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## **Corporate Governance Research on Listed Firms in China: Institutions, Governance and Accountability**

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## Abstract

The objective of this monograph is to review prior studies and propose new research directions for the corporate governance of Chinese listed firms. The focus of this monograph is to investigate the underlying relation between China's institutional environment and its listed firms' corporate governance, and to show how formal and informal governance mechanisms actually work within these firms. A top-down institutional framework is adopted to integrate prior research and guide us in identifying first-order factors that shape the corporate governance practice in China. Following this institutional framework, I propose a number of research directions that study the formal and informal governance approaches unique to China's environment.

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# 1

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## Introduction

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China has experienced a phenomenal growth in of the gross domestic product (GDP) at an average annual rate of 10% for the past 20 years. In October 2015, China had the second largest GDP in the world at current prices and was ranked first in the world in Purchasing Power Parity terms, according to the IMF Economic Outlook Report. Together with Hong Kong, Shanghai and Shenzhen combined, China's stock market was ranked third in the world in 2014, only after NYSE and Nasdaq. Despite the rapid growth in the number of firms and market capitalization in the domestic stock markets, the fledging market is plagued with a number corporate governance challenges facing the listed firms, including opaque accounting, expropriation by controlling shareholders, and political intervention by the government.

These challenges are in conflict with the original intention of the Chinese government to list the state-owned enterprises (SOEs) in Hong Kong and the domestic stock markets in Shanghai and Shenzhen, and to reform the SOEs through efficiently allocating capitals to these firms and improve their corporate governance by using Anglo-American style governance mechanisms such as instating board of directors, listing regulations, company laws, accounting and auditing standards, and

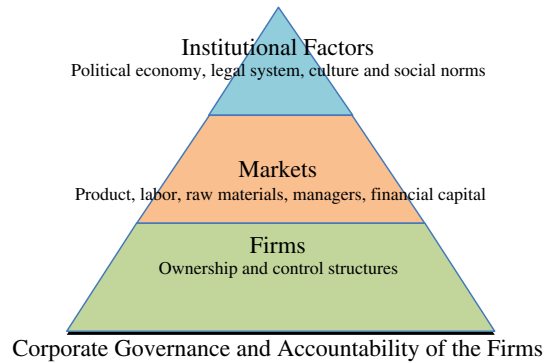
information and financial intermediaries. [Allen et al. \[2015\]](#) argue that these governance issues are part of the key contributing factors, and explain that the stock price performance of the firms listed in China's domestic markets has failed to reflect the stellar performance of the country's GDP in the past 20 years. Thus, research that can shed light on the underlying factors that explain a firm's choices in corporate governance design and whether there are alternative corporate governance approaches that can substitute or complement the Anglo-American model would be invaluable to its SOE reform and its stock markets' capital allocation efficiency.

The objective of this monograph is to review prior studies and propose new research directions on the corporate governance of Chinese listed firms. The focus is on investigating the underlying relation between China's institutional environment and its listed firms' corporate governance and study how formal and informal governance mechanisms actually work within these firms. A top-down institutional framework is adopted to integrate prior research and guide us in identifying first-order factors that shape the corporate governance practice in China. Following this institutional framework, I propose a number of research directions that study the formal and informal governance approaches unique to China's environment.<sup>1</sup>

The top down approach allows us to trace the chain of effects from institutions at the country level to the corporate governance mechanisms practiced at the firm level. Identifying the institutional factors and understanding the paths through which these institutions impact corporate governance is an essential first step for researchers. The reason for a firm in China to adopt a governance system that is different from that of the United States (U.S.) is not necessarily because the managers of the firm behave opportunistically, it may be that such a

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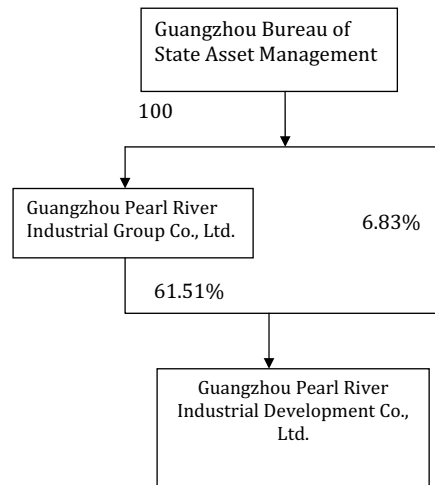
<sup>1</sup>In this review, I have primarily selected papers from top U.S. accounting and finance journals that are relevant to China's corporate governance research and the top-down institutional framework. A large body of corporate governance and accounting papers published in China's academic journals are excluded in this paper. A review of these governance and accounting papers can be found in [Li and Sun \[2009\]](#).



**Figure 1.1:** Layers of factors that shape corporate governance.

system is optimal to the institutional environment in which the firm is operating.

As shown in Figure 1.1, the corporate governance mechanisms adopted by a firm are determined by key institutional factors, which are at the top of the pyramid, and layers of intermediate factors below the apex. The bottom layer of the pyramid, which has the most direct impact on the corporate governance of a firm, is the corporate and ownership structures of the firm. Compared to U.S. firms, a typical Chinese listed firm is not diffusely owned, but controlled by a large shareholder such as the state, family, or an entrepreneur. In addition, the listed firm often belongs to a corporate group that is under the control of the same large shareholder. The group typically comprises of firms that are vertically integrated or belonging to a diversified portfolio of industries or both. In most cases, the group of firms is structured in a stock pyramid, with the large shareholder controlling the holding company, which in turn, holds shares of another group company and so on. Figure 1.2 illustrates how a listed firm in China is ultimately controlled by the large shareholder at the top of a stock pyramid. Past research has shown that firms' corporate and ownership structures can have a significant impact on their corporate governance, firm performance, and accounting properties [Fama and Jensen, 1983, Morck et al., 1988, La Porta et al., 1999, Fan and Wong, 2002].



**Figure 1.2:** A listed company controlled by a local government through a two-layer pyramid.

*Source:* This figure was reproduced from [Fan et al. \[2013\]](#).

**Description:** Guangzhou Pearl River Industrial Development Co., Ltd., a listed company, is controlled by Guangzhou Pearl River Industrial Group Co., Ltd., its parent company, with 61.51% ownership. This parent state-owned firm is ultimately controlled by the Guangzhou Bureau of State Asset Management with 100% ownership. Thus, Guangzhou Pearl River Industrial Development Co., Ltd. is ultimately controlled by the government asset management bureau via a two-layer stock pyramid.

The underdevelopment of market institutions is one of the reasons why Chinese listed firms have a high concentration of ownership and/or belong to a corporate group that is either vertically integrated or diversified into various industries. In China, access to natural and financial resources is heavily controlled by the state. Corporate groups are formed because in the absence of private markets for these scarce resources, such structure could create internal markets for accessing and allocating these resources. Large shareholders such as a local government or an entrepreneur with strong political connections can access these state-controlled resources and channel them to members of the corporate group via an internal market. The group can form internal labor markets for member firms when the market for talents is



underdeveloped, and achieve a vertical integration that secures the contractual relationships of suppliers and customers, which are otherwise difficult to maintain; especially when the market and legal institutions for many products and services are not yet established (See [La Porta et al. \[1999\]](#), [Claessens et al. \[2000\]](#), and [Khanna and Yafeh \[2005\]](#) for prior research on stock pyramids and corporate groups).

Ultimately, it is the country's institutions that shape the development of markets, which in turn, determines the corporate and ownership of the listed firms. According to the property rights literature, the three key institutional factors in a country that have a significant effect on markets, corporate and ownership structures, and corporate governance are political economy, law and social norms.<sup>2</sup> As a communist state adopting market socialism, the state's influence on the economy is still ubiquitous. As argued earlier, the markets for natural resources, managerial talents and financial capital are not well developed because access to these resources are still heavily controlled by the state. Even in some markets where the state has given up control, the transactions are carried out not at arms-length but through private networks. One important reason is that the legal system is not well established in China. Contracting parties therefore use their social networks to enforce contracts, rather than relying on the courts [[Granovetter, 1985](#)]. The dependence on social networks, termed *guanxi* in China, for business transactions is especially prevalent in China because its society is traditionally structured in webs of personal ties. Instead of using formal and universal rules and regulations that govern individual behaviors, members in a social group rely on rituals and mutual obligations that are informal and situation specific [[Fei et al., 1992](#), [Faure, 2006](#)]. Therefore, the weak legal system and the traditional practice of *guanxi*-based transactions will further constrain business transactions from being at arms-length, further slowing down the market development.

These country institutional factors sometimes have direct effects on the lower tiers of the pyramid in [Figure 1.1](#). For example, the

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<sup>2</sup>The body of property rights literature provides a general framework for analyzing the determinants of corporate ownership structures. This literature was pioneered by [Coase \[1960\]](#), [Demsetz \[1964\]](#), [Alchian \[1965, 1977\]](#), [Cheung \[1970, 1983\]](#). Interested readers are referred to [Eggertsson \[1990\]](#) for a survey of the literature.

development of legal institutions can shape a firm's ownership structure directly. As argued by [La Porta et al. \[1999\]](#), firms that operate in economies with weak investor protection tend to have high ownership concentration because investors that fear expropriation by corporate insiders will avoid buying shares of such companies, and vice versa. Similarly, the political economy and social norms in China also shape its firms' ownership structure. As China is still transitioning from a state-controlled economy to a market-based economy, many of the listed state firms are still under majority control by the state. Even for entrepreneurial firms, establishing political ties that allow them to access scarce resources would be essential for the firms' growth or even survival. To facilitate rent-seeking activities with the government, which require the ability to build clandestine and long-term relationship with the politicians, entrepreneurs maintain a high concentration of ownership and even form stock pyramids [[Fan and Wong, 2002](#)].

Using this institutional framework for analyzing China's corporate governance offers a number of advantages. By identifying China's institutional features that determine its firms' corporate governance, we can gain a better understanding of the differences in governance practice between China and more developed economies such as the U.S. This allows policy setters and researchers to observe the reasons why one size does not always fit all. That is, not all U.S. governance mechanisms are appropriate in China due to the differences in the institutional environment. An undesirable governance arrangement in the U.S. may well be optimal in China. Also, many agency conflicts and governance challenges in China cannot be fixed with simple solutions such as the appointment of a few independent directors, adopting new accounting standards, or introducing pay-for-performance compensation schemes. Many of the problems are deeply rooted in the institutions that cannot be remedied by quick-fix solutions.

Another benefit of using the institutional perspective to study China is that it points us to possible alternative governance systems that are suitable for its environment. One key institutional difference of listed SOEs compared to the U.S., is that the government still retains control in the appointment of senior executives, who are government

bureaucrats rather than professional managers. Another important distinction from the U.S. is that *guanxi* is often used as an informal governance mechanism. In this monograph, I propose to examine how the bureaucratic management system, compared to the professional managerial market in the U.S., serves its corporate governance role in the listed SOEs. I also argue that more efforts should be devoted to understanding what roles social networks play in the corporate governance and transfer of information of Chinese listed firms. As will be discussed in Section 2, since there are institutional constraints that prevent the formation of formal governance systems in China, *guanxi* will continue to be a crucial informal substitute. Stakeholders such as business partners, suppliers, customers, creditors, and investors will extensively use network ties to engage in business transactions with the firms. Policy setters should get a better understanding of the values of these network ties and not to be too quick to restrict the usage of such informal contracting and governance mechanisms.

Finally, the corporate governance research of Chinese listed firms offers researchers a rare opportunity to study how a country's institutions can fundamentally change the way firms establish their governance and accounting systems. For instance, the government's retention in the ownership control rights and the rights to appoint senior executives of the listed firms leads to serious agency conflicts between the government as the controlling shareholder and the politicians and bureaucrats who have management control over the firms. These conflicts allow us to examine the direct effect of politicians' incentives on firm behaviors. Other institutional features that have first order effects on the firms are China's legal system and social norms. These institutional factors shape the way firms contract, the formation of markets in which the firms operate and the ownership and corporate structures of the listed firms. This, in turn, will affect the firms' corporate governance and accounting systems. By applying this institutional framework to the China setting, we can identify fundamental conditions or constraints, which are embedded in China's institutions, that cause its governance practice to be different from that of the U.S. and other developed economies.

Also, by carefully mapping the relations between these institutional factors and firms' corporate governance, we can expand our theoretical understanding of the endogenous relations between the firms' operating environment and their governance practice. Having the knowledge of these latent factors will enable us to identify first-order effects and omitted variables in corporate governance research in China. In contrast, without this institutional perspective, our research models will guide us towards inappropriate governance solutions by focusing on the wrong fundamental factors. Also, not considering the right set of underlying determinants of corporate governance will lead to endogeneity or correlated omitted variable problems in the analysis.

This institutional approach to researching China offers new insights in corporate governance research that uses cross-country data or focuses on a single economy. The unique institutional conditions and constraints identified in China are likely to be weaker in more developed economies and stronger in similar emerging economies. Cross-country research can examine whether and how the fundamental institutional factors identified in China also apply in other emerging economies, whereas a different set of institutional features are shaping corporate governance in developed economies. Likewise, the findings of this research could guide cross-country studies in identifying and comparing formal and informal governance mechanisms practiced in certain countries, and analyzing how they differ from those in other countries because of their institutional differences. Although the institutional features and informal governance mechanisms documented in China are not dominant factors in the developed economies, they could play an important role in certain industries or during a particular stage in the life cycle of the firms within those economies. The corporate governance research discussed in this monograph could potentially provide new insights on these research areas.

The remainder of the monograph is organized as follows. Section 2 provides a discussion of the key unique institutional features in China. Section 3 reviews prior research on the effects of government ownership and control on firm performance, managerial turnover and compensation, and accounting. I propose a number of research directions in Section 4, and conclude in Section 5.

# 2

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## Institutional Background

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In this section, I provide a more in-depth discussion of the major institutional factors that shape the listed firms' corporate governance in China. A summary of the differences in these institutional factors between China and the U.S. is presented in Table 2.1.

### 2.1 State control and ownership of listed firms

China's two domestic stock markets, the Shenzhen and Shanghai Stock Exchanges, were established in 1991 and 1992. Before the economic reforms that started in 1979, the entire economy was under state control. All resource allocation was administered by the state and there were no free markets for products and services. Only with the establishment of the two domestic stock exchanges in the early 1990s, state-owned firms started to turn into joint stock companies and have been partially privatized through listing in the stock markets. Family-controlled or entrepreneurial firms also emerged, as the government allowed some of the listed firms to transfer the control ownership to private individuals. Accompanying this important state enterprise reform and stock market establishment, the government had to introduce new

**Table 2.1:** Key institutional differences between listed firms in China versus the U. S.

	China	U.S.
Institutions	Political economy	
	State ownership	Private ownership
	<ul style="list-style-type: none"> <li>The majority of the listed firms are controlled by the state with <math>\geq 20\%</math> ownership.</li> </ul>	<ul style="list-style-type: none"> <li>Most of the publicly listed firms are privately owned, not by the state.</li> </ul>
	Concentration of control and ownership	Diffuse ownership
	<ul style="list-style-type: none"> <li>All firms listed in the stock exchanges have a controlling owner with <math>\geq 20\%</math> ownership.</li> </ul>	<ul style="list-style-type: none"> <li>Firms are typically diffusely owned.</li> </ul>
	Group and pyramidal structures	Single industry
	<ul style="list-style-type: none"> <li>Listed firms belong to a corporate group, which is organized as a stock pyramid (see Figure 1.2 for an example).</li> <li>Many of the groups own firms that are vertically integrated or firms in diversified industries.</li> </ul>	<ul style="list-style-type: none"> <li>Firms are typically not organized in a group structure. Many belong to a single industry. Pyramidal structures are not allowed in the U.S.</li> </ul>
	Bureaucratic management system of SOEs	Professional management system
	<ul style="list-style-type: none"> <li>The appointment of Chairmen and CEOs are carried out by the Organization Department of the CCP in the government where the SOEs belong, or by the SASAC. Listed firms have boards but they don't make the decisions.</li> <li>A significant portion of the CEOs are ex-government bureaucrats (27% in Fan et al. [2007]) and their career path is to rise in ranks within the state firms system or join the government.</li> </ul>	<ul style="list-style-type: none"> <li>The appointment of Chairmen and CEOs is carried out by the board of directors, which represents the interests of the shareholders.</li> <li>CEOs are mostly professionals and their career path is to serve as senior executives in bigger and better companies.</li> </ul>

(Continued)

Table 2.1: (Continued)

	China	U.S.
	<ul style="list-style-type: none"> <li>Managers are selected within the bureaucracy of the government and state-firms system.</li> </ul>	<ul style="list-style-type: none"> <li>There is an active market for CEOs in the U.S.</li> </ul>
Institutions	Law	
	Courts are not independent from the government	The court system is an independent branch of the government
	<ul style="list-style-type: none"> <li>Judgment can be biased when SOEs are involved in the litigation.</li> <li>No class action suits are allowed.</li> </ul>	<ul style="list-style-type: none"> <li>Class action suits are allowed.</li> </ul>
	Administrative governance	Governance through market and law
	<ul style="list-style-type: none"> <li>IPOs and subsequent share issuances are heavily regulated by the CSRC (for example, the quota system and IPO selection committee have been used as regulation mechanisms).</li> <li>Investor protection falls in the hands of the CSRC. Courts rely on the CSRC's judgment before making their own rulings.</li> </ul>	<ul style="list-style-type: none"> <li>IPOs and share issuances are regulated by listing criteria but it is a market decision once the criteria are met.</li> <li>Lawyers and the courts play an important role in investor protection. Many civil and criminal cases against the corporate insiders are decided by the courts.</li> </ul>
Institutions	Social norms	
	<ul style="list-style-type: none"> <li><i>Guanxi</i> is commonly used as an alternative mechanism to enforce business contracts.</li> <li>Contracts are typically relational.</li> </ul>	<ul style="list-style-type: none"> <li>Law is commonly used as the mechanism to enforce business contracts.</li> <li>Contracts are mostly at arm's length.</li> </ul>

company laws, adopt global standards for accounting and auditing, establish the securities regulator called the China Securities and Regulatory Commission (CSRC). It also created information and financial intermediaries such as investment banks and brokerage houses, audit firms, and mutual funds and their management companies.

The first step in the creation of the two domestic stock exchanges was to convert SOEs into joint stock companies.<sup>1</sup> By issuing shares publicly and listing in the stock exchanges, these state firms partially privatize their ownership while the government still retains majority control of the firms. Anglo-american governance mechanisms such as the board of directors to protect the interests of the shareholders, the requirement of periodic accounting reports, and external audits of the annual accounting reports were introduced. This partial privatization is a step for the government in decentralizing the control of the SOEs from the central or local governments to the shareholders and managers. However, the government's continuous influence on the firms creates tensions between the firms and the outside shareholders.

As shown in Table 2.2, although only 37.88% of the listed firms in the two domestic stock exchanges are SOEs by the end of 2014, they still make up of 64.36% of the total market capitalization. From 2003 to 2014, there is an increasing trend of non-SOEs, with families or entrepreneurs as the controlling shareholders, in the two stock exchanges. More specifically, the percentage of SOEs has dropped from 74.86% to 37.88%,<sup>2</sup> while the total market capitalization has only dropped from 86.48% to 64.36%, suggesting that the non-SOEs are mostly smaller firms. Although the growth in the newly listed firms primarily comes from the non-state sector, the dominance of the SOEs in the stock exchanges makes the China stock markets uniquely different from the U.S. market. Another distinguishing feature of the China market is that ownership is heavily concentrated in the hands of the controlling shareholders. Table 2.3 reports that in 2014, the state as the

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<sup>1</sup>Steinfeld [1999] provides detailed accounts from the early period of the SOE reform.

<sup>2</sup>In Table 2.2, Wang et al. [2008] present the distribution of SOEs and non-SOEs from 1993 to 2003. In terms of the number of firms, 92% of the listed firms are SOEs in 1993, and it drops to 85% in 1998.



**Table 2.2:** Distribution of SOEs and non-SOEs in China's domestic stock exchanges from 2003 to 2014.

Year	Total <sup>a</sup>		SOE <sup>b</sup>		Non-SOE <sup>c</sup>		SOE <sup>b</sup>		Non-SOE <sup>c</sup>	
	n <sup>d</sup>	n <sup>d</sup>	% <sup>e</sup>	n <sup>d</sup>	% <sup>e</sup>	n <sup>d</sup>	% <sup>e</sup>	% <sup>f</sup>	% <sup>f</sup>	% <sup>f</sup>
2003	1261	944	74.86%	317	25.14%	86.48%	13.52%			
2004	1351	946	70.02%	405	29.98%	83.94%	16.06%			
2005	1350	934	69.19%	416	30.81%	84.88%	15.12%			
2006	1431	932	65.13%	499	34.87%	89.35%	10.65%			
2007	1542	950	61.61%	592	38.39%	89.70%	10.30%			
2008	1595	967	60.63%	628	39.37%	88.16%	11.84%			
2009	1742	988	56.72%	754	43.28%	84.29%	15.71%			
2010	2092	1024	48.95%	1068	51.05%	77.01%	22.99%			
2011	2329	1024	43.97%	1305	56.03%	77.07%	22.93%			
2012	2412	1006	41.71%	1406	58.29%	74.92%	25.08%			
2013	2473	976	39.47%	1497	60.53%	62.07%	37.93%			
2014	2582	978	37.88%	1604	62.12%	64.36%	35.64%			

*Note:*

<sup>a</sup>The population of all domestically listed firms from the CSMAR database.

<sup>b</sup>The controlling owner is the government or a state-owned entity.

<sup>c</sup>All firms other than the SOEs.

<sup>d</sup>Number of firms of the population or the corresponding group.

<sup>e</sup>The percentage is based on number of SOEs (non-SOEs) relative to the population.

<sup>f</sup>The percentage is based on the total market capitalization of all SOEs (non-SOEs) relative to the total market capitalization of the population.

controlling owner controls an average of 39.92% of the shares, and other SOEs and state-owned investment trusts hold an average of 18.2% of the shares. Only an average of 41.88% of the shares are controlled by outside shareholders, mostly individual shareholders. For non-SOEs, the entrepreneurs or families own an average of 33.39% of the shares, while individual shareholders hold an average of 47.34% of the shares.

The state ownership control of the listed firms creates two property rights issues in China. The first is the absence of a residual claimant

**Table 2.3:** Average percentage of shared ownership for each type of shareholder.

Year	SOE			Non-SOE		
	Controlling owner	Other block holders	Individual shareholders	Controlling owner	Other block holders	Individual shareholders
2003	45.93%	20.65%	33.42%	32.73%	21.41%	45.86%
2004	45.65%	21.03%	33.32%	33.22%	22.00%	44.78%
2005	44.04%	20.88%	35.08%	32.16%	21.09%	46.76%
2006	39.32%	19.40%	41.29%	30.96%	20.03%	49.01%
2007	38.82%	18.76%	42.42%	31.88%	20.10%	48.02%
2008	38.78%	19.03%	42.19%	32.57%	19.58%	47.85%
2009	39.19%	18.78%	42.03%	33.21%	20.61%	46.18%
2010	39.09%	19.41%	41.50%	34.44%	21.25%	44.32%
2011	39.14%	18.93%	41.93%	34.05%	21.24%	44.71%
2012	39.98%	19.10%	40.92%	34.52%	20.53%	44.95%
2013	40.17%	18.57%	41.26%	34.03%	19.84%	46.13%
2014	39.92%	18.20%	41.88%	33.39%	19.27%	47.34%

*Note:*

<sup>a</sup>Other block holders are shareholders that hold  $\geq 5\%$  of the shares.

<sup>b</sup>This may include block holders with  $< 5\%$  owners.

with well-defined property rights, which is a common problem among SOEs around the world. The government officials, who have control over the state shares, are not the true residual claimants. This poor delineation of property rights significantly weakens the government officials' incentives in monitoring the managers [Alchian and Demsetz, 1972]. Another property rights issue is that the state shares were not tradable until the split-share structure reform in 2006. That is, the government, which held the majority shares of the listed firms, was not allowed to sell off the shares in the secondary market subsequent to the initial public offering (IPO). This restriction in the rights to transfer the shares further reduced the government's incentives to maximize firm performance and share values.<sup>3</sup> As will be further discussed in Section 3, the

<sup>3</sup>The effects of the non-transferability of property rights on firms' incentives and organizational forms can be found in Alchian [1965], Jensen and Meckling [1979] and Karpoff and Rice [1989].

state ownership has a first order effect on firms' corporate governance and accounting practice in China.

## **2.2 SOE management and government bureaucracy**

In addition to retaining a majority of the stock ownership in the listed state firms, the government exerts its control through the appointment of key officers, such as Chairmen and CEOs of these listed firms. These appointments were carried out by the Organization Department of the Chinese Communist Party (CCP) within the central or local (provincial or city) governments under whose jurisdictions these firms were operating. In 2004, the government further decentralized its control of the state-owned firms by setting up the State Assets Supervision and Administration Commission (SASAC), whose role was to serve as a holding company with the power to appoint key executives, supervise the operations, and deploy state assets of these listed firms. By adding this corporate layer between the government and the SOEs, the government is further decentralizing its control, and granting more autonomy to managers in pursuit of commercial interests rather than political objectives. However, even after the establishment of the SASAC, a large number of the SOEs' appointments of key officers are still carried out by the Organization Department of the CCP in the local or central government to which these firms belong.

Retaining the party control in the appointments of corporate executives in the listed state firms creates two distinct differences in corporate governance between U.S.' and Chinese listed firms. First, U.S. Chairmen and CEOs are selected by company boards that represent the interests of all the investors. For the listed SOEs in China, the boards do not have the ultimate control in choosing the company executives. The appointment decisions reside in the local or central governments, or in the SASAC. Second, many of these key officers are typically quasi-government officials and not professional managers. They are pegged to the government ranks (for example, many Chairmen of the large SOEs have vice-minister ranking) and enjoy fringe benefits of high-ranking government officials. The senior management and boards are

filled with current or ex-politicians with heavy government connections. Their career paths often overlap with local and central government officials. Thus, compared to the well-established professional market for Chairmen and CEOs in the U.S., such a market does not exist for the SOEs in China. In fact, the managerial market is even underdeveloped for non-SOEs because many of the private firms are family-owned and they prefer to hire family members to run the firms.

These differences in corporate governance arrangements create, in turn, very unique incentives for the Chairmen and CEOs of China's listed SOEs. With a bureaucratic appointment system and the aspiration to climb the government hierarchy, it is the politics within the bureaucracy rather than the economic incentives of a professional managerial market that will drive the incentives of these SOE managers.

The government's practice of adaptive authoritarianism in its bureaucracy also shapes the corporate governance of its SOEs [Rothstein, 2013]. Instead of decentralizing decision powers to its local bureaucrats, the central government retains tight control and monitoring of the bureaucracy through a strong chain of commands from the top to the bottom of the hierarchy. The benefit of the system is that the government can quickly respond to changes in macro and micro conditions, and fine-tune its policies without dissents or obstructions by local units. This proves particularly helpful for the government in making sweeping reforms and engaging in massive infrastructure development projects that require sacrifices in local units. This system of command and control extends to the governance of listed SOEs, which are expected to carry out the policy mandates of the government when needed.

Given this system, the governance of the listed SOEs are subject to the public governance of local and central governments. Unlike the U.S., the key officers of the listed firms in China are quasi-government officials, pursuing political goals, evaluated under a bureaucratic system, that are not necessarily focusing on firms' profitability but rather on carrying out government policy mandates. This creates tension between the government as the controlling owner of the firm and its outside shareholders. Another risk, especially from the perspective of

the government as the controlling owner, is that the bureaucrats would pursue political promotions at the expense of the policy mandates or the general interests of the shareholders, including the government [Tullock, 1965]. They may only fulfill the short-term targets to gain political capital and sacrifice long-term benefits, which harms both the government and the shareholders. Sections 3 and 4 will discuss the past research and future research directions in relation to the bureaucratic management system of SOEs.

### **2.3 Law, regulations, and administrative governance**

In the past 20 years, the government promulgated many new laws that govern the listed firms. However, China has no shortage of laws but the challenge is in the enforcement of these laws. The main issue is in its court system. There is no independent judiciary in China and the courts are controlled by the local governments, which also directly or indirectly hold the stock ownership of the state firms. Therefore, the courts do not and cannot serve as the ultimate arbiter in legal disputes, especially when it involves conflicts between a private party and the government [Layton, 2008]. Under the code law system of China, the enacted laws have to be interpreted by the courts before they can be enforced. In many cases, the courts refuse to issue their interpretations and avoid taking responsibility for judgments that involve SOEs and the government [Pistor and Xu, 2005b].

In the absence of an independent and well-developed legal system, China has relied heavily on the securities regulator, the CSRC, to uphold corporate governance of the listed firms and protect investors' rights. Pistor and Xu [2005a,b] argue that this administrative governance approach has been relatively successful. In terms of trading volume, the total market capitalization of listed firms, and the number of investors, including domestic and foreign institutional investors, the market has grown steadily over the past two decades. The central feature of this approach is to grant IPO quotas to various provinces and hold the local politicians accountable for the performance of the listed firms. This quota system has been subsequently replaced by a

committee approval system that does not strictly control the quotas but the CSRC continues to regulate the IPO numbers and pays close attention to the firms' performance. For example, the CSRC will delist firms that experience three consecutive years of loss, and require firms to meet specific earning targets before making seasoned equity offerings to the market.

This CSRC-led regulatory regime versus the market-based regime in the U.S. has its own unique challenges. Due to the lack of manpower and the high information costs, the regulator relies on bright line rules, such as return-on-equity targets for regulating IPO and subsequent share offerings, and maintenance of listing status. This however leads to a misallocation of resources and acute earnings manipulation problems among the listed firms in China. This and other problems related to the administrative governance approach will be discussed further in the next two sections.

## 2.4 Culture and norms

China is a relational society. Business transactions are typically carried out between parties with close private and social ties — the aforementioned *guanxi*. This way of doing business is not purely a result of the weak legal system, in which social ties serve as a substitute to enforce contracts privately [Granovetter, 1985]. The importance of social ties with politicians in an authoritarian government could only partially explain the prevalence of *guanxi* in China's business world. The widespread practice of using *guanxi* in business dealings is likely to originate from the social structures and norms in the Chinese society. Fei et al. [1992] argue that for the past centuries in Chinese villages, each individual is connected to others through a web of social ties. The individual's behavior is governed not by universal law but by social norms in the form of rituals and informal rules. The most fundamental unit in a person's network is her family. In Chinese society, the role of a family unit often goes beyond pro-creation. The eldest son typically inherits the family wealth and takes the helm of the family business if there is one. Fukuyama [2011] argues that the underlying reason

for China's emphasis on lineage is its religious practice of ancestral worship. Each family tries to ensure the future extension of its family through channeling all its wealth to one offspring in the succession plan.

The advantage of this way of organizing society is that in the absence of a stable government to enforce universal laws, individuals can use their own social ties to build trust, exchange private information and enforce contracts using the reward and punishment mechanisms within the social structures [Granovetter, 2005]. However, the disadvantage of this relational system is that although individuals' interests are protected within a close-knit network, they may clash with the interests of individuals outside the network and society in general. That is, these rituals and informal rules within a private network are not necessarily the universal rules that govern Chinese society as a whole. Deep trust established within a small network of friends could result in mistrust and even conflicts between various different private networks in a society [Granovetter, 1985]. In Section 4.3, I will discuss the role of social and political ties in the governance of Chinese listed firms.

# 3

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## Institutions, Governance, and Accountability

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### **3.1 How do institutions shape the corporate governance of Chinese listed firms?**

As discussed in Section 2, countries' institutions have a first-order effect in shaping firms' corporate governance and accounting practice. In the following subsections, I will discuss prior research findings concerning the effects of state control and privatization, the bureaucratic system in the management of SOEs, and the administrative governance approach in security regulations; specifically on Chinese listed firms' performance, managerial turnover and compensation, accounting properties, and auditor choice.

### **3.2 The effect of government ownership on performance**

#### **3.2.1 State ownership, privatization, and firm performance**

A number of recent studies have asked fundamental questions about whether the partial privatization of China's SOEs generates positive performance. Namely, with the government still retaining ownership control of the firms, does the introduction of private ownership through



IPO lead to a rise in performance? Does the ownership composition, such as the relative percentage ownership by the state, other state-owned firms, and foreign shareholders, have any effect on firm performance subsequent to the IPO? Will further privatization of the listed SOEs (after the IPO) lead to better performance?

Sun and Tong [2003] use the IPOs from 1994 to 1998 and find that the level of earnings, sales, and workers' productivity improve after privatization. However, the rate of profitability measured in return on sales (ROS) and earnings of before interest and tax (EBIT) to sales drop significantly after the IPOs. These results suggest that China's partial privatization has, at best, mixed results. They then test whether the ownership structure is associated with post-IPO firm performance as measured by market-to-book assets, ROS, and EBIT to sales. The three types of shares that are studied are state shares, legal person shares, and individual shares (H- or B-shares) that are sold to overseas investors during the IPO. The individual shares sold to domestic investors are called A-shares. State shares are typically held by the parent SOEs or the SASAC, or directly by the government prior the establishment of the SASAC. The legal person shares are held by other SOEs or government-controlled investment funds and trusts. During this sample period, domestic mutual funds are not developed and foreign mutual funds can only buy H- and B-shares. Their results show that the percentage of state shares is associated with negative firm performance, while the percentage of legal person ownership is associated with positive firm performance. The foreign stock ownership percentage does not show a uniformly positive effect on firm performance.

Using a sample period from 1991 to 2001, a slightly longer period than that of Sun and Tong [2003], Wei et al. [2005] re-examine how the ownership structure of these listed SOEs is associated with performance, estimated by Tobin's Q. They find that Q is negatively associated with state and institutional shares but positively associated with foreign shares. The results of the institutional and foreign shares are not consistent with that of Sun and Tong [2003] but both papers find that the percentage of state shares is associated with poor performance after the IPO. Consistent with the finding that state control is negatively

associated with firm performance after the IPO, [Chen et al. \[2008\]](#) use a sample of firms that transfer block ownership control and find that firms that change control from a state owner to a private owner have superior operating performance and a positive response from the stock market.<sup>1</sup>

These results are consistent with the arguments in [Section 2](#) that property rights are not well defined in these state and institutional shares. The absence of a residual claimant and the prohibition of the free transfer of these shares in the secondary market significantly reduce the incentives of these shareholders to perform their ownership role. The next two papers that are discussed examine the split-share structure reform from 2005 to 2007, which gave these state and institutional share owners the right to freely transfer the shares in the secondary market. Prior to this reform, they could only conduct block transfer of their shares in a closed market as studied by [Chen et al. \[2008\]](#). According to the property rights literature, this reform will provide incentives for shareholders to maximize firm performance and share value.

[Liao et al. \[2014\]](#) find that the split-share structure reform significantly increases the listed state-owned firms' performance, as measured in the change in three-year operating revenues and profits before and after the reform, and the three-year post-reform Fama-French model-adjusted returns. This is consistent with the property rights theory that lifting the restriction in the rights to transfer increases monitoring incentives of the owners. Using this same research setting of the split-share structure reform, [Chen et al. \[2012\]](#) find that there is a significant drop in the listed firms' cash holdings after the reform. This result is consistent with the hypothesis that the split-share structure reform removes a financial constraint of the state shareholders and aligns the interests between them and the minority shareholders. The alignment of incentives to improve firm performance results from the right to sell, which gives controlling owners a way to capitalize in share price appreciation.

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<sup>1</sup>These block transfers had to be approved by the government and were carried out in private negotiations.

### **3.2.2 Lingering state control and the mechanisms to limit its influence**

The papers discussed in the previous subsection have shown that the Chinese government has used the listing of the SOEs as a way to decentralize control by allocating it to the private sector. However, due to the remaining state ownership control after the IPO, the government continues to have an influence over the listed SOEs. [Fan et al. \[2007\]](#) have identified a channel, other than ownership, through which the government retains its influence over the firms. Using the three-year post-IPO stock returns performance of 790 Chinese listed firms from 1993 to 2001, they find that firms with CEOs that are current or former government officials (politically connected CEOs) underperform those with (politically unconnected) CEOs that are professionals by 18%. They argue that two important governance features have led to the result. First, the government has decision rights to appoint the CEOs. Second, the government retains control of the listed firms after the IPO and the government shares (state shares) cannot be traded in the stock market (prior to the split-share structure reform), which therefore precludes managers or the state from reaping benefits of any share-price appreciation after the listing. They find that 27% of the 790 firms in the sample have politically connected CEOs. The evidence also shows that when the firm's CEO is politically connected, its board members are likely to be connected with the government as well. These results suggest that the political connection of CEOs is a channel through which the state continues to exert its influence on the firms. Even after the listing, the state and the firms' leadership pursue political and social objectives at the expense of minority shareholders, which lead to the post-IPO return underperformance.

Realizing that lingering control over the listed SOEs can lower performance and depress share prices, there is evidence that local governments do find ways to further decentralize their control in addition to listing their firms in the stock exchanges. [Fan et al. \[2013\]](#) find that the local governments set up corporate pyramids (see [Figure 1.2](#)) to reduce their influence on the listed firms that are situated at the bottom of the pyramids. The additional corporate layers between the government and

the listed firms at the bottom of the pyramid can reduce government intervention due to information loss. That is, the additional corporate layers between the government and the listed firms can prevent the government from directly accessing strategic and operational information of the firms, making it difficult for the government to intervene. This approach allows the government to credibly commit to reduce its influence without having to engage in further or full privatization.

Consistent with this hypothesis, they find that adding layers between the government and the listed firms are associated with higher operational efficiency as a result of less government interference. However, corporate layers can induce agency problems because it is more difficult for the government to monitor the managers. Their results show that corporate pyramids are more extensive in regions with better legal and market institutions, where monitoring of the managers is expected to be more effective in mitigating the agency conflicts.

Finally, [Berkman et al. \[2011\]](#) study three regulatory changes designed to protect minority shareholders against the expropriation by the government as the majority shareholder (state intervention). The evidence shows that the market reactions to all three regulatory changes are more positive for firms with stronger governance (that is, firms with less related party transactions) than those with weaker governance (more related party transactions). This evidence suggests that large shareholders' expropriation exists and regulations can serve as deterrence. However, such administrative governance may favor the SOEs. [Berkman et al. \[2011\]](#) find that firms with strong political ties have weaker positive market response to the regulatory changes, suggesting that the market fears that the regulators will enforce the new rules selectively. This further demonstrates the downside of administrative governance and that politics can easily get in the way of administering the regulations fairly. It further illustrates the difficulty in using government regulations to restrain its own intervention. Perhaps a more credible approach is to pre-commit to not intervene through pyramidal structures [[Fan et al., 2013](#)] or other arrangements that are difficult to undo by the government.

### **3.3 SOEs' management compensation and turnover**

#### **3.3.1 Performance, turnover, and compensation**

One institutional constraint discussed in Section 2 is the government control of the appointment of CEOs of listed SOEs. These CEOs are bureaucrats and many have political aspirations. Their career paths overlap with those of city, provincial and even central government officials. Their incentives and compensation schemes differ significantly from the professional managers in the U.S. market. Promotions and demotions of these bureaucrats are likely to be less associated with operating performance and more related to political considerations such as loyalty in carrying out policy mandates and connections with powerful politicians. In addition, each of the listed firm in China, either state or non-state, is controlled by a large shareholder. The controlling shareholder typically has alternative monitoring channels to monitor the CEOs, which also reduce the turnover-performance sensitivity and the relative importance of the U.S.-style performance-based compensation schemes [Fama and Jensen, 1983].

Using CEO turnover data from 1998 to 2002, Kato and Long [2006] find that the performance-turnover relation is stronger for firms with a majority owner (that is, the controlling owner having more than 50% ownership), for non-state firms, and for firms with independent directors. Moreover, the turnover will lead to subsequent performance improvement measured by stock returns and return-on-assets when the firm is a non-state firm or when it is controlled by a majority owner. The weaker performance-turnover sensitivity is consistent with the notion that the government has weaker incentives to monitor the managers due to a weak delineation of property rights. Also, these CEOs are likely to be bureaucrats that are evaluated on a wider set of economic as well as political indicators other than firm performance. However, it is puzzling that the controlling owner's stock ownership of greater than 50% has a positive effect on performance-turnover sensitivity. Since the majority of the listed firms are state-owned in the sample period, the incentive-alignment effect of stock ownership concentration is unlikely to have any significant effect given such a weak delineation of property rights [Morck et al., 1988].

Two recent papers document that state control has a significant effect on reducing the use of incentive schemes to motivate listed firms' managers and directors. [Ke et al. \[2012\]](#) compare the pay-for-performance compensation schemes of two types of China's state-owned firms listed in Hong Kong — H-shares, which are incorporated in China and managed by bureaucrats, and Red-chips, which are incorporated outside of China and are typically managed by professional managers. They find that H-share firms do not have more sensitive pay-for-performance compensations for their senior executives than their counterparts in China. However, the state-controlled Red-chips listed in Hong Kong have more sensitive pay-for-performance compensations than similar firms in China. This result further supports the notion that government control reduces firms' adoption of pay-for-performance incentive schemes.

In the second paper [Chen et al. \[2013\]](#), they use a sample of state-controlled Red-chip firms in Hong Kong between 1990 and 2005 and find that the directors forfeited a significant portion of their vested in-the-money stock options. This is consistent with the conjecture that even for Red-chip firms that are relatively less exposed to government control, the stock option grants are not being fully used as compensation for these state-owned firms.

### **3.3.2 The government's internal evaluation process of SOE managers**

The two papers discussed in the previous subsection show that a western-style compensation scheme is not likely to be adopted by Chinese SOEs. However, there is very little research that examines how the senior executives of these SOEs are evaluated. Using a proprietary data set of evaluation scores and ratings of 63 state-owned firms under the supervision of the SASAC between 2005 and 2007, [Du et al. \[2012\]](#) provide some evidence that shows that political factors affect the government's appraisal of the CFOs of these state-owned firms. The results show that CFOs' political connection and the SOEs' political rank have a positive effect on the CFOs' evaluation scores and ratings. This is consistent with the idea that politics, and more specifically political

favoritism, can have an important influence on their performance evaluation. Further analysis suggests that the SASAC puts more weight on firm-specific targets than common targets for firms that are in a higher political rank.

### **3.4 State ownership, accounting transparency, and auditor choice**

By retaining a controlling stake in the listed SOEs, the research presented in the previous subsections shows that the state has a strong influence on firm performance, the appointment of senior executives, and the corporate structures and governance of the firms. In the remaining subsections, I will discuss how state control of the listed firms affects the accounting properties, stock return synchronicity, and auditor choice of the firms.

There are a number of distinct institutional features in China that shape its listed firms' accounting and auditing properties. First, with the stock ownership being concentrated in the hands of a small number of larger shareholders, and almost all the bank loans being from the four biggest state banks, the firms' communication strategy will tend to be insider-based. That is, the firms will focus on private communication with these major stakeholders, rather than providing more transparent and timely public disclosures and financial reporting to the market [Ball et al., 2000a].

Second, the government still maintains control over the capital markets. In contrast with the market-based approach in the U.S., the IPO process in China is highly regulated. Many applicant firms are turned down despite meeting the pre-set criteria. Major loans are only granted by state banks, which favor SOEs over non-SOEs. Furthermore, local politicians view the listing privilege as a source of capital for their firms and regions. The performance of these listed firms could also be viewed as an indicator of the politicians' success in administering the economic policies in the regions. This creates a soft budget constraint to these listed SOEs, as the politicians will make sure that their SOEs will perform well or at least maintain their listing status. These privileges

will further reduce listed SOEs' incentives to increase accounting transparency and hire high quality auditors.

Third, as shown in [Fan et al. \[2013\]](#), these Chinese listed SOEs often operate within a pyramid-structured corporate group. Past research finds that East Asian group firms exhibit low transparency and use related-party transactions among member firms within the corporate group to smooth individual firms' earnings [[Fan and Wong, 2002](#), [Khanna and Yafeh, 2005](#)]. In China, this type of income smoothing and shifting is likely to be more significant for a number of reasons. Many of the listed firms at the bottom of the pyramids are carved out from the parent companies at the top of the pyramids. After the listing, the listed firms have obligations to transfer cash and other resources to the parent companies. Because of the lack of development in capital and product markets, many of the firms are vertically integrated within the corporate groups. The related-party transactions are ways to reduce transaction costs but they can also be used to manipulate earnings.

Finally, as presented in [Section 2](#), China does not have an independent and well-developed court system to enforce investor protection laws. The government employs an administrative governance approach in regulating the IPO process, the subsequent share issuances, and corporate disclosures and governance. For instance, the CSRC sets earnings targets at fixed percentages of return on equity for IPO and rights offerings. Firms are required to give mandatory earnings forecasts when the year-end earnings deviate from prior year's earnings by more than 50%. With the weak demand for public accounting reporting by stakeholders (they prefer internal communication), such bright line rules imposed by the regulators will create strong earnings management incentives for the listed firms. This will further distort reported accounting numbers in reflecting the fundamentals of the listed firms.

### 3.4.1 Earnings management and share issuance processes

Even in the early years of SOE listing, earnings management around the IPO was documented. [Aharony et al. \[2000\]](#) examine the earnings patterns of 83 H-share firms in Hong Kong and B-share firms listed



domestically in Shanghai and Shenzhen between 1992 and 1995. Compared to the A-shares that are issued to domestic investors in China, these are shares sold to overseas investors. They find evidence that these firms manage earnings prior to the IPO and that the earnings decline afterwards. Earnings management is more significant for B-share firms and firms that do not belong to industries such as petrochemicals, energy and raw materials that are protected by the state. The differences in the level of earnings management are consistent with the conjecture that monitoring by a more developed market, such as Hong Kong, reduces earnings management. Also, firms that receive more government support are likely to be chosen for listing and thus have less incentive to manage earnings. This shows that politics do play a role in earnings management in the IPO setting in China. It is interesting to note that SOE managers, unlike their U.S. counterparts, do not hold company shares during this early period of the reform. They have the incentive to manage earnings because their local governments are short in foreign currencies and listing the shares for overseas investors provides the necessary resources. Also, the firm managers and their politician bosses have political aspirations and a successful IPO gives them political capital.

The next two papers illustrate that Chinese listed firms use an earnings target set by regulators to manage earnings. Using a bright-line rule of three consecutive years of 10% return on equity, the CSRC attempts to use this criterion to select better performing firms for rights issues. [Chen and Yuan \[2004\]](#) find that from 1996 to 1998, firms inflate non-operating earnings in order to qualify for the rights issue. Among the firms that are selected by the CSRC for rights issues, those that manage earnings do perform worse than firms that do not manage earnings. It shows that this administrative governance mechanism is compromised due to earnings management, and the government is making a suboptimal resource allocation. Using the same rights-issue events and sample period, [Haw et al. \[2005\]](#) also document earnings management prior to the rights issues. They also write that firms that apply for but fail to be selected for rights offerings manage earnings even more. This is consistent with the CSRC demonstrating abilities to single out firms

that engage in more severe earnings management. However, the results do show that firms that are selected for rights offerings have engaged in earnings management.

### 3.4.2 Related party transactions, propping, and tunneling

As discussed earlier, many of the listed firms in China are part of a corporate group. These firms engage in related-party transactions to manage their earnings to meet the CSRC's earnings targets for rights issues or other requirements. Using a sample of listed firms from 1998 to 2002, [Jian and Wong \[2010\]](#) show that they use sales to their parent firms, which are related-party transactions, to prop up earnings to meet the security regulators' earnings targets when presenting these earnings to the parent firms. This propping is more pronounced among SOEs and firms in less developed regions. These abnormal related-party sales are not entirely accrual-based. In fact, abnormal related-party sales serve as a substitute for accrual-based earnings management. Since these related-party sales can be cash-based, they also find that there is significant cash transfer back to the parent firm via related lending after the propping.

With the evidence of [Jian and Wong \[2010\]](#) that the parent firms extend their help to the listed firms through related-party sales, it is likely that when the parent firms or the rest of the group are in financial need, they will extract resources from these listed firms. [Jiang et al. \[2010\]](#) document evidence from a sample between 1996 and 2006 and prove that the parent firms siphon off cash (tunnel) from the listed firms through related-party loans (other receivables). They find more serious tunneling for non-SOEs and firms in regions with weak market developments. They argue that institutional investors and auditors could not stop the tunneling. There were attempts to stop such expropriation behavior by security regulators from 2001 to 2006 but they failed. It took a joint statement of eight ministries, threatening public disclosure and personal action against the management of the controlling entities to stop the tunneling. This demonstrates that different government units, that is, regulators versus other ministries, and central versus local governments, may not always agree with each other.

Constraining the government from interfering with the SOEs is difficult because it is highly political and often goes beyond the corporate governance of the firms. This is a topic that we will explore further in Section 4.

### **3.4.3 Ownership structures, timely loss recognition, and synchronicity**

Despite adopting accounting standards that are closely resembling the western standards, Ball et al. [2000b] use an early sample of Chinese listed firms from 1992 to 1998 and show that the timely loss recognition pattern, a key earnings properties for corporate governance, does not resemble that of the U.S. firms. They argue that accounting standards do not drive earnings properties but firms' incentives do. Chinese firms are controlled by the state, which demands a stable income stream for tax revenue purposes. The state shareholders as well as other stakeholders, such as the state banks and other institutional shareholders, will rely on internal communication (insider-based accounting) rather than public accounting reports. Thus, in China, we do not observe the high corporate transparency and strong timely loss recognition that is typical among U.S. firms.

This insider-based accounting system leads to significantly less firm specific information in the market, which hurts the information environment of Chinese listed firms. Using a sample of listed firms between 1996 and 2003, Gul et al. [2010] examine the determinants of these firms' information environment as measured by stock return synchronicity [Morck et al., 2000]. Gul et al. [2010] document that the relation between synchronicity and ownership concentration is positive and concave, peaking at an ownership level of 50%. Furthermore, synchronicity is higher for SOEs than for non-SOEs and is negatively associated with foreign ownership and auditor quality.

### **3.4.4 State ownership and auditor choice**

Two recent papers illustrate that state ownership and control of listed SOEs has an impact on their choice of auditors. In the first paper, DeFond et al. [1999] use the event of China's adoption of

the international auditing standards in 1995 and find that after the adoption, the percentage of modified opinions issued by the auditors increased by nine times in 1995 and 1996 compared to the previous two years. This suggests that the new standards have made Chinese auditors more stringent than before. They also find that the top 10 auditors, which are audit firms that have the largest domestic market shares, have a higher quality as they have a greater propensity to issue modified opinions after controlling for the clients' financial conditions and characteristics. However, the increase in modified opinions is followed by a decline in the market share of these top 10 auditors. The drop is a result of Chinese listed firms not having a strong demand for top 10 auditors to signal quality. Auditors are hired to fulfill a government requirement but not to meet market demands. Like the argument in [Ball et al. \[2000a\]](#) that the adoption of western accounting standards does not necessarily improve accounting quality, this new evidence shows that auditing standards alone are insufficient to create a stronger demand for independent audits in the financial markets.

In a follow-up paper to [DeFond et al. \[1999\]](#), [Wang et al. \[2008\]](#) expand the sample period to between 1993 and 2003 and compare the auditor choice between SOEs and non-SOEs. They aim to examine the reasons for the lack of demand for top 10 auditors, which are supposed to be larger and more stringent. They find that SOEs, which are controlled by local governments, are more likely to choose small (non-top 10) local auditors than non-SOEs in the same province. This is a major reason for the lack of demand for top 10 auditors in [DeFond et al. \[1999\]](#). This result is consistent with three potential explanations. First, it is opportunism, which suggests that local SOEs hire small, local auditors because it is easier to collude with them. Second, local auditors have local knowledge to audit local SOEs. Third, local SOEs lack strong incentives to hire top 10 auditors because they are privileged to raise capital through the equity markets and the state banks, and they will be bailed out by the government if they ever experience financial trouble. The overall evidence supports the third argument for local SOEs' lack of demand for top 10 auditors.

Although Wang et al. [2008] do not document opportunism in the choice of small local auditors in China, Yang [2013] finds that partners of non-top-tier audit firms (firms outside the top 14 audit firms in terms of market share) exchange favors with their clients in order to raise audit fees and increase the firms' market share. Specifically, he finds that non-top-tier audit firms with partners, who have served in the government's IPO regulatory committee that selects firms for public listing, increase their audit fees and market shares, and reduce their clients' IPO rejection rate. Top-tier audit firms, which care more about their market reputation, do not exhibit such opportunistic behavior. Further supporting the argument of opportunism, non-top-tier auditors' clients tend to experience a post-IPO earnings decline if the IPO is carried out in the period when audit partners of the firms serve or have served in the regulatory committee (connection period). This is not the case if the IPO happens outside the connection period.

# 4

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## New Emerging Topics

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In this section, I will propose a number of future research directions for corporate governance of Chinese listed firms. To do that, we first need to examine if there are any possible shifts in the institutional factors that can have first-order effects on the governance of these firms. The government has made announcements that it will further relinquish control of the IPO market. Instead of regulating the number and selection of firms into the IPO market through the CSRC issuance committee, it will adopt a registration-based approach similar to the system in the U.S., which allows qualified firms to make IPO decisions based on market conditions. Another government policy that will have a great impact on the domestic stock markets is the plan to convert RMB into a global currency, which means that RMB will be fully convertible in the near future. China's stock markets, which have not been fully open to foreign investors, will eventually be given free access to global investors while domestic investors can invest in global markets with little or no restrictions.

As a result of this market liberalization, there will be an increase in the demand for more western-style corporate governance and accountability by domestic and global institutional investors. However, there

are other major institutional factors that are unlikely to change in the short- to medium-term. First, the government is unlikely to give up control of the listed SOEs. Even after the split-share structure reform, the government remains having effective control of the firms even though it has sold off a portion of the state shares. There is no reform expected in the bureaucratic management system of the SOEs. By restricting the appointments of SOEs' senior executives by the government rather than by the boards, these remain to be political rather than economic decisions.

Second, as long as China remains an autocracy, there is no independent judiciary and thus the courts will never be independent from the government. The CSRC will shift some of the investor protection responsibility to the courts, as they begin to accept civil litigations from shareholders against corporate insiders and even their auditors. However, if the case involves a high-ranking SOE and senior local government officials where the court is located, it will become difficult for the local court to remain completely independent. This means that a certain level of administrative governance, especially when involving state interests, remains necessary while the full development of law and finance will be significantly hampered.

Finally, the role of *guanxi* in the contracting and transferring of private information remains strong, mainly because of the social structures in the Chinese society. This way of associating with others in social relationships survived communism; especially the Cultural Revolution, the 30 years of rapid economic reforms and urbanization. Not only does the deeply rooted culture of *guanxi* perpetuate the practice of relational contracting, the government's continuous involvement as shareholders and regulators in the market, the underdeveloped legal system, and firms' dependence on connections with the government for protection and rent seeking render this relationship-based system in doing business a necessity in China.

Since these major institutional factors are unlikely to shift in the near future, I do not expect any drastic change in the governance model of Chinese listed firms. Although there is significant growth in the non-state sectors, most of the large listed firms remain SOEs, as shown in

Table 2.2. As presented in Table 2.3, both SOEs and non-SOEs continue to have concentration of ownership. The professional managerial market remains small in China because SOEs continue to hire from within the bureaucratic system, while family firms are reluctant to hire outsiders. With the underdeveloped legal and court system because of the government's involvement as regulators and key players in the market, firms still conduct their business based on relational contracting. The accounting system remains insider-based through private communications, because the controlling owners would enjoy few benefits but incur high costs when engaging in public communications with stakeholders.

Based on the expectation that China's major institutional arrangements remain unchanged in the near future, let me discuss the emerging key governance issues of listed firms in the following subsections.

#### **4.1 New orientation**

The research discussed in Section 3 focuses mainly on how the political economy of China shapes its market reforms and ownership structures of the listed firms, which in turn determine the firms' governance, performance, and accounting. In this section, I propose to go one step further in exploring how various governance mechanisms actually work within the unique institutional environment of the country.

Let me first summarize what we have learned from the prior research discussed in the previous section before proposing an agenda for future research. The first set of results presented in the previous section primarily demonstrated the negative relation between state ownership and performance. There is only mixed evidence that the share issuing partial privatization program can generate positive results [Sun and Tong, 2003, Fan et al., 2007]. In fact, a number of papers show that firms with a large percentage of state ownership or with politically connected CEOs perform worse after the IPOs [Sun and Tong, 2003, Wei et al., 2005]. This supports the notion that poor delineation of the property rights to the residual claim in the state shares lowers the politicians' incentive to monitor the managers. Another reason is that during the



sample period of these research papers, state shares were prohibited from trading in the secondary market. Subsequent research, such as [Liao et al. \[2014\]](#), finds that the removal of the constraint against the right to transfer state shares in 2005 to 2007 raised the accounting and stock return performance of the listed SOEs.

With the exception of [Fan et al. \[2007\]](#), who examine the political connections of the CEOs and directors in the listed firms, all the other prior research discussed in Section 3 does not examine any possible channels through which the state ownership lowers the accounting and stock return performance of the listed SOEs. But even [Fan et al. \[2007\]](#) do not discuss the underlying causes of the effect of CEOs' political connections on firm performance. To address this question, we have to examine the objectives and incentives of the politicians in the SASAC and/or the government unit that has direct supervision over the listed firms. Thus, one important future research agenda item is to investigate how the political forces in these supervisory units influence the behavior of firm managers and shape the firm's corporate governance and accountability.

The second set of evidence illustrates how the government control over the appointment of senior executives (Chairmen and CEOs) of the listed SOEs affects the relation between firm performance and CEO turnover, and between firm performance and executive compensations [[Kato and Long, 2006](#), [Ke et al., 2012](#), [Chen et al., 2013](#)]. Despite the evidence for how politics influences government's evaluation of the SOE managers in [Du et al. \[2012\]](#), we know very little about these SOE managers, whose incentives, career paths, and aspiration resemble that of bureaucrats or politicians more than that of professional managers in the U.S. I therefore propose that another future research direction is to examine the bureaucratic management system of the SOEs, and ask: What are the SOE executives' primary duties? How exactly are they being evaluated? Is the executive appointment system of the government performing any important and effective corporate governance role for the SOEs?

These two sets of earlier results highlight the fundamental effects of a country's formal institutions — political economy and legal system

on its listed firms. However, there is a more informal institutional factor that is equally important, if not more fundamental, in shaping business transactions, market development, firm organization structures, and, ultimately, governance and accountability. I propose that future research on the corporate governance of China's firms should focus on social structures and norms.<sup>1</sup> In the absence of a well-developed market and legal system, what is the role of social networks in establishing trust among business partners, enforcing contracts, and transferring private information? What is unique about China is that social ties are very prevalent and individuals mix social and political ties in their business dealings. This allows us to delve into the mechanisms through which individuals use network ties to build trust, transmit private information, and enforce contracts. Mapping out these social networks and examining the corporate governance roles they play in Chinese listed firms will offer great research opportunities in the future.

The third set of research findings presented in Section 3 illustrate that the state ownership of the SOEs and its preferential treatment to the listed SOEs reduce these firms' demand for high accounting transparency and hiring high quality auditors. Also, China primarily relies on the CSRC's regulation of IPOs and subsequent share issuances to enforce investor protection. This administrative governance approach places a high demand on the regulators to police the firms, force them to set bright-line rules such as earnings targets that are easily enforceable.

Another proposed future research agenda item is to investigate how accounting is used in Chinese listed firms. The adoption of the International Financial Reporting Standards (IFRS) in 2007 has created challenges to the listed SOEs because the international standards are based on a common law tradition and their successful applications rely heavily on a well-functioning market and legal system. However, in

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<sup>1</sup>In the review, I mainly focus on the relation between social ties and contracts and its effect on corporate governance. Other than social ties, social structures and norms in Chinese society, future research should also examine a broader scope in culture such as how unique Chinese cultural elements affect beliefs, values and constraints, which in turn shape the governance of Chinese firms [Sapienza et al., 2006].

China, SOEs are governed under a bureaucratic system that is primarily highly relationship-based rather than rule-based. Given this relationship-based system, what are the constraints against the effective adoption of IFRS, especially in its role of protecting outside shareholders? Under what conditions do IFRS provide an effective governance role in Chinese listed firms?

Finally, as shown in Table 2.2, there is a growing number of privately controlled firms in China. The central government is currently promoting entrepreneurship and innovation, which seems to suggest that the government is trying to level the playing field between the state and non-state sectors. It is an important research direction to gain understanding of the corporate governance of these listed entrepreneurial and family firms. In the midst of weak protection of private property rights, the heavy government control of the economy and its preferential treatment of the SOEs, how do these privately controlled firms stay competitive and obtain the resources they need to survive and even excel. How do they manage their corporate governance challenges and the political risks they face in an authoritarian government?

In the following four subsections, I will discuss the incentives of politicians and the role of bureaucracy in the governance of listed SOEs in Subsection 4.2. I will then present the role of social and political networks, media, and financial and information intermediaries in the corporate governance in Subsections 4.3 and 4.4. In Subsection 4.5, I will propose research opportunities in investigating the corporate governance issues of privately controlled firms in China. Finally, I will also discuss research opportunities arising from an Anglo-American accounting standards being applied in the Chinese relationship-based governance system in Subsection 4.6.

## **4.2 Incentives of politicians and the role of the bureaucracy**

### **4.2.1 Politics of bureaucracy and agency problem in SOEs**

The public choice literature has shed light on the incentives of the politicians in the local governments or the SASAC, and of the SOE managers under their supervision. In Section 2, I have discussed that

the SOE managers in China are selected by the government within the bureaucracy, which differs from the market approach in the U.S. in which the board of a company selects a professional manager from a well-developed managerial market. Using Tullock's [1965] analysis of the politics of bureaucracy, a few important differences can be shown by comparing the bureaucratic system of China with the market system in the U.S.

It is much harder for a bureaucrat who serves as a CEO of an SOE to initiate a job change, unless she decides to leave the bureaucracy entirely. This means that she is locked up in the political relationships with her superiors, who decide on her future. The relationship between a superior (or superiors) and a subordinate gives rise to a political situation that primarily shapes the incentives of the bureaucrat. Her biggest incentive is to seek promotions within the bureaucratic hierarchy, which will give her more power and influence. In contrast, a U.S. CEO operates in a market situation in which she is relatively free to choose where to work as a CEO of a company. Though the board of directors decide on her appointment, their relationship with the CEO is more equal than hierarchical because she is free to move to another company. The CEO's objective is to maximize her pay and will move to a better position if it offers more attractive compensations.

According to Tullock [1965], although most bureaucracies around the world employ a merit-based system for evaluation, the criteria for good performance are not always objective. This matches with the SASAC's evaluation criteria for senior executives of SOEs, which include, besides some objective firm performance metrics, political correctness, loyalty, and other subjective personal qualities. There are several reasons for such a subjective evaluation system. First, no simple key performance indicators can capture true performance, especially when the SOEs are operating as monopolies. Second, many CEOs are charged with carrying out government policies with the SOEs, and it is difficult to use policy outcomes to gauge their success. Third, control and loyalty are highly valued in the hierarchy. By relying too much on objective criteria, the superiors will lose control over the subordinates.

The downside of this bureaucratic system is that the relationship between the corporate supervisor (a politician) representing the

government and the SOE manager is highly political. Since the primary objective of the SOE manager is to climb the hierarchy and the evaluation criteria are not objective, she will engage in opportunistic behavior in order to gain promotions. The SOE manager is likely to sacrifice the firm's efficiency for her own pursuit of political capital, which is a serious agency problem that is typical of all SOEs.

As a controlling shareholder, this is the primary agency problem that the government has to resolve. This is different from the property rights discussion in Section 3 that the weak delineation of property rights in state ownership reduces the incentives of the politicians serving as the monitor and the SOE managers as agents to perform. The political relationship between the principal and agent identified here are inherent in the bureaucratic management system of the SOEs that make any incentive scheme for the managers very complex and difficult. Also, this agency conflict is not the same as the policy burdens described in [Fan et al. \[2007\]](#), which is suggested to be a contributing factor to the post-IPO underperformance of the SOEs. SOE managers do carry out policy mandates for the government and could burden the listed firms, potentially conflicting with the interests of the outside shareholders. However, if these policies help to achieve social stability, environmental sustainability, and other goals that benefit society as a whole, then this may benefit all stakeholders in the long run. It is the exploitation of the politicians and managers in using SOE resources for political and economic gains that concern the government most. Not only is it a corporate governance problem for the SOEs, it is also a public governance issue for the government because the SOE managers and the politicians at the local and even central government levels could use the resources that they control in the SOEs to benefit their political careers, and some would amass large sums of wealth for themselves and their families.

#### **4.2.2 Effects of promotion incentives on firm behavior**

There are a number of recent research papers that examine the impact of politicians' promotion incentives on managers' behaviors. [Piotroski and Zhang \[2014\]](#) demonstrate that the impending promotion of a

provincial politician creates incentives to accelerate the pace of IPO activities. The incentives can be the politician's private benefits of developing the listed firms in the province or firms capitalizing on their relationships with the politician for facilitating the IPO process before she leaves for a more senior position in the government. They also find that the increase in IPO activities in the period immediately before a politician's promotion exists in both SOE and non-SOE firms. However, non-SOE IPOs experience negative post-IPO performance and divert the IPO proceeds away from the stated purposes in the prospectus, suggesting that these IPOs are opportunistic in nature.

When we turn to the SOEs that seek listing in the overseas markets, [Hung et al. \[2012\]](#) find that these firms are more politically connected than their domestic counterparts. That is, a significantly larger percentage of the Chairmen and CEOs of these firms are ex-government officials before serving as senior executives. The ex-government officials are not chosen to run the overseas listed firms because they can enhance firm performance through their political connections. In fact, [Hung et al. \[2012\]](#) find that the firms with politically connected executives end up performing worse than those without these politically connected executives. Consistent with the rent seeking explanation, they find that connected firms' managers receive more coverage in political news media and are more likely to be promoted to senior government positions after the overseas listing than those of unconnected managers.

In addition to listing decisions, prior research also finds that political incentives shape the Chinese listed firms' information environment. [Piotroski et al. \[2015a\]](#) document that politicians and their affiliated firms respond to political incentives by suppressing negative information. Using two visible political events, the National Congress of the Chinese Communist Party and promotions of high-level provincial politicians, they find that there are fewer stock return crashes prior to the events and more crashes afterwards. This time-series pattern of crashes suggests that the firms suppress the bad news prior to and during the events and subsequently release it to the market. Consistent with the political incentive arguments, these bad news suppression results are stronger among firms that are more politically connected, and when the province is dominated by faction politics and cronyism.

These papers have illustrated that political promotion incentives of the politicians as well as the SOE managers can have a first-order effect on firm behavior. However, there is very little research on how politicians are being evaluated in the bureaucratic system, and the possible effects of this system on the corporate governance of the listed SOEs. Is there a positive role in this system? If so, under what conditions does this arise and under what conditions does it outweigh the apparent costs of the bureaucratic system as discussed previously. We will explore these and other related issues in the next subsection.

#### **4.2.3 The bureaucratic system in SOE management structure and the norm-based approach in China's bureaucracy**

Following the discussion of the bureaucratic management system in Section 2, we further explore the role of this governance approach in determining the way SOEs are run in China. Despite the setting up of the joint stock companies, listing in the stock exchanges, and the adoption of a western-style board governance structure to monitor the managers, the appointment of senior executives such as the Chairmen and CEOs are still administered by the government. Depending on the firms' ranks and importance to the government, they are either directly under the control of the Organization Department of the CCP or the SASAC. In such a system, loyalty is more important than professionalism. It is not surprising to find that pay-for-performance sensitivity is relatively lower than that of the U.S. firms, and there may even be favoritism, which could be a result of rewards for loyalty.

This bureaucratic system for China's SOEs parallels the governance structure of the central and regional governments of the country. China adopts a regionally decentralized authoritative system characterized by highly centralized political and personnel control, and decentralized administrative and economic system across the various provinces [Xu, 2011]. The central government and provincial governments are structured in an *M*-form hierarchy, in which each region enjoys economic autonomy in finance, industry, and agriculture, while the central government decides on personnel matters and controls ideology and the mass media. By controlling the appointments of provincial leaders, the

central government can extend its influence to the bottom level of the hierarchy through a nested network as the provincial leaders appoint the mayors at the municipal or city level. They, in turn, select leaders at the county and township levels [Qian and Xu, 1993].

This centralization of personnel control allows the central government to practice an adaptive authoritarianism approach [Rothstein, 2013] in managing its bureaucracy. In the western bureaucracy, the decision power decentralized to lower ranks of the hierarchy is well defined. Independent rules are set up to protect their autonomy and guard against any abuse of power and corruption. In the Chinese system, the central government retains the flexibility to retract the decision rights and the bureaucrats of all ranks are less subject to independent rules and mechanisms for defining and protecting their rights and guarding against corruption. This pragmatism allows government officials to sometimes bypass rules and regulations in order to carry out higher order policy mandates of the central government. The tradeoff of such pragmatism and flexibility is that violation of the rule of law, if unchecked, can lead to serious abuse of power and corruption.

Rothstein [2013] argues that this authoritarian approach in fact provides more flexibility for the central government and its entire bureaucracy to respond to changes in external conditions. This is particularly useful given that the market and legal system are not well established, the economy is susceptible to large external and internal macro shocks, and China is still carrying out economic reforms at an unprecedented pace without any role models or road maps.

Another important feature of this adaptive authoritarian approach is that it uses norms rather rules to guard against the abuse of power by the bureaucrats and guarantee a smooth operation of the bureaucracy. The norm-based approach relies on network relationships among the bureaucrats and their ideological commitment to the policy doctrine through various educational, social, and cultural measures. Within these SOEs, many specific assets and contracts have been developed and managed through the social networks and norm-based mechanisms of the bureaucrats.



I propose that a new research direction is to study how this norm-based adaptive authoritarian system could benefit the governance of SOEs. Under what conditions do they have a positive effect on the listed firms? Does it enable the government to administer certain policies that withstand macro shocks or reduce the risks and costs incurred by the reform itself? However, the downside of this flexible approach is that there are no universal rules or other independent rule-based systems to discipline the bureaucrats. It relies heavily on the norms and the social relationships within the bureaucratic structures to carry out the policy reforms. It is unclear how this system can prevent the politicians and SOE managers from exploiting firm resources to build personal political capital.

This agency conflict between the politicians and managers as agents and the government as principal is a major organizational cost that lowers firm value. The solution to this problem rests not only in the corporate governance mechanisms designed for the firms but also in the public governance and putting in place a check and balance system to restrain the power of the politicians that oversee these SOEs. Realizing that China's bureaucracy depends greatly on a norm-based rather than a rule-based system, it is all the more important for investors and researchers to know about the social and political connections of the managers and politicians that are affiliated with the listed firms in order to govern the bureaucrats. The knowledge of their network ties can reveal potential risks of malfeasance and enable the government to design possible check-and-balance mechanisms. This leads us to the next subsection on the role of social and political ties in the corporate governance of China's firms.

### **4.3 The role of social and political networks**

#### **4.3.1 Social structures, *Guanxi* and contracts of Chinese listed firms**

The one fundamental institutional factor that has not been extensively discussed is the role of social networks in enforcing contracts, and how they shape the corporate governance of listed firms. These networks

are much more general than the political relationships described in the bureaucratic structures of the government. They can be social ties developed in families, schools, social clubs, and at work. These networks can be used in simple day-to-day transactions in complex strategic partnerships. Regardless of whether the firm is an SOE or not, these social ties can facilitate private transfers of proprietary information between the firm and its investors for investment decisions, build trust among stakeholders or with strategic partners of the firms, enforce contracts, and reduce agency conflicts between the controlling owner and the managers.

Allen et al. [2005] have provided arguments for the important roles of reputation, trust, and social networks in facilitating business transactions and financing in the private sector in China. This explains why despite the weak legal system and heavy government bias against privately controlled firms, the non-state sector has been growing much faster than the state sector in the past 20 years.

In Section 2, I have discussed how the social structures of Chinese society give rise to the reliance on personal ties for business dealings. It is argued that such emphasis on social networks, which originated from lineage and kinship ties, is because the Chinese widely practiced ancestral worship up until the start of the communist regime. However, there is evidence that communism, and especially the Cultural Revolution, did not weaken traditional social networks in China. In fact, they, at times, became even more important. As goods and services became scarce, instrumental relationships through *guanxi* enabled citizens to obtain needed goods and services [Gold, 1985].

There has been a debate on whether *guanxi* has become more important in the economic transition since 1978 or if its role is in fact declining because of the development of market institutions and law [Yang, 1994, Guthrie, 1998]. Also, urbanization moved millions of migrant workers away from their villages into the cities. The question is whether and, if so, how these social and economic developments since the transitional reforms affect the social structures and the importance of *guanxi*. In the next subsection, I will discuss recent research that finds that social networks continue to be prevalent and imperative in the business world of China.

### 4.3.2 Alternative governance and contracting mechanisms

A number of recent research articles in accounting and finance have examined whether and how social networks serve as alternative mechanisms for contracting and channels to transfer private information for China's firms. [Allen et al. \[2005\]](#) argue that despite the weak development of law and finance for the private sector in China, it grows at a phenomenal rate because the firms use alternative financing and governance mechanisms based on reputation and relationships. This suggests that these alternative mechanisms serve as substitutes for the formal system of law and finance in promoting growth of the private sector in China. While informal financing can provide advantages in financing for very small entrepreneurial firms, as it does in developed economies, [Ayyagari et al. \[2010\]](#) do not find results that support the conjecture that informal financing can substitute formal financing in promoting growth. Using World Bank survey data of 2400 Chinese firms, they find that private firms that use formal sources of financing are positively associated with performance. However, those that receive informal financing are not associated with superior performance and faster growth.

Two recent papers demonstrate that social networks are used to transfer private information for Chinese listed firms. [Gao et al. \[2014\]](#) find that social ties enable Chinese mutual fund managers to obtain private information from their investees and increase their investment timeliness. However, this positive effect of social ties only exists in funds that are closely monitored (that is, having a high percentage of institutional holdings, having the Big 4 as auditors and foreign investors' holdings, and being located in regions with high market development). When the funds are weakly monitored then not only do the social ties fail to facilitate the transfer of information that leads to efficient investment but they even lead to an exchange of favors between the fund managers and investees, which is at the expense of the fund holders.

This is consistent with Granovetter's [\[1985\]](#) argument that social networks build trust and enable private transfer of information but they can also lead to malfeasance. A similar idea is also found in [Fei et al. \[1992\]](#), who show that in the Chinese social structures, the in-groups

often compete with other in-groups or society in general. Because the loyalty to the bigger organization outside of an individual's in-group is weak, she only adheres to the informal rules within the small network rather than the rules of the bigger organization. These individuals disregard universal rules and choose to sacrifice those outside their own in-group to protect the interests of the members within the in-group, creating a malfeasance as suggested by [Granovetter \[1985\]](#).

[Li et al. \[2014\]](#) also document that private information is being transferred through social ties between firm managers and financial analysts in China. They argue that for contracts, Chinese firms rely heavily on private networks because of the country's poor capital market and legal institutions. Due to their implicit nature, these relational contracts create a challenge for public disclosure because the information is often imprecise and difficult to verify. Public reporting may reveal sensitive information about network ties, which can jeopardize the firms' competitiveness and possibly destabilize the connection itself. Thus, the firms need to balance between the proprietary costs of disclosing information associated with relationship-based contracts and the high cost of financing that results from information asymmetry.

[Li et al.'s \[2014\]](#) results show that forecasts by analysts who are connected through social and business ties are more accurate and timely than those of unconnected analysts. The activities of connected analysts have a positive spillover effect on the forecasts activities of other unconnected analysts. Firms with more connected analysts following have more accurate consensus forecasts and lower forecast dispersion than those with fewer connected analysts following. The authors also show that following the departure of a connected analyst, the accuracy of consensus forecasts reduces significantly. There is however no drop in forecast accuracy following the departure of an unconnected analyst.

### 4.3.3 **New research agenda**

This recent research on the role of social networks in contracting and private transfer of information illustrates the prevalence and importance of networks in the Chinese market. Given that it is deeply rooted in Chinese culture, it is difficult to build trust outside of a family or

very close-knit social network [Fukuyama, 2011]. This makes it unlikely that the reliance on social ties for business transactions will diminish significantly due to the recent market reforms and urbanization. The weak legal system and state dominance in the economy further elevate the importance of social ties in enforcing contracts privately, rather than through well developed markets and courts, and in building connections with the government for seeking protection and political rents.

These political ties for Chinese listed firms are found to have great values in a recent paper in which Hung et al. [2015] examine corporate scandals. Instead of directly testing the value of these existing ties between the politically connected firms, they examine if the disruption of these political ties are associated with any significant decline in the firms' stock prices. They operationalize the test by investigating the stock price reaction to various types of corporate scandals. They find that the market responds significantly more negatively to scandals that disrupt the firms' relationship with the government than to scandals that damage the firms' market credibility. They argue that the relative weight that the market puts on these scandals reflects that listed firms still rely more on relational rather than arm's-length contracts. Thus, having government support and protection is more important than market credibility to enforce contracts.

There are still many unanswered questions concerning the role of network ties that are embedded in the unique institutional environment of China. How are social ties used in developing political connections? How do politicians develop political networks with bureaucrats in the SOEs, and with entrepreneurs in the non-SOEs? These questions are particularly important to China because, compared to the U.S., China does not have an open system and a set of well-defined rules for the public to participate in making political contributions and electing government officials. Instead, they rely on social and political ties to build such connections. As discussed in the previous subsection, China adopts a norm-based rather than a rule-based system to discipline politicians and government officials against corruption and political rent seeking. This will lead to further differences between China and the U.S. in incentives and rent seeking behaviors of the politicians and business leaders.

Another important issue for social networks is the agency conflicts deriving from the malfeasance of social ties documented in [Gao et al. \[2014\]](#), which are rooted in China's social structures and culture [[Fei et al., 1992](#)]. These agency conflicts between close-knit in-groups and outgroups are also often found in China's factional politics [[Shih, 2004](#), [Shih et al., 2012](#)]. In this respect, the following questions are important: How widespread are these agency conflicts in the listed firms of China? Do they significantly hamper the value of social ties in serving as an informal substitute for contracts and information transfer? More generally, under what conditions do social ties lead to malfeasance? How do we mitigate such malfeasance? Do firms set up mechanisms to reduce the agency problem resulting from such malfeasance? These questions also lead to a more general set of questions about the role of social ties in China. Can these alternative mechanisms replace market institutions? Under what conditions do they work well and under what conditions they fail?

The biggest challenge of conducting empirical research that attempts to address these questions is the limitation of data. [King et al. \[2014\]](#) have made an attempt to construct a detailed dataset of the network ties between corporate executives and directors of all the listed firms and the politicians at the city government to the central government level. Centrality measures [[Burt, 2009](#)] are used for capturing the strengths of their network ties. The dataset allows them to construct these ties based on business, social, and political relationships between the corporate leaders and politicians.

With the availability of textual analysis tools, future research can also dig deeper into these network relationships that are unique to the Chinese culture. For example, according to [Hwang \[1987\]](#), the norms of *bao* (the social obligation to pay back) are much more intense in China. The idea of obligations in social capital is a universal concept but *bao* is much more emphasized in China. Also, the norms of reciprocity are much more socially situated than those in the western context. That is, the hierarchical network of *guanxi* heavily shapes reciprocity. We could use computer technology to obtain detailed information about the ties between corporate leaders and politicians and the intensity of

their social relationships. We could also look at their relative social standing within the networks by tracking the social activities of these individuals.

#### **4.4 The role of the media and financial and information intermediaries in corporate governance**

The Chinese government realizes the importance of the media and other information intermediaries in the economic reforms and especially in the establishment of the stock markets. Over the past two decades, the government actively reformed the media industry to increase the information flow in the economy and developed a mutual-fund market to provide more stability in the stock markets. This subsection reviews a number of recent papers that study the incentives and roles of these intermediaries and raise some questions for future research on corporate governance and accountability.

##### **4.4.1 Commercialization, conglomeration and credibility of media coverage**

[Piotroski et al. \[2015b\]](#) examine whether the Chinese government's recent commercialization and conglomeration reforms achieve the balancing act of increasing the credibility of corporate news by injecting market incentives into state controlled newspapers on the one hand, and heightening control of these newspapers on the other. Compared to official newspapers that serve as the government's mouthpiece, commercialization has created business newspapers that primarily respond to market incentives, while conglomeration merges official newspapers with the newly-created business newspapers under the same news groups. Using textual analysis techniques on close to 1.8 million articles, they find that business newspaper articles have a less positive tone and political slant than official newspaper articles, suggesting that commercialization increases news credibility and attenuates state influence. They also find that the difference in the tone and political slant between business and official newspapers is magnified in conglomerated newspapers, which is consistent with the notion that this reform

simultaneously enhances both the political role of official newspapers and the credibility of business newspapers. These results are confirmed when they use stock returns to capture the effects of the two reforms on the tone of the newspapers.

This research raises a number of issues about the potential corporate governance role of China's official and business newspapers. Future research should focus on whether the observed increase in news credibility significantly enhances the information environment of the capital market in China. Questions to ask are: Do these reforms reduce information asymmetry of the listed firms and/or improve the stock price formation process? Does the reduction in positive bias suggest that business newspapers provide more critical reports of listed firms and perform a governance role in monitoring the controlling owners and managers? Although the official papers are more political and positively biased in their reporting, do they serve as important public official channels to provide policy directives and even strategic guidance for the listed firms?

#### **4.4.2 Financial analysts and institutional investors**

Financial analysts can play an important corporate governance role by providing timely information for investors to make investment decisions. The evidence in [Li et al. \[2014\]](#) suggests that in China, where relational contracts have significantly constrained firms' ability to engage in public disclosures, financial analysts can make use of their social ties to obtain private information from the firms. This dependence on network ties rather than using public sources and independent research for information raises doubts about whether Chinese financial analysts can serve as monitors independent from the management. Another force that potentially weakens analysts' role as monitors is the mutual funds. Both [Gu et al. \[2012\]](#) and [Firth et al. \[2013\]](#) document that through their trading commission fees in the brokerage firms, mutual funds put pressure on these firms' sell-side analysts to issue optimistic opinions to support their stock positions.

There is also evidence suggesting that Chinese institutional investors may not be able to serve as monitors for the listed firms.



As discussed earlier, [Gao et al. \[2014\]](#) find that weak corporate governance of mutual funds leads to fund managers exploiting their social ties with investees for opportunistic behavior. Only by increasing the corporate governance of the mutual funds can we reduce this malfeasance caused by social ties between mutual fund managers and their investees.

However, [Firth et al. \[2010\]](#) have documented a potential conflict of interests between the mutual fund managers and the fund holders that may be much more difficult to solve than the malfeasance in social ties found in [Gao et al. \[2014\]](#). [Firth et al. \[2010\]](#) examine the amount of new shares given by the controlling owners to the individual shareholders in the split-share structure reform as a compensation for the cost of share dilution when the non-tradable shares are sold in the market. They find that the compensation is higher for SOEs than non-SOEs, since the state has incentives to complete the split-share reform quickly. However, evidence shows that the positive effect of state ownership on the compensation is mitigated by the stock ownership of the mutual funds. This is consistent with the state putting pressure on mutual funds to vote in favor of its proposal at the expense of the fund holders. This result reveals the amount of influence the government has on the mutual funds, and raises doubts about how the fund managers can ever serve as monitors of listed SOEs. Given this political influence that limits the monitoring role of financial analysts and mutual funds, future research should examine whether and under what conditions these intermediaries play the corporate governance role as their counterparts do in the U.S.

#### **4.5 Corporate governance issues of non-SOEs**

As discussed in the beginning of this section, the Chinese government is planning to engage in liberalization reforms that will increase the number of non-SOEs or privately controlled firms in the stock markets. This will lead to a rising of privately controlled listed firms in the Chinese market and will open up new opportunities for future research. These firms are typically family controlled or in the hands of entrepreneurs.

Their governance issues are not too different from those in East Asia, which have been extensively studied in the aftermath of the Asian Financial Crisis. One distinguishing feature of China's privately controlled firms is that they operate and compete in markets that are still heavily controlled by the state with many of their major competitors being SOEs. This suggests that the privately controlled firms are even more dependent on the government than their East Asian counterparts. These political connections can generate political rents to the firms, but they can also create political risks, and even loss of property rights. Another cost of seeking political relationships is that the firm needs to remain opaque and the controlling power has to be concentrated so that the owner can easily exchange favors with politicians. All these would create governance challenges to the firms as the stock markets demand more investor protection and transparency.

Another emerging topic involves the government's recent promotion of indigenous innovation. In 2006, the State Council of the central government issued the Medium-and-Long-Term Plan for Innovation from 2006 to 2020. Fang et al. [2015] find that after 2006, the patenting rate and R&D investments of the listed firms increased significantly, and the rate of increase is significantly larger for non-SOEs than SOEs. This evidence supports the argument in Section 3 that state ownership lacks the high-power incentives due to poorly defined property rights. Also, innovations is nurtured better through arm's-length contracts in a market- or rule-based system rather than in an authoritarian, though flexible, norm-based system. Shleifer and Vishny [2002] argue that the politics of bureaucracy create barriers against innovations. Politicians and managers of influential SOEs often lobby to retain monopoly rights by setting up barriers against any creative destruction of the innovations that transfer their economic rents from the firms to the consumers. Given these negative arguments against innovations by the SOEs, can there be real innovative activities that are orchestrated by the government in the private sectors? The government has devoted a great amount of resources in the form of direct subsidies, tax breaks, discounted loans, land grants, and it even set up investment funds to promote innovations. Do these efforts end up being used for politicians'

private benefits or do some of them have significant economic payoffs? Does China's private sector take advantage of these policies to create and innovate in a market that is dominated by SOEs and, if so, how? Under what conditions does the government serve as a helping hand in promoting innovation in China?

Finally, the policies of deregulating the IPOs and allowing a free flow of equity investments in and out of China would have significant governance implications for the domestically listed firms. Can the government simply rely on the CSRC to enforce investor protection or can the Chinese courts take more of the responsibility? Given the absence of an independent judiciary in China, can the courts uphold their objectivity and provide unbiased judgment even against large SOEs? Do privately controlled firms capitalize on the liberalization policies and lobby for a market infrastructure that promote transparency and corporate governance, and level the playing fields for all the firms? Furthermore, with the increase in foreign institutional investors and the ability of mainland shareholders investing in overseas equity markets, the corporate governance and accounting system of Chinese listed firms will have to adopt mechanisms to protect minority shareholders and engage in more public communication. How do these new policies affect listed firms' corporate governance, accounting system, the role of auditors, and other information and financial intermediaries? Will the privately controlled firms be most responsive to these changes and capture a larger share of the benefits from the liberalization reforms? These are all important questions that need to be addressed in future research.

#### **4.6 Challenges in applying Anglo-American-based accounting standards to a relationship-based governance system**

In this subsection, I will discuss the institutional constraints that hinder the application of IFRS in Chinese listed firms and then propose a few directions for future research. Since accounting is part of a firm's governance and organizational design to reduce its agency conflicts [Jensen and Meckling, 1976, Watts and Zimmerman, 1986, Kothari et al., 2010],

this research agenda will shed light on how to enhance a firm's accounting quality and strengthen its role in corporate governance in China. A more detailed discussion about the relation between institutions and the information environment of listed firms in China can be found in [Piotroski and Wong \[2012\]](#). In this subsection, I will focus more on the governance role of accounting rather than the firms' general information environment, and examine how the institutional constraints that are discussed in Sections 2 and 3 shape firms' corporate governance through their impact on accounting.

The first constraint is the contracting environment in China, which is relationship-based rather than market-based. This is particularly problematic for SOEs, which are primarily operating within a large network of firms with the government as the controlling owner and coordinator. Their transactions are mostly related-party rather than arm's-length. This creates a number of challenges to the accounting of these transactions. First, the transactions are not easily verifiable because they do not necessarily have market prices or fair values. Second, the business relationship between the two parties in each transaction is not at arm's-length and highly specific. It is hard to find a comparable transaction in the market. Third, the transactions involve two connected parties over multiple periods so it is hard to settle the score in one period. A loss in this year may lead to a gain in the next year and vice versa. However, proper accounting and valuation of these transactions requires private information about the relationship of the two connected parties and the true intentions of the government if they are SOEs. This may lead to accounting records not reflecting the true long-term value of the transactions. Finally, government contracts are highly relational and subject to frequent changes. As discussed in Subsection 4.2, the government adopts a norm-based approach in managing the SOEs and can renege their contracts in response to macro shocks.

Thus, understanding the transactions' true implications requires in-depth studying of the networks within the related parties and the intention of the ultimate controlling parties and their incentives, especially when they involve the government. One example of the challenge

from the relationship-based contracting in China is the application of fair value to the balance sheet items of listed firms. [He et al. \[2012\]](#) find that listed firms in China use fair value of exchanged assets between two related parties to manipulate earnings to meet the government's regulatory thresholds.

Another key constraint in the application of the Anglo-American accounting standards is a firm's political incentive to suppress bad news. As discussed in the previous subsection, [Piotroski et al. \[2015a\]](#) find evidence consistent with the idea that political events heighten firms' incentives to suppress bad news. [Ball et al. \[2000a,b\]](#) also find that listed firms report significantly weaker timely loss recognition than U.S. firms. The incentives to defer or suppress bad news is likely to be more acute in China because local government officials view the listed firms under their control as a way to signal the economic achievements of the jurisdiction.

Finally, as discussed in Sections 2 and 3, the Chinese government uses an administrative governance approach instead of a market approach to allocate resources in the stock markets. Due to the lack of manpower and the ease of administration, the CSRC uses bright line rules of accounting targets to regulate the listed firms, especially when selecting firms for IPOs and subsequent share issuances. This creates serious accounting manipulation incentives around the earnings targets. One reason is that the regulators cannot detect all the firms that manipulate earnings due to the high information cost when discovering the violators. Another reason is that the regulators condone some of these accounting discretions. The local governments may have strong needs to promote their SOEs and help them to raise financial resources. They can even provide resources that the listed firms need to meet the earnings targets.

There are three potential directions for studying the challenges in the application of the Anglo-American accounting standards in China. First, it is important to understand how relationship-based contracts affect the various balance sheet accounts and the recognition of revenues and expenses in a Chinese firm. For example, the terms for the relational transaction can be implicit and vague, which challenge the

fundamental accounting concept of verifiability. This will also create risks for the auditors in evaluating clients' transactions that derive from these relational contracts. Second, as argued earlier, the one difficulty in properly valuing related-party transactions is the opacity of the network relationship between the two engaging parties, which can have a first-order effect on the transaction price and on whether the transactions only last for one-period or over multiple-periods. We can make use of the network database discussed in Subsection 4.3. or develop other databases of the network relationships of the firms to address these research questions. Finally, the incentives of politicians have first-order effects on accounting properties such as earnings suppression and timely loss recognition. How do these political incentives actually affect the application of IFRS in Chinese listed firms? How do managers, auditors and institutional investors respond to the government's interventions that could distort the application of IFRS? In Section 4, we have discussed how politicians' and managers' agency conflicts with the government as the controlling shareholder affect firm value. Can the controlling shareholders and securities regulators make use of the Anglo-American accounting standards to alleviate the agency conflicts with the politicians and managers?

# 5

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## Conclusion

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This monograph reviewed the research on the corporate governance and accountability of Chinese listed firms and proposes a number of new research directions on this topic. Using a top-down framework of analysis in linking a country's political economy, law, and social norms to its firms' governance and accountability, this monograph aimed to show that there are unique underlying causes for the differences and the challenges in governance and accounting practice in China, and explored possible alternative approaches, other than the Anglo-American system, that are optimal to its institutional environment. For these corporate governance and accounting systems to operate efficiently, they must fit the firms' unique environment that is shaped by China's most fundamental institutions.

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