies; and
4. the period corresponding to 2006 onward in which there have been legislation toward improving the growth of corporate governance.

These different developmental stages stem from China's movement toward free-enterprise, including its development of stock markets and the privatization of SOEs. In light of these developmental stages, the aforementioned corporate governance themes are investigated in what follows.

2.1 Concentration of state ownership

China's capital market is unique in that it is characterized by a distinct ownership structure. High levels of state ownership, comprising of the central government, its ministries and the local, regional and city governments, are characteristic of many individual firms in China. Importantly, the high degree of state ownership lends itself to a number of significant implications, such as a greater emphasis on control and cash flow rights. For example, Li (2010) argues that high levels of state ownership lead to inefficiencies in capital allocation because there is a strong relationship between financial power and local authorities. In addition to inefficient capital retention, industries that exhibit significant importance to the Chinese national interest lead the state ownership to maintain close control over firms residing in such industries. Empirically, Jiang and Kim (2015) review data from the Statistical Yearbook of China and present descriptive statistics in regard to ownership concentration and investor composition of tradable shares in China. In their study, the authors find that from 2009 through 2012, the percentage of tradable shares held by ordinary institutional investors, inclusive of the state, increases from 51.53 to 57.28 per cent. This finding suggests that state ownership levels are high in China. When focusing exclusively on SOEs, Jiang and Kim (2015) find that the average percentage of shares held by the top manager is 0.0039, further suggesting that the state is the largest shareholder. In contrast, Jiang and Kim (2015) find that the average percentage of shares held by the firm's top manager is close to 16.58 per cent for non-SOEs. As the authors in the latter study point out, ownership concentration and managerial ownership are important variables because these variables reflect the potential for large shareholder monitoring and the alignment of interests between shareholders and managers. Specifically, high ownership concentration allows for more control and oversight, whereas managerial ownership helps to mitigate agency conflict issues.

The degree of concentrated ownership in China also leads to an additional corporate governance problem, namely, that of the PP conflict that is characteristic of many emerging economies. A wide body of literature investigates PP conflicts in emerging economies because corporations in such countries are controlled by a family or the state with concentrated ownership (Young *et al.*, 2002; Chang, 2003; Thomsen *et al.*, 2006). Li and Qian (2013) define the PP conflict as that of goal incongruence between controlling and minority shareholders and argue that concentrated ownership leads to such conflicts of interest as majority shareholders pursue appropriation of value from minority shareholders through influencing management. The latter study investigates the PP perspective using data on corporate takeovers for China's publicly listed firms from 1998 to 2008 and find that minority shareholders' interests are better protected in regions with more institutional development, as well as for those target firms in which the chief executive officers (CEOs) are politically connected. Similarly, Young *et al.* (2008) identify PP conflicts to be a major concern of corporate governance in emerging economies such as China and attribute such conflicts to concentrated ownership and control. Su *et al.* (2008) establish that ownership concentration in Chinese firms is related to the level of state control and find that PP conflicts lead to high agency costs for firms in China. Thus, concentrated state ownership also yields implications for different groups of shareholders.

Prior research also suggests that the degree of state ownership exhibits implications for the financial performance of Chinese-listed firms and the incidence of enforcements against fraud. For example, Li *et al.* (2009) report a robust and significant negative relation between government shareholding and corporate performance among the more profitable firms. Similarly, Chen *et al.* (2006a) investigate SOEs and find that there is a decline in profitability and asset utilization when the Chinese government retains ownership control of listed firms. Jiang and Kim (2015) examine firm performance based on largest shareholder ownership for SOEs and non-SOEs using data from 1999 through 2012. In particular, their study finds that non-SOEs generally exhibit higher median return on equity relative to SOEs. In other words, non-SOEs generally tend to perform better than SOEs, and the results are robust in terms of whether the largest shareholder owns less than 30 per cent, owns between 30 per cent and 50 per cent or owns at least 50 per cent of the firm. In regard to fraud, Lam *et al.* (2008) find that employees in SOEs and employers in Mainland China exhibit a higher acceptability of unethical behavior compared to workers in collectives. Hou and Moore (2010) examine the impact of state ownership in the Chinese stock market on fraud and find that retained state ownership in privatized firms increases the incidence of regulatory enforcements against fraud. Furthermore, the latter study argues that corporate governance and the financial regulatory system are the internal and external monitoring mechanisms, respectively, in deterring corporate fraud and protecting investors. Thus, continual improvements in the regulatory environment and ensuring investor protection are vital to the integrity of Chinese financial markets.

Several studies indicate that state ownership may be quite beneficial, especially in times of financial crisis. For example, Liu *et al.* (2012) find that Chinese SOEs that perform poorly prior to the financial crisis of 2008 do perform better during the crisis. In light of their reliance on bank debt, the latter study suggests that state ownership helps to mitigate financial constraints during crisis periods. This stems from the behavior of Chinese state-owned banks that provide bailout loans to distressed SOE firms. Similarly, Deng and Wang (2006) provide evidence suggesting that the Chinese government often rescues financially distressed firms, leading outside investors to believe that SOEs do not suffer in times of liquidity shortages. Hence, state ownership also exhibits certain benefits for firms in China.

In contrast to the observed levels of state ownership in China, the United States (US) market comprises a high proportion of institutional investors that are not affiliated with the government and are not prone to political pressure. The lack of state control for US firms exhibits direct implications for the quality of US corporate governance. In particular, traditional research in corporate governance suggests that institutional investors are an important means of external monitoring and raises the standard of corporate governance. For example, Chung and Zhang (2011) examine US data and present empirical evidence, indicating that the fraction of a company's shares held by institutional investors increases with the quality of its governance structure. Similarly, Aggarwal *et al.* (2011) finds that increases in institutional ownership lead to improvements in corporate governance. Gillan and Starks (2003) also argue that growth in institutional ownership should result in improved corporate governance. In a related study, Pitelis and Clarke (2004) argue that institutional investors exhibit a key role in pressuring corporations to maintain higher standards of accountability and disclosure. For the case of China, however, the evidence suggests that the type of institutional investor matters. For example, Huang and Zhu (2015) show that domestic institutional investors are susceptible to political pressure and yield to the state. Similarly, Firth *et al.* (2010) find that local mutual funds yield to political pressure and assist state-owned firms during China's split-share structure reform. In a related study, Piotroski and Wong (2012) caution against the idea that institutional investors are important monitoring agents for the case of China because there is weak protection of property rights, limited ability to privately enforce contracts and the reliance on social and political networks by dominant, state-owned firms. However, Huang and Zhu (2015) find that Qualified Foreign Institutional Investors (QFIIs) exhibit greater influence over controlling state shareholders and are more likely to monitor state-controlled companies because QFIIs are more immune to political pressure. Thus, an important element differentiating the Chinese system of corporate governance is the degree of institutional ownership and its composition. In the US, institutional investors are influential in bringing about change within a firm in the US, whereas domestic institutional investors play a minor role in monitoring management in China. Arguably, increasing foreign institutional ownership is important for enhancing corporate governance and the efficiency of capital allocation for emerging markets, such as China.

Research in Chinese corporate governance also indicates that the concentration of state ownership promotes poor auditing. For example, Piotroski and Wong (2012) argue that ownership concentration decreases demand for external auditing. Lin and Liu (2009) use ownership concentration, the size of the supervisory board and the duality of board chairman and CEO to proxy for internal corporate governance mechanisms and finds that Chinese firms with larger controlling shareholders, smaller size supervisory boards or a dual chairman–CEO are less likely to hire a high-quality auditor, thereby resulting in less-transparent disclosures. Wang *et al.* (2008) find that Chinese SOEs controlled by province, city and county governments at the local level are more likely to hire small auditors within the same region relative to firms that lack state ownership. Firth *et al.* (2011) provide evidence indicating that firms are more likely to manipulate their financial statements if they are controlled by the central government. In a related study, Habib and Jiang (2015) argue that the demand for financial information is reduced in state-controlled firms because of the perceived implicit insurance by the state against stakeholder losses.

There is mixed evidence surrounding the quality of financial reporting for SOEs. Wang and Wu (2011) find that poor-quality financial reporting is prevalent among firms with weak profitability and a shareholder base that is state-controlled. The latter study suggests that state ownership exhibits negative implications for the quality of financial disclosures. Additionally, Chen and Rezaee (2013) find evidence of more concentrated ownership being associated with tunneling fraud. However, several studies find that state ownership can lead to a higher quality of financial disclosures. For example, Liu and Sun (2010) find that corporate disclosure quality is higher for firms controlled by the state. Similarly, Gao and Kling (2012) examine data from 2001 through 2007 and find that ownership concentration exerts a positive impact on disclosures, whereas Wang and Wu (2011) find that accounting restatements are positively correlated with SOEs. In addition, Wang and

Campbell (2012) and Wang and Yung (2011) argue that state ownership discourages earnings management because the government serves as a significant external monitor.

Higher levels of insider stock ownership provide an alternative to high levels of state ownership in China. For example, Wei *et al.* (2005) argue for increases in managerial ownership when examining the Chinese stock market because a higher level of insider stock ownership may potentially improve performance. Li *et al.* (2007b) and Hu and Zhou (2008) provide evidence indicating that firms in China perform better when there are a larger proportion of managers taking equity stakes, whereas Liu and Sun (2005) argue that the Chinese government adopts strategies that involve retreating from state control of small- and medium-sized enterprises that operate in highly competitive markets. Jiang and Kim (2015) provide evidence suggesting that non-SOEs perform better than SOEs for high levels of concentrated shareholder ownership. Thus, increases in managerial ownership provide an alternative to state ownership.

2.2 Independence among board directors

Effective and strong corporate governance commands an independent board of directors. Numerous studies investigate this theme for the case of China. For example, Chen *et al.* (2006b) examine enforcement actions from the Chinese Securities Regulatory Commission (CSRC) and find that ownership and board characteristics are important in explaining fraud. Specifically, their study finds that the proportion of outside directors, the number of board meetings and the tenure of the chairman are associated with the incidence of fraud. In a related study, Lo *et al.* (2010) find that firms with boards exhibiting a higher percentage of independent directors are less likely to engage in transfer pricing manipulations: the quality of corporate governance helps to deter manipulated transfer prices in sales transactions. Ding *et al.* (2010) examine the interaction between enforcement actions and responses from the board of directors and the supervisory board in their analysis of China's corporate governance reform. Specifically, their study investigates whether the different reactions of the boards play a role in preventing future occurrences of fraud. Using enforcement actions as proxies for fraudulent activities, Ding *et al.* (2010) find that while both boards react to enforcement actions, only the responses from the board of directors helps to mitigate future enforcements, thereby highlighting the importance of rule setting for ethical conduct at the board level.

Using data from the China Stock Market and Accounting Research database, Jiang and Kim (2015) investigate the composition of the boards of directors for nonfinancial firms listed on the main boards of the Shenzhen and SSEs from 1999 through 2012. Specifically, their study finds that the average percentage of directors that are independent increases monotonically from 1999 through 2012, suggesting that corporate governance in China is improving in this dimension. In terms of time trends, the latter study finds that the percentage of independent directors increases from 76 basis points in 1999 to nearly 37 per cent in 2012. In particular, Jiang and Kim (2015) find that the largest percentage increases occur in 2002 and 2003 as the percentage of independent directors increases from 6.22 per cent in 2001 to 24.09 per cent in 2002 to 32.75 per cent in 2003. These percentage increases coincide with China's requirement that a firm have at least one-third of its board to be independent (Jiang and Kim, 2015). In a recent study, Liu *et al.* (2015) find that the effect of board independence is becoming stronger when using data from 1999 through 2012. In terms of whether the CEO is also Chair of the board of directors, Jiang and Kim (2015) find lower percentages of the CEO-Chair duality for SOEs relative to non-SOEs over the 1999 through 2012 period. This finding suggests that there is less likelihood of the board of directors working closely with the CEO to create value for the case of SOEs. This is expected because the CEO of a SOE is often appointed by the government. For the case of non-SOEs, Jiang and Kim (2015) document a U-shaped pattern for the CEO-Chair duality: the percentage of firms exhibiting the CEO-Chair duality decreases from 28.37 per cent in 1999 to 14.11 per cent in 2002, prior to increasing to 27.08 per cent in 2012. The increase in the CEO-Chair duality for the case of non-SOEs may make it more difficult for shareholders to monitor and discipline corporate management.

While independence among board directors is an important element in attenuating the degree of fraud among Chinese firms, it has also been shown to exhibit considerable importance with respect to research and development activities. For example, Dong and Gou (2010) find that the number of independent outside directors in the board has a positive influence on a firm's R&D investment. R&D activities are important sources of growth and often serve as a competitive edge for firms. In a related study, Guo (2008) argues that the future of China's economic performance will depend on the ability to acquire, adapt and create new technologies, thus requiring investments in R&D. In addition to the lack of independence among board directors, Delcoure (2007) presents evidence suggesting that firms in China rely heavily on short-term financing. Such a reliance on short-term financing pressures managers to make short-term returns and thus promotes a decrease in R&D activities and investments.

A weak board of directors exhibits a variety of additional effects. For example, a weak board of directors often leads management to pursue higher compensation levels (Armstrong *et al.*, 2012). In contrast, Li *et al.* (2007a) find little evidence that Chinese CEOs take advantage of weaker board structures to extract higher compensation packages. For the 2005-2012 time period, Jiang and Kim (2015) report that the top manager of SOEs receives higher average compensation levels relative to non-SOEs, whereas the top director of SOEs generally receives lower average compensation levels relative to non-SOEs. In regards to securities trading, Tong and Yu (2012) find evidence that B-shares listed in China are traded at substantial discounts to their corresponding A-shares because of weaker governance, proxied by a higher proportion of directors appointed by the parent company. Li *et al.* (2010) investigate the role of the board of directors in the context of Chinese management buyouts of listed corporations. Their study finds little evidence that outside board members have the skills to add value and that the boards mainly focus on related-party transactions with limited attention to growth strategies. Thus, there are diverse effects that resonate from an ineffective board of directors.

2.3 Insider trading

Insider trading adversely affects financial market participants. In a seminal study, Leland (1992) argues that insider trading regulation is important because insider trading discourages investors and market professionals from investing in the stock market. Maug (2002) finds that insider trading creates adverse selection problems for their corporations, whereas Bainbridge (2000) argues that insider trading violates the corporation's property rights. In agreement with these studies, it is believed that insider trading stems from a variety of factors, including elements such as the absence of a well-defined concept for the fiduciary duty and inefficient enforcement of securities law. These factors are especially important in China because a lack of incentive mechanisms discourages reporting or whistle blowing about insider trading. Historically, China exhibits a poor track record in enforcing insider trading regulations. Over the 1990-2008 period, Duan (2009) finds evidence of 21 insider trading cases. Among the 21 cases, only five cases proved to be criminal. In contrast, over the 2001 to 2006 time period, Shen (2008) presents evidence of 300 enforcement actions against insider trading in the US market. In a related study, Du and Wei (2004) find that China ranks seventh highest in the world when examining the extent of insider trading. Tong *et al.* (2013) find evidence of insider trading in China when examining listed firms and their public announcements in regards to the initiation of share-structure reform. Hence, insider trading poses risks for the long-term viability of China's financial markets.

Regulation is vital in mitigating insider trading. Huang (2005) provides an analysis of the CSRC and the Chinese Securities Law in forming the legal foundation for insider trading regulation in China. However, several problems exist for insider trading regulation within China. For example, significant loopholes exist in regards to the scope of insiders, thus undermining the effectiveness of regulations. Additionally, as Shen (2008) points out, the CSRC possesses two objectives that conflict with one another: enforcing regulations to protect investors and the duty to protect state assets. Given the conflict-of-interest that exists between these two objectives, the CSRC may hesitate to pursue enforcement actions that would conflict with the best interests of the state assets. In addition, Duan (2009) argues that China exhibits insufficient mechanisms for enforcing insider trading regulation. Specifically, while China's legal system may contain provisions related to insider trading, no details exist in regards to how the liabilities should be quantified. Shen (2008) further elaborates on the limited power and the resources of the CSRC, presenting evidence of understaffing and inadequate funding. Recent evidence suggests that China is expanding their efforts on regulating insider trading. For example, Zhu (2015) reports that Chinese authorities are investigating CSRC officials in an alleged insider-trading probe involving the country's largest stockbroker. Similarly, Hong and Gu (2015) reports that China is cracking down on a well-known fund manager for alleged insider trading and stock price manipulation. Recently, Forsythe *et al.* (2016) report that China's top securities regulator at the CSRC has been replaced in light of the increasing attention on modernizing China's securities markets, protecting investors and ensuring market stability. Such efforts are necessary to reassure investors that the stock market in China is well regulated and protects investors' rights. Hence, regulating insider trading is improving in China.

2.4 Quality of financial disclosures

The quality of a firm's published financial statements is important to investors, regulators and other stakeholders. Signs of falsified financial statements arise from companies that manipulate their earnings in annual reports and subsequently issue financial restatements, thus indicating low quality financial information disclosures. Firth *et al.* (2006) argue that Chinese managers are tempted to fraudulently boost reported net income because CEO and top management compensation levels depend on reported earnings. With respect to geographical location, Cheung *et al.* (2008) find that overseas-listed Chinese companies tend to show more regard for the role of stakeholders and disclosure relative to Chinese companies that are not listed overseas. When examining the 1999-2005 time period, Wang and Wu (2011) find that up to a quarter of listed firms in Mainland China admit the poor quality of their financial information by issuing restatements. Firth *et al.* (2007) use audit opinions as a measure of the informativeness of earnings and find that the type of dominant shareholder, supervisory board size and the percentage of independent directors exert an impact on the frequency of modified audit opinions (MOAs) in China. In addition, Chen *et al.* (2005) find that weak corporate governance is a factor contributing to the high number of MOAs. Tu (2012) argues that audit quality is not a variable in the cost-benefit analysis of listed companies in China, and, furthermore, the controller chooses the auditor on an *ad hoc* basis. Hence, these studies suggest that the hiring of low-quality auditors stems from the lack of demand for the information and insurance roles of auditors in China. Hence, firms with weaker internal corporate governance are more likely to select a low-quality auditor.

Regulatory legislation in the USA, such as the Sarbanes-Oxley Act of 2002, helps to ensure a high quality of audit services. DeFond and Lennox (2011) find that over 600 auditors, with fewer than 100 Securities and Exchange Commission clients, exit the market following passage of the Sarbanes-Oxley Act. Additionally, the latter study finds that the exiting auditors are of lower quality, where quality is assessed using several metrics, including:

- avoidance of peer reviews and failure to comply with rules; and
- severity of the peer review and inspection reports.

Recently, Habib and Jiang (2015) point out that a high-quality financial reporting regime is an important ingredient of an effective corporate governance system as it helps capital allocation efficiency. Thus, improvements in the quality of financial disclosures are critical for China.

Governance mechanisms play an important role in discouraging financial manipulation. For example, a large number of directors on the board may lead to less effectiveness in constraining unethical behavior of management (Jensen, 1993). Firth *et al.* (2011) find that firms whose board consist of directors with a financial background are less likely to have restatements. Additionally, the latter study finds that the detection and reporting of false accounting is more likely when firms are located in more developed regions because of the presence of better regulatory enforcement mechanisms. In a recent study, Chi *et al.* (2013) examine data from 2001 to 2009 and find that audit quality improves following the implementation of new rules by the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) in China. Hence, governance mechanisms can play an important role in elevating the quality of financial disclosures and recent evidence indicates that China's accounting environment is improving in this dimension.

2.5 The relative maturity of capital markets

Immature capital markets are a contributing factor to China's corporate governance practices. For example, studies have investigated the extent to which Chinese banks prefer to deal with SOEs. Such preferential treatment occurs because bank managers exhibit strong incentives for maintaining good relationships with the government. Moreover, Cull and Xu (2003) find that the Chinese government can require banks to issue "policy lending" to SOEs because the major banks are controlled by the government. Wang *et al.* (2008) argue that loans issued to SOEs are safer because the government bails out the SOEs in the event of financial distress. Furthermore, Li and Zhou (2005) claim that successful SOEs create additional resources for the government. Lu *et al.* (2012) argue that firms that are not state-owned are more likely to suffer bank discrimination. Hence, evidence suggests that preferential treatment occurs in China's banking sector.

In addition to China's banking sector, China's corporate bond market is also relatively immature. For example, Hale (2007) finds that the corporate bond market provides only 1.4 per cent of the total financial needs of corporations in China. This statistic is low relative to other countries. However, recent data from the SSE, available via the URL http://english.sse.com.cn/investors/introduction/chinacapital/, indicates that the bond market in China is growing. Based on the latter website's Chart 11, it is found that both the number of bonds and the nominal value of outstanding bonds for China's capital markets has increased significantly since 2007. By the end of 2012, the total nominal value of outstanding bonds reached 23.7 trillion Chinese yuan (CNY), and the number of bonds amounted to 3,570 (Shanghai Stock Exchange, 2015). A vibrant corporate bond market is important for China because it helps to meet the needs of more risk-averse investors and increases the capital supply for Chinese companies (Kang *et al.*, 2008). The growth of financial institutions such as insurance companies, pension funds and investment funds in China helps to fuel the demand side for corporate bonds. The supply side of the corporate bond market, however, dictates that Chinese banking system function more competitively. In agreement, Huang and Wang (2014) present evidence indicating that Chinese firms are conservative in using debt financing. Pillai *et al.* (2015) report that China's bond market is growing from a very small base and that the debt-to-gross domestic product ratio remains low relative to other countries. While China's bond market continues to experience rapid growth, Allen *et al.* (2005) find evidence of weak creditor rights in China and that the legal system is weak when it comes to protecting investors, particularly bondholders.

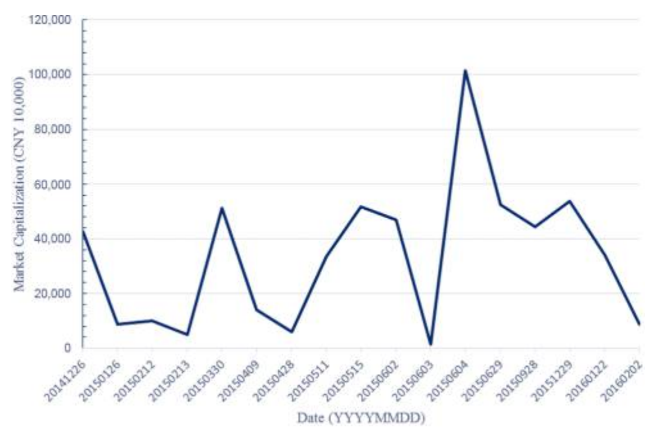
Another sign indicating the relative infancy of China's capital markets is the emergence of preferred shares in 2014. Issuing preferred shares is a new development in China's equity markets and has recently become available for the top 50 Shanghai-listed companies, as well for companies that are part of mergers and acquisitions between listed firms in China (Zhu *et al.*, 2014). In Figure 1, a time series plot of the market capitalization for realized preferred stock offerings on select dates is presented, which is based on transaction statistics data from the SSE. Specifically, of the 17 days for which data are available on realized preferred stock offerings, it is found that on eight days, the market value for the preferred stock offerings exceeds 400,000,000 CNY for each of the eight days. Furthermore, it is found that the most active month for preferred stock offerings in the SSE is June 2015, with the combined value of preferred stock offerings amounting to 2,023,835,000 CNY.

In the corporate governance context, holders of preferred shares have limited rights on decision-making. That is, preferred shares are an important means of raising new capital and increasing investor confidence without weakening the votes of common shareholders. Thus, an increase in preferred share issuance is critical for increasing access to capital and enabling more financing for individual firms in China.

3. Avenues for future research

Future research can further investigate corporate social responsibility in China. Recent empirical studies evaluate the ethics positions of senior business leaders in China. For example, Ramasamy and Yeung (2013) survey 256 senior managers from Mainland China in evaluating their ethics position and find that a sizeable portion of them are absolutist. Their study implies that a moral set of rules will be followed because it will more likely result in the best consequence for all involved. Woodbine *et al.* (2012) studied 612 Certified Public Accountants employed in four separate regions of China and found that the ethical tone within local accounting firms plays a significant role in forming ethical positions. Clarke (2000) links weak corporate governance to the Asian financial crisis of 1997 and delineates

Figure 1 Market capitalization for preferred stock offering on select dates



Notes: Figure 1 presents a time series of the market capitalization for realized preferred stock offerings (in units of 10,000 CNY) on select dates based on preferred stock transaction statistics data from the Shanghai Stock Exchange. Market capitalization for a preferred stock offering is defined as the multiplicative product of Final Price and Volume for a transaction offering. Market capitalization for a select date (YYYYMMDD) is defined as the sum of the market capitalizations for preferred stock offering transactions occurring on the select date. Data is available at: http://www.sse.com.cn/market/stockdata/pshare/

key objectives for developing robust corporate governance in East Asia. Such objectives include:

- a strengthening of internal control structures;
- greater disclosure of information and a strengthening of external monitoring through law and regulation; and
- developing training modules to improve understanding of corporate governance procedures.

Buyaert (2012) also argues that the education of "value-based leadership" and strengthened regulatory compliance and enforcement will accelerate the successful development of corporate social responsibility in China.

Future work could further investigate PP conflicts for the case of China and explore governance mechanisms that would mitigate the expropriation of minority shareholders. For example, Jiang and Peng (2011) examine ownership and control data for firms in Hong Kong, Indonesia, Malaysia, Singapore, South Korea, Taiwan and Thailand and present evidence indicating that legal institutions and the presence of multiple blockholders are important governance mechanisms in constraining possible expropriation of minority shareholders. Li *et al.* (2013) hypothesize that building up China's legal system is important in developing a more efficient institutional system that would limit the power of controlling shareholders, thereby reducing the possibility of expropriating minority shareholders. In a recent study, Schonfelder *et al.* (2016) find positive features in China's regulatory frameworks and argue that transparent disclosure would further raise the reputations of Chinese multinational corporations internationally.

Additionally, future work could investigate whether business ethics and corporate governance mechanisms improve capital acquisition and reduce the cost of capital for entrepreneurs in China. For example, a recent panel noted the lack of a regulatory structure in Canada for facilitating financial market integrity, thereby increasing the cost of capital for Canadian firms (Cressy *et al.*, 2010). For the case of China, Ben-Nasr *et al.* (2012) find evidence of an increased cost of equity capital with an increase in state control of the firm. Thus, future work could further investigate the impact of corporate governance on the cost of equity capital for entrepreneurs in China. These topics are left for future research.

4. Concluding remarks

This study examines China's corporate governance structures through the thematic lens of Kang *et al.* (2008):

- concentration of state ownership;
- independence among board directors;
- insider trading;
- quality of financial disclosures; and
- maturity of capital markets.

The literature review reveals evidence of state ownership being associated with cash flow rights, inefficiencies in capital allocation, declines in asset utilization and increased regulatory enforcement against fraud. In addition, the review finds that non-SOEs outperform SOEs. However, there are also studies indicating that state ownership can be beneficial in crisis periods because evidence indicates that the state often rescues financially distressed firms, and several studies find that SOEs outperform non-SOEs during such crisis periods. In this review, it is also found that concentrated state ownership presents political pressure for local mutual funds and domestic institutional investors. Thus, QFIIs are more immune to political pressure and are more likely to monitor state-controlled firms. In addition, the review finds that employees of SOEs are more likely to accept unethical behavior and are more likely to manipulate their financial statements, partly because of the decrease in demand for financial information and external auditing. However, there are also studies indicating that state ownership exerts a positive impact on corporate disclosure quality. In the review, it is also found that concentrated state ownership leads to PP conflicts and that such conflicts lead to high agency costs for firms in China.

With respect to the independence of the board, the literature review finds that the average percentage of independent directors has been increasing over time. This is important because studies indicate that independent directors are less likely to engage in pricing manipulations, exhibit a positive role in a firm's R&D activities, deter fraud and decrease the likelihood of management extracting higher compensation levels, thereby helping to promote stronger corporate governance.

The literature review reveals evidence of insider trading in China and the lack of sufficient mechanisms for enforcing insider trading regulations. In addition, the review indicates that the CSRC possesses objectives that conflict with another. In light of these findings, it is found that there are recent moves by China's government to crack down on alleged insider trading and stock price manipulation, such as investigating the country's largest stockbroker, investigating well-known fund managers and even replacing the top securities regulator at the CSRC. Increasing the effectiveness of insider trading regulations will help to elevate investor confidence and promote investments in China.

With respect to the quality of financial disclosures, this review finds that managers in China are tempted to report higher net income figures because management compensation levels are dependent on the reported earnings. Additionally, studies indicate poor quality for the financial information of listed firms in China, as proxied by the frequency of issuing restatements and MOAs. The hiring of low-quality auditors in China is likely because of the lack of demand for the information and insurance roles of auditors. Thus, firms with weaker internal corporate governance are more likely to select a low-quality auditor. Importantly, the review finds that audit quality in China is improving in light of the implementation of new rules by the SASAC.

When reviewing literature on capital market maturity in China, studies indicate that there is preferential treatment in China's banking sector. In addition, recent reports indicate that firms in China are conservative in using debt financing, suggesting the need for a vibrant bond market in catering to the needs of risk-averse investors. In examining data from the SSE, positive evidence for the preferred shares market is found, suggesting that firms in China are finding new means of raising capital and increasing investor confidence through preferred stock offerings because holders of preferred shares have limited rights on decision-making. In addition, studies argue that the legal system is important for protecting investors in such markets. The general findings of the literature review are summarized in Table I.

An understanding of corporate governance in China is important in understanding the role of business ethics and related factors for promoting the integrity and long-term sustainability of China's capital markets and corporations and to ensure that company assets are used efficiently and productively in the best interests of investors and other stakeholders. In this study, the existing literature on corporate governance in China is synthesized and avenues for future research are offered. In addition, this study offers insights to policy-makers interested in enhancing the quality of corporate governance within their nation. In addition, the review provides a macro-level perspective for executives of multinational firms to consider if they are considering making a direct investment in China.

Table I Summary of findings

Macro-level theme	*Representative literature*	*Main finding(s)*
Concentration of state ownership	Li (2010)	Inefficiencies in capital allocation
	Jiang and Kim (2015)	Non-SOEs tend to perform better than SOEs
	Lam *et al.* (2008)	SOE employees exhibit a higher acceptability of unethical behavior
	Liu *et al.* (2012)	Chinese SOEs perform better during financial crisis
	Huang and Zhu (2015)	Political pressure on domestic institutional investors; QFIIs more immune
	Habib and Jiang (2015)	Demand for financial information is reduced in state-controlled firms
	Gao and Kling (2012)	Ownership concentration exerts a positive impact on disclosures
	Li and Qian (2013)	Minority shareholders better protected with politically connected CEOs
	Young *et al.* (2008)	Attribute principal–principal (PP) conflicts in China to concentrated ownership and control
	Su *et al.* (2008)	PP conflicts lead to high agency costs for firms in China
Board independence	Lo *et al.* (2010)	Independent boards are less likely to engage in transfer pricing manipulations
	Jiang and Kim (2015)	Increases in average percentage of directors that are independent over time
	Liu *et al.* (2015)	Effect of board independence is becoming stronger over time
	Armstrong *et al.* (2012)	Weak board of directors leads management to pursue higher compensation levels
	Tong and Yu (2012)	B-shares traded at substantial discounts because of lack of board independence
Insider trading	Duan (2009)	Insufficient mechanisms for enforcing insider trading regulation
	Shen (2008)	CSRC possesses two objectives that conflict with one another
	Zhu (2015)	Investigation of CSRC officials and largest stockbroker in alleged insider-trading
	Hong and Gu (2015)	Best-known fund manager investigated for alleged insider trading
	Forsythe *et al.* (2016)	China's top securities regulator at the CSRC replaced
Quality of financial disclosures	Wang and Wu (2011)	Up to a quarter of listed firms in mainland China issue restatements
	Chi *et al.* (2013)	Audit quality improves following the implementation of new rules by the SASAC
Relative maturity of capital markets	Lu *et al.* (2012)	Firms that are not state-owned are more likely to suffer bank discrimination
	Huang and Wang (2014)	Firms are conservative in using debt financing
	Pillai *et al.* (2015)	China's debt-to-gross domestic product ratio remains low relative to other countries
	Zhu *et al.* (2014)	Issuing preferred shares is a new development in China's equity markets

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Corresponding author

Omid Sabbaghi can be contacted at: sabbagom@udmercy.edu