A SURVEY OF CORPORATE GOVERNANCE STUDIES IN CHINA

Larry Li*, Tony Naughton*

Abstract

This paper reviews the theoretical and empirical corporate governance literature in China, concentrating on relationships between ownership, board characteristics and firm performance. In addition, we explore the recent floatation of non-tradable shares and relationship contracting (Guanxi), which are two unique corporate governance issues in China. Overall, the understanding of the key driving forces of firm organizational structure, corporate governance practices, and performance remains largely inconclusive and we make recommendations for future research direction.

Keywords: Corporate Governance, China, Economic Reform

JEL Classification: G34; P21

*Corresponding author. School of Economics, Finance and Marketing, RMIT University, GPO Box 2476 Melbourne, Victoria 3000 Australia
Tel.: +61399255858
Fax: +6199255624
Email: Larry.Li@rmit.edu.au
**School of Economics, Finance and Marketing, RMIT University

I. Introduction

The economic reform initiated in 1978 has launched a dynamic economic growth in China in the past three decades. The remarkable economic growth has made China the second-largest economy in the world after the US in 2011 (World Bank, 2012). To improve the economic productivity and efficiency, China has dramatically changed many areas of its economy. Corporate governance, being a major aspect of corporate reform, was targeted as a very visible component of the program.

Recent global financial crisis and corporate scandals around the world has stimulated more interest in corporate governance. Work of Shleifer and Vishny's (1997) has been regarded as the first major attempt to consolidate the key theoretical influences and starts with the premise that corporate governance is the mechanism by which suppliers of finance can assure themselves of a return on their investment. In China, corporate governance is considered as the set of rules and practices regulating relationships among participants in a post-traditional[3] Chinese business enterprise which governs decision making within that enterprise. Although post-traditional enterprises are no longer as tightly controlled by the state as they once were, most studies pay more attention to the three primary types of firm in China: state-owned enterprises (SOEs); , publicly listed companies, and privately controlled firms. In this paper, we review the growing literature on corporate governance issues in China. We critique papers that mainly focus on Chinese markets, and other works that help to clarify the issue in a broader context. Our survey identifies a range of mixed results in many areas of empirical analysis. Moosa et al. (2011) suggest that empirical studies in China suffer from a lack of robustness in the methodological approach adopted. The authors suggest a tendency to select models that provide the "best" outcomes in terms of results. This leads to inconsistencies in findings.

This paper is motivated by the burgeoning literature on Chinese corporate governance and the necessity to summarise and compare the alternative findings across the range of governance issues. It is further motivated to provide directions for future research in the specific context of China as well as the potential to contribute more broadly to the corporate governance literature. Corporate governance studies on China show that the combination of ownership concentration dominated by the state, state controlled financial system, legal system and unique business culture fundamentally distinguishes the Chinese corporate governance system from those in the rest of world. The main findings of this paper can be summarised into a number of issues. Like other Asian countries, ownership concentration is a common way to

[3] A post-traditional enterprise is an enterprise that is no longer tightly controlled by the state through the traditional planning system.

minimise agency problems with state ownership remaining a strong feature in China. In addition, free market mergers and acquisitions are not common in China unless they are engineered by the state, especially before the floatation of non-tradable shares in 2005. These circumstances further subdue the function and participation of other investors, such as financial institutions and other domestic institutional investors. Other corporate governance mechanisms, such as board of directors and board of supervisors in general have limited effectiveness. The current Chinese legal system does not offer good protection to investors and effective enforcements of investor rights, which in turn is conducive to the cultivation of personal ties or related parties transactions (referred to as *guanxi*).

This paper is organised as follows: Section II surveys the findings of corporate governance research on China under a number of traditional headings. Section III reviews some specific features of Chinese corporate governance while Section IV presents the conclusions.

II. Chinese Corporate Governance Studies

Researchers have generally classified corporate governance into two major types of research categories: internal and external governance of businesses (Denis & McConnell, 2003; Gillan, 2006). Internal governance research focuses on the companies characteristics, such as features of boards of directors, ownership and control, and managerial incentive mechanisms. External governance, on the other hand, investigates issues related to the external market and government policies and regulations (Gillan, 2006). Denis and McConnell (2003) provide a comprehensive summary of these two types of corporate governance research, and posit that there are two major generations of research. The first generation focused on internal governance mechanisms, and aim to investigate whether information of the board of directors, executive compensation and ownership structure affect firm performance in individual countries. The second generation, began with the work of La Porta et al. (1998), pay more attention to the influence of external forces, such as market and legal and regulatory issues, on the structure and effectiveness of corporate governance around the world.

Corporate governance research in China mainly focuses on listed firms due to the data availability, and these studies can be summaries into two main streams. The first can be defined as qualitative studies which include surveys and interviews of the descriptive of practices and recommend policies, including Clarke (2003; 2006) and Allen et al (2005 ;2007). The second can be defined as quantitative research, which mainly explores the relationship between the quality of corporate governance and firm performance, with a particular focus on the growing number of listed firms (Xu & Wang, 1999; Dahya et al., 2003; Hovey et al., 2003; Firth et al., 2006; Fan et al., 2007; Gul et al., 2010).

A. Ownership Structure and Firm Performance

The relation between ownership structure and firm performance in China has been well documented (Xu and Wang, 1999; Hovey et al., 2003; Bai et al., 2004; Wei et al., 2005), because in theory ownership structure is a key determinant of corporate governance (Shleifer & Vishny, 1997; La Porta et al., 1998). Among these empirical different methodologies and data samples were used to answer different questions, either directly or indirectly examine whether and in what pattern ownership structure impacts on firm performance in China.

i: State Ownership

In terms of state ownership, most studies find that the state still controls a significant number of listed companies in China even after three decades of economic reform (Claessens & Fan, 2002; Li & Naughon, 2007; Gul et al., 2010). In addition, the majority of public companies in China fall within the category of having a controlling shareholder. International literature shows that governance problems vary significantly between companies with and without a controlling shareholder (La Porta et al., 1999; Claessens & Fan, 2002, Bebchuk and Weisbach, 2010). If a controlling shareholder is observed, the fundamental governance problem will be the interest conflicts between minority shareholders and minority shareholder instead of professional managers and public shareholders.

For the studies in China, most studies argue state ownership has negative impact on firm performance, implying the further reduction of state ownership (Xu & Wang, 1999; Bai et al., 2004). Other studies, however, Tian (2001) reports that the relation is not linear: there is a negative relationship when state ownership is small, with improving performance when state ownership is large. Wei et al. (2005) also find a non-linear relation between state ownership and firm performance, but one that is significantly convex. Their findings suggest that when governments privatise SOEs, conflicts of interest among different block shareholders can weaken a firm's value Recently, Chen et al. (2009) argue that the relationship between performance and state ownership varies because different types of state ownership have different management and monitoring effectiveness. They divide state

ownership into three sub-categories: firms controlled by the State Asset Management Bureau (SAMB), SOEs affiliated to central government, and SOEs affiliated to the local government. The empirical results show that firms perform best when directly controlled by central government and perform worse if controlled by the SAMB. One possible explanation is the virtual absence of incentives and management skills of the SAMB and their officials.

The empirical findings of other studies find that privatization is not the only way to improve the performance of SOEs in China. Groves et al. (1995) and Li (1997) argue that the introduction of the managerial incentive contract system has improved the productivity of SOEs in China. Aviation et al. (2005) conclude that corporatization alone can significantly improve SOE performance, therefore, privatization is not the only means of improving performance. Such mixed findings lead to the question of how Chinese SOEs can best improve their performance. Unfortunately, to date the answer on this question remains inconclusive.

ii: Institutional Ownership

Domestic institutions also play an active role in the Chinese corporate governance system. Domestic institutional shares, normally called legal person shares, can be classified into two types: state legal person shares and legal person shares. State legal person shares are shares held by other state-owned institutions or enterprises, and legal person shares are shares held by non-state-owned institutions or enterprises. Most previous studies have treated these two types of ownership as the same. However, we argue that legal person shareholders are more concerned with the financial performance of the companies. Moreover, directors representing legal person shareholders tend to have more experience in industry than directors from state shareholders. Compared to other minority individual shareholders, legal person shareholders are more likely to attend board meetings to express their true opinions. The majority of previous studies of the Chinese market have found that holdings by legal persons are positively related to firm performance (Xu & Wang, 1999;Hovey et al., 2003;). Wei et al. (2005) and Hovey (2005) also identify a positive relation between institutional ownership and firm value, but this relation is non-linear, and suggests the optimal level of legal person ownership is in the range of 3.8–32.1%.

iii: Foreign Ownership

Theoretically, firms with significant foreign ownership are associated with higher market valuation and better governance rules that encourage appropriate behavior of insiders. Evidence to support this can be drawn from both developing and developed economies (Andrade et al., 2001; Girma et al., 2007). The influence of foreign investors is also evident in the "bonding theory" explanation of why firms from emerging markets cross-list on developed market exchanges. Listing on strictly regulated foreign markets can enhance investor protection, and reduce the agency cost of firms (Stulz, 1999; Doidge et al., 2004). Not all listed firms in China are cross-listed. Bai et al. (2004) and Wei et al. (2005) conclude that foreign ownership is significantly positively related to firm value in China. Li et al. (2009) identify that firms with foreign investment are more productive than firms that are entirely domestic owned in China. However, only equity owned by foreign firms has a positive impact, and not investment from foreign institutions, banks or individuals. When a major foreign firm invests, the productivity increment can be attributed to active trading with the rest of world, technology transfer, advanced managerial skills and products.

iv: Tradable A Shares and Other Ownership

The empirical evidence on tradable A shares is mixed. Xu and Wang (1999) could not find a strong relationship between firm performance and tradable A shares, suggesting that privatisation of SOEs needs to be re-examined. However, the data on which they based their study is from the period 1993–1995, and their findings perhaps can also be attributed to the immature market, the supermajority of state ownership and the undeveloped legal environment at that time. In addition, tradable A shares account for approximately one third of the total shares outstanding, yet most private holdings are very small, with only a very few being greater than 1% (Wang et al., 2004). Consequently, it is difficult for individual shareholders to play an important role in monitoring the firms' business operations. Recently, Hovey (2005) finds a positive relation between percentages of tradable A shares and firm performance, however, the relationship was not found to be significant. Therefore, determining how the influence of individual investors might be improved is an area for potential future research. It is worth noting that family businesses have been growing rapidly and making significant economic contributions to the Chinese economy, even though they are disadvantaged in terms of financing and other policy restrictions (Allen et al., 2005). However, the research on Chinese family businesses is very limited mainly due to data availability even though more family firms are being listed on the stock exchanges. But it is fair to say that publicly listed family firms are not typical representatives of family firms in China.

Besides state, legal person, foreign and tradable A shares, a typical listed firm in China also issues employee shares and management shares. However, few studies mention the influence of these types of shares, because normally they only account for a very small proportion of the total shares outstanding or only a small number of companies have such shares. Wei et al. (2005) find that management and employee shares only represent 0.015% and 1.75% of total shares in their sample firms, respectively. While these levels appear low, they could represent a significant amount of the wealth of the individuals concerned. This presents research opportunities to examine the incentive effects.

v: Concentrated Ownership

The ownership structure of Chinese public companies is highly concentrated and the top 10 shareholders of Chinese companies are normally state, state legal persons or legal persons. This highly concentrated ownership structure is prevalent in China for several reasons. First, at the initial stage of stock market formation, the state was reluctant to hand over control to the private sector, and therefore retained a substantial portion of controlling shareholdings. Second, weak legal protection of shareholder rights and poor enforcement of such rights are also considered to be major causes of ownership concentration in China, consistent with the argument proposed by La Porta et al. (1999) that countries with poor investor protection typically exhibit more concentrated control of firms..

Empirically, most prior studies have found that firm performance or market valuation of publicly listed firms is positively related to the level of ownership concentration, suggesting that block shareholders can monitor a firm's business activities more effectively in China (Xu & Wang, 1999; Cheung et al., 2008). Bai et al. (2004) draw a similar conclusion even though a U-shaped relation has been found to exist between market valuation and the proportion of shares held by the largest shareholder. Hovey et al. (2003), on the other hand, have not been able to confirm the impact of ownership concentration on market performance. A possible explanation for this apparently uncertain relationship is that a typical Chinese public company is highly concentrated, and the market does not discern between firms based on ownership concentration. Recently, Ma et al. (2010) identify a positive linear relation between ownership concentration and firm value in their research. In addition, they find that the ownership concentration of tradable A shares has more significant explanatory power on firm performance than does total ownership concentration. The highest levels of firm performance are evident when a firm is characterized by both total ownership concentration and tradable ownership concentration.

vi: Financial Institutions

The findings drawn from the international literature on the role governance plays in financial institutions are mixed. On the one hand, researchers argue that financial institution investors can solve or minimise the agency problem via active monitoring (Shleifer & Vishny, 1986; Noe, 2002). On the other hand, David and Kochhar (1996) and Webb et al. (2003) conclude that financial institutions are generally passive shareholders, and play a limited role in corporate governance. The role of financial institutions in China has attracted little attention from researchers, partly because they have not exerted a significant impact because of the size of investment. Banks and insurance companies are not allowed to actively participate in the stock market, therefore, only mutual funds and securities companies can invest in the stock market without any policy restriction.

Mutual funds and securities companies tend not to be active investors in China for several reasons. First, the size of investment by mutual funds and securities companies is very small. The average size of the ownership controlled by these two types of institutions is around 0.9% (Yuan et al., 2009), so it is unlikely that they can play an effective role. Second, the high concentration of state and legal person ownership limits the influence of financial institution investors, because the agency problem is dominated by the conflict between controlling shareholders and minority shareholders (La Porta et al., 1999; Claessens & Fan, 2002; Bebchuk & Weisbach, 2010). Third, the weak legal system and inadequate disclosure of financial information are detrimental to the function of financial institution investors (Yuan et al., 2009). However, Yuan et al. (2008) identify that mutual fund ownership has a positive effect on firm performance, suggesting that the corporate governance reform policies have encouraged the active participation of financial institution investors in the Chinese market. Furthermore, it has been anticipated that the voice of financial institution investors would grow louder since the program of gradual flotation of non-tradeable shares was launched in 2005.

B. Board Characteristics

Issues related to board characteristics have been well documented. The major responsibilities of the board are to hire, fire, monitor and compensate management, and ensure that shareholders' wealth is maximised (Fama & Jensen, 1983). Traditionally, corporate board research globally has primarily focused on the relationship to board size (Yermack, 1996; Bhagat & Black, 2002), management

compensation(Core et al., 1999; Martin & Thomas, 2005) , board composition (Rosenstein & Wyatt, 1990; Bhagat & Black, 2002), the separation of CEO and Chairperson (Bhagat & Black, 2002), and firm performance and other matters, such as CEO turnover and takeover activity. Hermalin and Weisbach (2003) and Adams et al. (2010) provide a comprehensive review of this area.

i: Board of Directors/Supervisors

In China, it is common that politicians and state-controlling owners occupy the majority of board seats in state-controlled firms. Chen et al. (2002) have found that around 80% of directors on Chinese boards are closely connected to the government or government agencies, and only a few are professionals. The likelihood of finding a director representing minority shareholders is very small, which is consistent with the climate of poor investor protection in China (Allen et al., 2005). Fan et al. (2007) have identified that state-controlled firms are often associated with politically connected CEOs and ineffective boards of directors. Furthermore, in China, firms with politically connected CEOs are more likely to appoint other bureaucrats to the board.

Chen et al. (2006) identified that of the existence of external directors can significant reduce the firm's possibility to engage in fraud—a finding consistent with the international literature. In addition, they argue that firms with a combined CEO/Chair are associated with more instances of fraud. However, Li and Naughton (2007) argue that board size and board composition do not impact on firm performance. If this is so, it may be a consequence of the launch of new policies and rules in the Chinese stock market in recent years which detail the regulations covering board independence for all public firms in China. The introduction of the requirement for greater board independence has increased proportion of independent directors in many companies. Therefore, board size and board composition are have lost their explanatory power to firm performance. An alternative explanation could be that these factors are endogenous and so do not have explanatory potential (Harris & Raviv, 2008; Hermalin & Weisbach, 2003). Clarke (2006) also questions the efficiency of external directors in China on the basis that board function is unclear and their role as external directors is not well defined. Huwang and Kim (2009) argue that social ties need to be considered when assessing the independence of directors. Thus, studies that utilise the traditional definition of independent directors could be challenged, because *guanxi* (personal relationship) still plays an important role in business practices in China, and directorship appointments are typically based on these personal networks (see section IIIB below on *guanxi*).

Another interesting issue related to company boards in China is the role of the supervisory board. Chinese listed companies adopt a two-tier board structure: a board of directors and a board of supervisors. The board of supervisors of a listed firm, ranking above the directors, is usually comprised either of officials selected from government agencies, party officials or executives from parent companies. The board of supervisors is expected to play an important role in reducing agency costs, especially in relation to corporate malpractices, which were common in China in the 1990s, such as illegal insider trading, manipulation and corporate fraud (Xiao et al., 2000; Zhou & Wang, 2000). However, researchers have to date paid little attention to the board of supervisors, because they are regarded as ineffective (Tam 1999). Dahya et al. (2003) question the usefulness of the supervisory board and suggest further improvement of its independence and enforcement of its functions. Clarke (2006) also states that the board of supervisors has been unable to fulfil its monitoring role because it has no significant power to monitor daily business operations or appoint senior management. Therefore, how to improve the effectiveness of the board of supervisors in Chinese companies is a further challenge facing policy makers and academics.

iii: CEO Turnover

The relation between executive turnover and firm performance has been the focus of a large body of literature because this is an important measure of the quality of the corporate governance systems of firms. International studies, Kaplan (1994) and Franks and Mayer (2001) found that ownership structure and type do not explain CEO turnover. Volpin (2002), on the other hand, conclude that managerial ownership weakens the relationship between CEO turnover and firm performance, implying that managerial ownership might increase the likelihood of entrenchment. Other international studies have found that CEO turnover is negatively related to firm performance when controlling shareholders exist, but the relation is weak if the controlling shareholders are also top executives (Volpin, 2002; Brunello et al., 2003)

In China, state ownership is prevalent, and there is high concentration in listed firms. Therefore, studies are more likely to investigate the relationship among ownership structure, firm performance, and executive turnover. Groves et al. (1995) cannot find a significant relation between managerial turnover and labour productivity. Firth et al. (2006) observe a significant negative relationship between managerial turnover and firm profitability; however, no significant performance improvement was found after the change in management.

Chi and Wang (2009) have demonstrated that CEO turnover is significantly inversely related to firm performance, but that this relation is weak if firms are controlled by the state, which is consistent with the international evidence (Volpin, 2002; Brunello et al., 2003). Conyon and He (2008) further confirm that the sensitivity of firm performance to the impact of CEO turnover is greater if firms are privately controlled, have a majority shareholder, or have a greater proportion of independent directors on the board. The adoption of modern corporate governance practices also enhances the connection between turnover and performance, which confirms the findings of Aivazian et al. (2005). Chang and Wong (2009) investigate the turnover–performance relation from a different angle by dividing sample firms into loss- and profit-making firms. Shareholders are more likely to remove CEOs in loss-making firms with a subsequent improvement in performance. Profit-making firms are less likely to remove CEOs but do not exhibit improved performance.

In short, the results of the aforementioned studies suggest that a further decrease of state ownership is necessary in China. Companies controlled by the private sector are more likely to strengthen the performance–turnover link. However, the process of decision making around CEO turnover and appointment remains unclear, and thus requires further study.

III. Specific Corporate Governance Issues in China

Corporate governance is a country sensitive issue, because each particular corporate governance system stems from each country's unique historical, social and commercial environment (Tam, 1999). The unique features of the Chinese corporate governance system primarily include a highly concentrated ownership structure; state and legal person investors; and a weak legal system (Allen et al., 2005; Hovey & Naughton, 2007; Fan et al., 2007). It is evident that investors' interests are not being well protected, and firm value will likely dissipate under these conditions. How to solve these problems thus becomes one of the most challenging tasks facing policy makers in China.

A: Reform of Non-Tradable Shares

The limitations of non-tradable shares have been well documented (Hovey et al., 2003; Clarke, 2006; Li et al., 2009). Market liquidity is severely impeded when state and legal person shares cannot be traded on the stock market due to trading restrictions, which has significantly reduced market liquidity and became a major obstacle to market efficiency. The Chinese authorities previously tried to resolve this problem, in 1999 and 2001. However, these attempts did not receive a positive market reaction as they were not attractive to tradeable shareholders. In 2005, a third attempt was introduced for the gradual floatation of non-tradeable shares for all listed companies. Each company was required to provide a compensation package for existing tradable shareholders comprising flexible combinations of cash, warrants and bonus shares. While all state and legal person shares are now technically tradeable, there are restrictions in place for several more years on the quantity that can be traded. This ongoing reform will have an extensive long run impact on the investment community and financial system in China. The overall trading evidence shows that the original non-tradeable shareholders gradually reduce their shareholdings but still retain control through the creation of a dispersed ownership structure. There is also mounting evidence that mutual funds are becoming more active and increasing their holdings in listed firms, although their total holdings remain small to date (Yuan et al., 2008).

To float non-tradeable shares has been an important step in terms of market development, one which will ensure that Chinese markets are more aligned with international practice and can potentially improve standards of corporate governance. Theoretically, all shares can now be freely traded since the sector reforms. However, an interesting question for future research concerns whether previous non-tradeable shareholders will sell their shares, and what the potential market reaction might be. If state ownership declines dramatically, we can also ask how the participation of non-state shareholders in relation to monitoring can be increased.

B: Guanxi

Firms conduct business with each other through contracting. These contracts can be formal in that they rely on the capacity of the legal system or relational in the sense that the strength of personal ties forms the basis of enforcement. Relationship contracting can be observed to be particularly strong in economics where contracting law and its enforcement is inadequate or where there exists a high probability that the courts will err in their judgement. It is therefore reasonable to assume that relationship contracting is more prevalent in emerging or transitional economies.

Recently, the importance of legal protection for creditors and minority shareholders has been emphasised by financial researchers, suggesting that in an environment where the formal institutional constraints are weak, informal institutional constraints such as personal business relationships may play an important role in economic transactions, and hence generate a more

significant impact on firm performance (La Porta et al., 1997, 1999, 2000). The management literature, on the other hand, suggests that the greater the environmental uncertainty, the more likely it will be that firms rely on managerial ties when entering exchange relationships (Pfeffer & Salancik, 1978; Powell, 1990). Hermalin et al (2013) conclude that personal ties and relational contracting are significant variables in a weak legal system.

The Chinese form of personal business relationships, referred to as *guanxi*, has been established as the norm throughout the period of rapid economic growth in China and East Asia. Peng and Luo (2000) find that managers' business networks can improve overall firm performance in China by using survey data. In addition, *guanxi* with government officials is more important than with managers at other firms because scarce resources are normally controlled by these officials. Tsang (1998) argues that *guanxi* creates a sustainable competitive advantage for firms, and that the *guanxi*-based system is more reliable than the formal contract system under conditions of progress coupled with uncertainty. Studies of Park and Luo (2001) and Zhou et al. (2007) have found similar evidence overall. I*Guanxi* is important for Chinese firms to explore business opportunities in international markets (Zhou et al., 2007). However, Gu et al. (2008) and Li et al. (2008) identified that the relation between *guanxi* and performance is less definitive when market competition is intensive.

The negative aspects of personal business relationships are also worth considering. Anderson and Sandy (2005) argue that close relationships with suppliers or customers, while a popular business strategy, can be vulnerable to decline and destruction. Fan (2002) claims that *guanxi* is an ethical issue, with the potential to bring benefits to individuals at the expense of firms and at a broader levelbe detrimental to the economy. Chen et al. (2004) demonstrate that employees will view management as less trustworthy if human resource management decisions are based primarily on *guanxi*. Gu et al. (2008) state that *guanxi* can be seen as a major liability, for receivers of *guanxi* are obliged to return favours in future to maintain the relationship. Damage can emerge if the obligation becomes no longer affordable, and negatively affects business relationships. Moreover, *guanxi*-based relationships have been found to be closely related to corruption, nepotism, bribery and fraud in China (Yang, 1994).

There is no doubt that *guanxi* plays an important role in the Chinese corporate governance system. However, a number of issues still need to be clarified in relation to corporate governance. Potential future research questions include: How can the cost of cultivating and maintaining *guanxi* be quantified? Does market movement reflect the power of *guanxi* cultivated by managers or firms? What are the negative impacts of *guanxi* on firm operations?

IV. Conclusion

This paper has surveyed the corporate governance literature in China in the context of recent history within which an increasing private sector has led economic growth and where the state has reduced its overall ownership and control of formally state owned enterprises, from which we can draw the following conclusions:

1. It is widely believed that privately controlled firms are superior to SOEs in terms of productivity and efficiency. However, the empirical evidence from China is mixed. Not all studies identify a negative relationship between state ownership and firm performance. Furthermore, evidence suggests that firm performance can be improved through incentive contracting and corporate governance reform. In general, non-state-ownership, such as institutional ownership and foreign ownership, has a positive impact on firm performance. Ownership concentration is generally found to have a positive influence on firm performance. As with many studies of ownership, issues of non-linearity make understanding this relationship difficult.
2. Boards of Chinese companies tend to have strong representation of political appointees and state shareholder representatives. There is little evidence to support the effectiveness of independent directors. The literature also questions the issue of "true" independence in China. Therefore, it is no surprise that minority shareholders are not well protected in this context. Chinese public companies are also required to have a board of supervisors; however, these boards are widely regarded as ineffective.
3. Consistent with the international literature, privately controlled firms are more likely to strengthen the link between performance and CEO turnover in China.
4. Non-tradable shares were a unique characteristic of the Chinese corporate governance system. Since recognising their limitations, the government has eased the restrictions of the non-tradeable shares trading since 2005 to improve the overall quality of corporate governance in China. However, the long-term impact of these reforms on the capital market remains to be investigated.
5. Turning to *guanxi*, it is an ancient concept embedded in Chinese economic activities, and studies in general confirm that it has a positive impact on firm performance. However, the negative aspects of *guanxi* have also been well documented. The quality of the legal system is

a crucial determining factor in explaining the prevalence of personal relationship contracting.

Since the 1978 reforms, corporate governance reform and related issues have become major research topics in China. Although the relation between state ownership and firm performance is not conclusive, firms controlled by non-state investors are more likely to comply with international practices and be associated with better quality corporate governance. However, further research is required to enhance understanding of the Chinese corporate governance system. What is the optimal ownership structure of a typical Chinese company? Is state ownership all bad? What is the impact of the growing share of ownership held by mutual funds and securities companies? How can the effectiveness of boards of directors and supervisors be improved? How can a more market-orientated reward and recruitment system be established? How can the long-term impact of non-tradeable share reform be measured? Is it possible to quantify the costs and negative consequences of guanxi?

References

1. Adams, R. B., and D. Ferreira (2007), ‘A Theory of Friendly Boards’, *Journal of Finance*, 57, 217–250.
2. Adams, R. B., B. E. Hermalin and M. S. Weisbach (2010), ‘The Role of Boards of Directors in Corporate Governance: A Conceptual Framework & Survey’, *Journal of Economic Literature*, 48, 59-108.
3. Aivazian, V. A., Y. Ge and J. Qiu (2005), ‘Can Corporatization Improve the Performance of State-Owned Enterprises Even without Privatization?’ *Journal of Corporate Finance,* 11, 791–808.
4. Allen, F., J. Qian and M. Qian (2005), ‘Law, Finance, and Economic Growth in China’, *Journal of Financial Economics*, 77, 57–116.
5. Allen, F., J. Qian and M. Qian (2007), ‘China’s Financial System: Past, Present, and Future’ (March, 2007), Available at SSRN: http://ssrn.com/abstract=978485.
6. Anderson, E., and D. J. Sandy (2005), ‘The Dark Side of Close Relationships’, *MIT Sloan Management Review*, 46, 75–82.
7. Andrade, G., M. Mitchell and E. Stafford (2001), ‘New Evidence and Perspectives on Mergers’, *Journal of Economic Perspectives*, 15, 103–120.
8. Bai, C., Q. Liu, J. Lu, F. M. Song and J. Zhang (2004), ‘Corporate Governance and Firm Valuations in China’, *Journal of Comparative Economics*, 32, 599–616.
9. Bebchuk, L. A., and M. S. Weisback, 2010, ‘The State of Corporate Governance Research’, *Review of Financial Studies*, 23(3), 939-961.
10. Bhagat, S., and B. Black (2002), ‘The Non-Correlation between Board Independence and Long-Term Performance’, *Journal of Corporation Law,* 27(2), 231–243.
11. Boubakri, N., J. C. Cosset and W. Saffar (2008), ‘Political Connections of Newly Privatized Firms’, *Journal of Corporate Finance* 14, 654–673.
12. Brunello, G., C. Graziano and B. M. Parigi (2003), ‘CEO Turnover in Insider-Dominated Boards: The Italian Case’, *Journal of Banking and Finance* 27, 1027–1051.
13. Chan, K. L., K. J. Wei and J. B.Wang (2004), ‘Underpricing and Long-Term Performance of IPOs in China’, *Journal of Corporate Finance* 10, 409–430.
14. Chang, E. C., and S. M. L. Wong (2009) ‘Governance with Multiple Objectives: Evidence from Top Executive Turnover in China’, *Journal of Corporate Finance* 15, 230–244.
15. Chen, C. C., Y. R. Chen and K. Xin (2004), ‘Guanxi Practices and Trust in Management: A Procedural Justice Perspective’, *Organization Science* 15(2), 200–209.
16. Chen, D. H., J. P. H. Fan and T. J. Wong, 2002, ‘Do politicians jeopardize professionalism? Decentralization and the structure of Chinese corporate boards’, Working Paper, Shanghai University of Finance and Economics, and Hong Kong University of Science and Technology.
17. Chen, G. M., M. Firth., D. N. Gao and O. M. Rui (2006), ‘Ownership Structure, Corporate Governance, and Fraud: Evidence from China’, *Journal of Corporate Finance*, 12, 424–448.
18. Chen, G.M., M. Firth and L.P. Xu (2009), ‘Does the Type of Ownership Control Matter? Evidence from China’s Listed Companies’, *Journal of Banking and Finance*, 33, 171-181.
19. Cheung, Y. L., P. Jiang, P. Limpaphayom and T. Lu (2008), ‘Does Corporate Governance Matter in China?’ *China Economic Review*, 19, 460–479.
20. Chi, W., and Y. Wang (2009), ‘Ownership, Performance and Executive Turnover in China’, *Journal of Asian Economics*, 20, 465–478.
21. Claessens, S., and J. P. H. Fan (2002), ‘Corporate Governance in Asia: A Survey’, *International Review of Finance*, 3(2), 71–103.
22. Clarke, D. C. (2003), ‘Corporate Governance in China: A Review’, *China Economic Review,* 14(4), 494–507.
23. Clarke, D. C. (2006), ‘The Independent Director in Chinese Corporate Governance’, *Delaware Journal of Corporate Law*, 31(1), 125–228.
24. Conyon, M. J., and L. He (2008), ‘CEO Turnover and Firm Performance in China’s Listed Firms’ (November 5, 2008). Available at SSRN: http://ssrn.com/abstract=1084396.
25. Core, J., R. Holthausen and D. Larcker (1999), ‘Corporate Governance, Chief Executive Officer Compensation and Firm Performance’, *Journal of Financial Economics*, 51, 371–406.
26. Dahya, J., Y. Kabhari, Z. Xiao and M. Yang (2003), ‘The Usefulness of the Supervisory Board Report in China’, *Corporate Governance: An International Review*, 11(4), 308–321.
27. David, P., and R. Kochhar (1996), ‘Barriers to Effective Corporate Governance by Institutional Investors: Implications for Theory and Practice’, *European Management Journal*, 14, 457–466.
28. Denis, D. K., and J. J. McConnell (2003), ‘International Corporate Governance’, *Journal of Financial and Quantitative Analysis*, 38(1), 1–36.
29. Doidge, C., G. A. Karolyi and R. M. Stulz (2004), ‘Why Are Foreign Firms Listed in the US Worth

More?' *Journal of Financial Economics*, 71, 205–238.
30. Fama, E. F., and M. C. Jensen (1983), 'Separation of Ownership and Control', *Journal of Law and Economics,* 26, 301–325.
31. Fan, J., T. J. Wong and T. Zhang (2007), 'Politically Connected CEOs, Corporate Governance, and Post-IPO Performance of China's Newly Partially Privatized Firms', *Journal of Financial Economics*, 84, 330–357.
32. Fan, Y. (2002), 'Guanxi's Consequences: Personal Gains at Social Cost', *Journal of Business Ethics*, 38, 371–380.
33. Fich, E. M., and A. Shivdasani (2006), 'Are Busy Boards Effective Monitors?', *Journal of Finance*, 61(2), 689–724.
34. Firth, M., M. Y. Fung and O. M. Rui (2006), 'Corporate Performance and CEO Compensation in China', *Journal of Corporate Finance*, 12(4), 693–714.
35. Franks, J., and C. Mayer (2001), 'Ownership and Control of German Corporations', *Review of Financial Studies,* 14, 943–977.
36. Gillan, S. L. (2006), 'Recent Developments in Corporate Governance: A Review', *Journal of Corporate Finance*, 12(3), 381–402.
37. Girma, S., R. Kneller and M. Oisu (2007), 'Do Exporters Have Anything to Learn from Foreign Multinationals?' *European Economic Review*, 51, 981–998.
38. Groves, T., Y. Hong, J. McMillan and B. Naughton (1995), 'China's Evolving Managerial Labor Market', *Journal of Political Economy*, 103(4), 873–892.
39. Gu, F. F., K. Hung and D. K. Tse (2008), 'When Does Guanxi Matter? Issues of Capitalization and Its Dark Sides', *Journal of Marketing*, 72, 12–28.
40. Gul, F. A., J. B. Kim and A. A. Qiu (2010), 'Ownership Concentration, Foreign Shareholdings, Audit Quality, and Stock Price Synchronicity: Evidence from China', *Journal of Financial Economics*, 95, 425–442.
41. Harris, M., and A. Raviv (2008), 'A Theory of Board Control and Size', *Review of Financial Studies*, 21(4), 1797–1832.
42. Hermalin B.E., L. Li and T. Naughton, (2013), The Relational Underpinnings of Formal Contracting and the Welfare Consequences of Legal System Improvement, Economics Letters, Forthcoming.
43. Hermalin, B. E., and M. S. Weisbach (1988), 'The Determinants of Board Composition', *The RAND Journal of Economics,* 19(4), 589-606.
44. Hermalin, B. E., and M. S. Weisbach (2003), 'Boards of Directors as an Endogenously Determined Institution: A Survey of the Economic Literature', *Economic Policy Review*, April, 7–26.
45. Hovey, M. (2005), 'Do Ownership Structures Stimulate the Performance of Listed Firms in China?' In: Proceedings of the 10th AIBF Banking and Financial Conference, September 30.
46. Hovey, M., L. Li and T. Naughton (2003), 'The Relationship between Valuation and Ownership of Listed Firms in China', *Corporate Governance: An International Review*, 11(2), 112–122.
47. Hovey, M., and T. Naughton (2007), 'A Survey of Enterprises Reforms in China: The Way Forward', *Economic Systems*, 31, 138–156.
48. Hwang, B. H., and S. Kim (2009), 'It Pays to Have Friends', *Journal of Financial Economics*, 93, 138–158.
49. IFC, (2005), *Step by Step: Corporate Governance Models in China*, Washington DC, International Finance Corporation.
50. Kaplan, S., (1994), 'Top Executive Rewards and Firm Performance: A Comparison of Japan and the United States', *Journal of Political Economy*, 102, 510-546
51. Kanellos, M. J. (2007), China's New Weapon: Low Executive Pay, *CNET News*, 4 June 2007.
52. La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny (1998), 'Law and Finance', *Journal of Political Economy*, 106(6), 1113–1155.
53. La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny (1999), 'Corporate Ownership Around the World', *Journal of Finance*, 54(2), 471–517.
54. La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny (2000), 'Investor Protection and Corporate Governance', *Journal of Financial Economics*, 58, 3–27.
55. Lehn, K., S. Patro and M. Zhao (2003), 'Determinants of the size and structure of corporate boards: 1935–2000'. Available at SSRN: http://ssrn.com/abstract=470675.
56. Li, D., Y. Lu and T. Ng (2009), 'Foreign Ownership and Firm Productivity: Causality and Channels' (October 1, 2009). Available at SSRN: http://ssrn.com/abstract=1495683.
57. Li, J. J., L. Poppo and K. Z. Zhou (2008), 'Do Managerial Ties in China Always Produce Value? Competition, Uncertainty, and Domestic vs. Foreign Firms', *Strategic Management Journal*, 29, 383–400.
58. Li, L., and T. Naughton (2007), ‚Going Public with Good Governance: Evidence from China„ *Corporate Governance: An International Review*, 15(6), 1190–1202.
59. Li L., T. Naughton and M. Hovey, (2009), A Review of Corporate Governance in China in Felix J. Lopez Iturriaga (eds), *Codes of Good Governance Around the World*, Nova Publishers, 415-436.
60. Li, W. (1997), 'The Impact of Economic Reform on the Performance of Chinese State Enterprises, 1980–1989', *Journal of Political Economy*, 105, 1080–1106.
61. Linck, J. S., J. M. Netter and T. Yang (2008), 'The Determinants of Board Structure', *Journal of Financial Economics*, 87, 308–328.
62. Lovett, S., C. S. Lee and R. Kali (1999), 'Guanxi versus the Market: Ethics and Efficiency', *Journal of International Business Studies*, 30, 231–250.
63. Ma, S. G., T. Naughton and G. Tian (2010), Ownership and Ownership Concentration: Which is Important in Determining the Performance of China's Listed Firms? *Accounting and Finance*, forthcoming.
64. Martin, K. J., and R. S. Thomas (2005), 'When Is Enough, Enough? Market Reaction to Highly Dilutive Stock Option Plans and the Subsequent Impact on CEO Compensation', *Journal of Corporate Finance,* 11(1), 61–83.
65. McMillan, J., and C. Woodruff (1999), 'Interfirm Relationships and Informal Credit in Vietnam', *The Quarterly Journal of Economics,* November, 1285–1320.

66. Moosa, I., L. Li and T. Naughton (2011), 'Robust and Fragile Firm-Specific Determinants of the Capital Structure of Chinese Firms', *Applied Financial Economics*, forthcoming.
67. Noe, T. (2002), 'Institutional Activism and Financial Market Structure', *Review of Financial Studies*, 15, 289–319.
68. Park, S. H., and Y. Luo, 2001, Guanxi and Organizational Dynamics: Organizational Networking in Chinese Firms, *Strategic Management Journal* 22(5), 455–477.
69. Peng, M. W., and Y. D. Luo, 2000, Managerial Ties and Firm Performance in a Transition Economy: The Nature of a Micro-Macro Link, *Academy of Management Journal* 43(3), 486–501.
70. Pfeffer, J., and G. Salancik (1978), *The External Control of Organisations*, New York: Harper & Row.
71. Powell, W. W. (1990), 'Neither Market nor Hierarchy: Net-Work Forms of Organisation', in B. M. Staw and L. L. Cummings (Eds), *Research in Organisational Behaviour*, Greenwich, CT: JAI Press.
72. Ravina, E., and P. Sapienza (2010), 'What Do Independent Directors Know? Evidence from Their Trading', *Review of Financial Studies*, 23(3), 962-1003.
73. Rosenstein, S., and J. G. Wyatt (1990), 'Outsider Directors, Board Independence, and Shareholder Wealth', *Journal of Financial Economics*, 26(2), 175–191.
74. Shleifer, A., and R. Vishny (1986), 'Large Shareholders and Corporate Control', *Journal of Political Economy*, 94, 461–488.
75. Shleifer, A. and R. Vishny (1997), 'Survey of Corporate Governance', *Journal of Finance*, 52(2), 737–783.
76. Stulz, R. M. (1999), 'Globalization, Corporate Finance, and the Cost of Capital', *Journal of Applied Corporate Finance*, 12, 8–25.
77. Su, D. W., and B. M. Fleisher (1999), 'An Empirical Investigation of Underpricing in Chinese IPOs', *Pacific-Basin Finance Journal* , 7, 173–202.
78. Sun, J., and S. Cahan (2009), 'The Effect of Compensation Committee Quality on the Association between CEO Cash Compensation and Accounting Performance', *Corporate Governance: An International Review,* 17(2), 193–207.
79. Tam, O. K. (1999), *The Development of Corporate Governance in China*, Cheltenham: Edward Elgar.
80. Tian, G. L. H.(2001), 'State Shareholding and the Value of Chinese Firms', *Working Paper*, London Business School.
81. Tian, J., and C. M. Lau (2001), 'Board Composition, Leadership Structure and Performance in Chinese Shareholding Companies', *Asia Pacific Journal of Management*, 18, 245–263.
82. Tsang, E. W. K. (1998), 'Can Guanxi Be a Source of Sustained Competitive Advantage for Doing Business in China?', *Academy of Management Executive*, 12(2), 64–73.
83. Wang, X., L. C. Xu and T. Zhu (2004), 'State Owned Enterprises Going Public: The Case of China', *Economics of Transition*, 12(3), 467–487.
84. Webb, R., M. Beck and R. McKinnon (2003), 'Problems and Limitations of Institutional Investor Participation in Corporate Governance', *Corporate Governance*, 11, 65–73.
85. Wei, Z., F. Xie and S. Zhang (2005), 'Ownership Structure and Firm Value in China's Privatized Firms: 1991–2001', *Journal of Financial and Quantitative Analysis*, 40(1), 87–108.
86. World Bank, (2012), Gross Domestic Product 2011, Available at http://databank.worldbank.org/databank/download/GDP.pdf.
87. Volpin, P. F. (2002), 'Governance with Poor Investor Protection: Evidence from Top Executive Turnover in Italy', *Journal of Financial Economics*, 64, 61–90.
88. Xiao, J. Z., Y. Zhang and Z. Xie (2000), 'The Making of Independent Auditing Standards in China', *Accounting Horizons*, 14(1), 69–89.
89. Xu, X. N. and Y. Wang (1999), 'Ownership Structure and Corporate Governance in Chinese Stock Companies', *China Economic Review*, 10, 75–98.
90. Yang, M. M. (1994), *Gifts, Favors and Banquets: The Art of Social Relationship in China*, New York: Cornell University Press.
91. Yermack, D. (1996), 'Higher Market Valuation of Companies with a Small Board of Directors', *Journal of Financial Economics*, 40(2), 185–212.
92. Yuan, R., J. Z. Xiao, N. Milonas and J. H. Zou (2009), 'The Role of Financial Institutions in the Corporate Governance of Listed Chinese Companies', *British Journal of Management*, 20, 562–580.
93. Yuan, R., J. Z. Xiao and J. H. Zou (2008), 'Mutual Funds' Ownership and Firm Performance: Evidence from China', *Journal of Banking and Finance*, 32, 1552–1565.
94. Zhou, L. X., W. P. Wu and X. M. Luo (2007), 'Internationalization and the Performance of Born-Global SMEs: The Mediating Role of Social Networks', *Journal of International Business Studies*, 38, 673–690.
95. Zhou, M., and X. Wang (2000), 'Agency Cost and the Crisis of China's SOEs', *China Economic Review,* 11, 297–317.