

Chapter 3

**CHINESE CORPORATE GOVERNANCE
DEVELOPMENT: RELATED PARTY TRANSACTIONS
AND THEIR GOVERNANCE**

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Abstract

This chapter reviews the contemporary corporate governance framework in Chinese listed firms after the substantial financial reform in 2005. The author classifies corporate governance mechanisms of Chinese listed firms into (1) ownership structure, (2) internal management structure and (3) external corporate governance mechanisms. This chapter also reviews related party transactions of Chinese listed firms from 2007 to 2011.

Previous studies document that the ownership of Chinese listed firms was highly concentrated in the hands of single large shareholders; however, after share reform, their ownership remains the same. Nevertheless, related party transactions are still common in Chinese listed firms after the financial reform in 2005, and in some cases, they amount to a significant portion of normal business operations of Chinese listed firms.

We expect that the privatization of Chinese listed firms; the increase in product competition and the adoption of the Western model into the Chinese institutional framework can positively develop China's stock market and aim at the protection of minority shareholders.

Keywords: Corporate governance, Chinese listed firm, related party transactions

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1. Background

1.1. Historical Development

A stock market began to develop in China¹ following the economic reform in 1978. There are currently two stock exchanges, one situated in Shanghai and the other in Shenzhen, which were established on November 26, 1990 and December 1, 1990, respectively.

Chinese listed shares can be classified according to the residency of their owners as “A shares” for domestic residents or “B, H, and N shares” for foreigners. A and B shares are listed in China. A shares are available exclusively to domestic investors, and are denominated in the Chinese currency RMB. B shares, which are denominated in U.S. dollars (Shanghai) and Hong Kong dollars (Shenzhen), were only available for trade by foreign residents, and until 2011, the B-share market was opened to individual domestic investors. H shares are listed on the Hong Kong Stock Exchange and N shares are traded on the U.S. stock exchanges in the form of American Depository Receipts (ADRs), respectively. Nevertheless, all shares of Chinese listed firms have the same voting and cash flow rights by law.

As of May 31, 2013, the aggregate of Shanghai and Shenzhen Stock Exchanges has become the largest stock market in Greater China and in Asia in terms of monthly turnover and market capitalization, as shown in Table 1. By May 31, 2013, there were 2,577 listed firms in China, including 82 dual-listed in Hong Kong². In view of the significant number of listed firms, market capitalization and turnover, China, more precisely Shanghai, has become one of the leading global financial centers in the world.

Table 1. Comparison of the major global securities markets

| Name of Stock Exchanges | Number of listed firms | Monthly turnover (US\$ Billion) | Market capitalization (US\$ Billion) |
|-------------------------|------------------------|---------------------------------|--------------------------------------|
| New York | 2330 | 1220.7 | 15870 |
| Nasdaq | 2579 | 845.2 | 5280 |
| London | 2736 | 201.7 | 3828 |
| Euronext | 1061 | 141.1 | 3037 |
| Tokyo | 2321 | 789.4 | 2975 |
| Hong Kong | 1563 | 112.5 | 2873 |
| Shanghai | 954 | 340.5 | 2646 |
| Shenzhen | 1537 | 388.1 | 1393 |

(Source: The official website of the Taiwan Stock Exchange Corporation, www.twse.com.tw)

Since 2000, the concept of corporate governance was introduced in China in the form of listing rules and codes of practices. However, the institutional framework in relation to investors' protection in China was weak as there were a series of corporate scandals, including accounting frauds and embezzlements by the controlling (largest) shareholders³ and

¹ The term, “China”, in this paper does not include Hong Kong, Macau and Taiwan.

² These figures were extracted from the official website of the China Stock Markets Web of the Hong Kong Exchanges and Clearing Limited.

³ It is commonly believed that these two terms, “controlling shareholder” and “largest shareholder” can be used interchangeably. However, Chinese Company Law (2005) clearly states that a controlling shareholder is one

senior management in relation to Chinese listed firms; however, the regulators rarely investigated and prosecuted the related offenders.

For example, in 2005, the Beihe Local Government investigated the overstatement of revenue in Beihe Yinhe Hi-Tech Industrial Co. Ltd. (stock code: 000806) for the years 2002 and 2003, but regulators did not prosecute the firm or any management for that accounting fraud⁴.

Since 2005, substantial financial reform took place in China, including: (1) the Company Law and the Securities Law, which were amended in 2005 and effective in 2006, (2) the introduction of a share reform scheme (converting the non-tradable shares into tradable ones) since 2005, (3) the introduction and intensification of the Qualified Foreign Institutional Investor Scheme (commonly known as QFII) into the Chinese A-share market in 2006, and (4) the harmonization of Chinese Accounting Standards for Business Enterprises (CAS) with International Financial Reporting Standards (IFRS).

1.2. Corporate Scandals in Chinese Stock Market

In order to retain the control of those Chinese listed firms, a typical Chinese listed firm has two classes of shares: tradable and non-tradable shares. Normally, the largest (controlling) shareholders hold about 40% of ownership of listed firms before the share reform (i.e. concentrated ownership in the hands of the largest shareholders).

The largest (controlling) shareholders and the governments mostly hold those non-tradable shares (including state shares and restricted institutional shares), which could not be freely disposed of in the stock exchanges for cash, and those shares could only be transferred privately or through irregularly scheduled auctions.

Several domestic and foreign scholars have investigated corporate cases in relation to financial frauds; tunneling and earnings management involving listed firms based on the firm's data before the financial reform in 2005 (e.g. Jian & Wong, 2008; Jiang, Lee & Yue, 2010).

Typical corporate scandals in China include: Northeast Electrical (previous H-share Stock code: 0042; previous A-share Stock code: 000585), Sanju Medical & Pharmaceutical (stock code 000999), Guangxia (Yinchuan) (previous stock code 000557), Wuliangye (stock code 000858).

In those listed firms, their largest shareholders tunneled and used the funds to pay for the pensions and welfare of past employees (e.g., Northeast Electrical used its funds to support the expenditure of local government from 1999 to 2001) and to support the business expansions of their parent companies (e.g., Sanju Medical & Pharmaceutical), etc. Most of those Chinese listed firms were under the control of state-owned enterprises (SOEs).

These studies demonstrate that the protection of minority interests is also in doubt as there is strong empirical evidence showing that controlling shareholders tend to take

who holds more than 50% of the equity interest and/or voting rights of a company. (Article 217(2)) whereas a largest shareholder who holds a very small amount of voting rights cannot control the firm (e.g. at Minseng Bank, the largest shareholder only held 4.7% of ownership in 2012). The author cautiously considers the use of these two terms in this chapter.

⁴Source: CSRC Administration Penalty Decision on Hua Yin CPA Co Ltd on miscount in Beihai Yinhe Hi-Tech Industrial Co Ltd (20/2011), available from the website: www.csrc.gov.cn/pub/zjhpublic/G00306212/201107/t20110707_197224.htm, accessed on August 6, 2013. (in Chinese).

advantage of Chinese listed firms through related party transactions (RPTs)⁵, especially in emerging markets where the legal protection of investors is weak (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 2002; Peng, Wei & Yang, 2011). Wuliangye, which has been heavily tunneled by its controlling party but is still operating and profitable, is an exceptional case.

As mentioned in the previous section, substantial financial reform took place in China. SSE (2012) states that after the completion of the share reform scheme, the non-tradable shares (held by the controlling shareholders) were converted into tradable shares and therefore, the interests of those controlling shareholders in the listed firms have been changed from the book value of the firms to the market value of the listed shares. If the controlling shareholders engage in RPTs to expropriate their controlled firms, such effect would also deteriorate the value of the listed firms, resulting in the deterioration of interests of both controlling and minority shareholders. In addition, the major changes concerning the law and regulations of internal corporate governance and transparency of corporate information, which are related to the corporate governance, are shown as follows:

First, with the revision of the Company Law and the Securities Law in 2005, which were effective in 2006, the principles of corporate governance in listing rules and administrative regulations have been formulated into part of the legal system, mainly for the regulation of stock market and the protection of minority shareholders. For example, Chapter 4.5 of Company Law (2005) regulates the organization structure of listed firms, including Article 125, which requires the approval of RPTs by unrelated directors in the board meetings; Chapter 11 of Securities Law (2005) imposes civil and criminal offenses to the controlling shareholders, directors and officers of listed firms involved in corporate frauds.

Second, effective from 2007, the adoption of new financial reporting standards, CAS, and the statement of auditing standards (consistent with international professional practices) improves the disclosure and standardization of information content of the financial performance of Chinese listed firms and the audit quality of local auditors. The author expects that the increase in information dissemination of Chinese listed firms can reduce the likelihood of tunneling effects (see OECD, 2012⁶).

Third, after the completion of share reform, the non-tradable shares are converted into tradable ones on the stock exchange, and therefore the largest shareholders can readily realize their shares in Chinese listed firms for cash, reducing the likelihood of tunneling the resources under their control.

Fourth, in 2006, Chinese stock market was scrutinized by sophisticated foreign investors under QFII scheme. In addition, CSRC and two stock exchanges have regularly been enacting several administrative rules and regulations aiming at the improvement of corporate governance framework in China in line with international trends.

⁵In accordance with Chinese Accounting Standard No. 36 and the respective listing rules of Shanghai and Shenzhen Stock Exchanges and Measure on Information Disclosure of Listed Companies (CRSC Order 40, 2007), the term, related party, includes those controlling the firm, and those under the same control, the directors, supervisors and senior executives of the firms and those shareholders holding 5% or more of the shares of the firms, and related party transactions are those between the firm and its related parties. This chapter only focuses on those related party transactions between the firm and its largest shareholder because other related party transactions (i.e. those with the related parties other than the largest shareholder) are more likely to be restricted by the largest shareholder if they are unfavorable to the firm and the largest shareholder.

⁶OECD (2012) reports that the disclosure and transparency of RPTs (through the application of IFRS and related rules and regulations) have been adopted in several countries for minority protection.

Accordingly, it is generally believed that the corporate governance framework of Chinese listed firms would have been improved and strengthened. This chapter aims to review the key corporate governance framework of Chinese listed firms and the trend of normal RPTs in contemporary Chinese listed firms based on the firm's data between 2007 and 2011 from the CSMAR database.

From the above database, there were 9,461 firm-year observations. 160 firm-year observations in the financial sector⁷ and 2,168 firm-year observations with incomplete information were removed. Accordingly, there were 7,133 valid firm-year observations in this study and the details of those firms classified by industry sector are presented in Appendix 1.

2. Corporate Governance Framework of Chinese Listed Firms

The Organisation for Economic Co-operation and Development (OECD) provides six principles of corporate governance, namely, (1) ensuring the basis for an effective corporate governance framework⁸, (2) the rights of shareholders and key ownership functions, (3) the equitable treatment of shareholders, (4) the role of stakeholders in corporate governance, (5) disclosure and transparency, and (6) the responsibilities of the board (OECD, 2004).

The first principle is related to the institutional framework whereas the other five principles (corporate governance mechanisms) can be further reclassified as (1) ownership structure, (2) internal management structure and (3) external corporate governance mechanisms. In line with the six principles provided by OECD, this chapter classifies corporate governance framework into two key elements: (1) legal and regulatory framework and (2) corporate governance mechanisms.

2.1. The Legal and Regulatory Framework

There is a three-tier legal and regulatory framework in the Chinese stock market, composed of (1) the national congress, (2) administration departments, and (3) stock exchanges, which are summarized in Table 2:

There are, in principle, a comprehensive set of laws, rules and regulations in the institutional framework to protect the interests of shareholders and investors in China. First, the Constitution (2004) states that the state protects the rights of citizens to own lawful earned income ... and other property (Article 13).

Second, General Principles of the Civil Law (2009) provides the regulatory framework of the lawful civil rights and interests of citizens and legal persons (Chapter III).

Third, Company Law (2005) is enacted in order to standardize the organization and activities of all Chinese enterprises, to protect the legitimate rights and interests of enterprises, shareholders and creditors, to maintain the socio-economic order and to promote the development of the socialist market economy (Article 1).

⁷ The author adopted the general academic practice of eliminating financial sector firms (Industry Code I), possibly because there are additional rules and relations governing those firms.

⁸ This principle illustrates that the corporate governance framework should promote transparent and efficient markets, be consistent with the rule of law and clearly articulate the division of responsibilities among different supervisory, regulatory and enforcement authorities (OECD, 2004, P. 17).

Specifically, Securities Law (2005) is formulated for the purpose of regulating the issuance and transaction of securities, protecting the lawful rights and interests of investors, safeguarding the economic order and public interests of the society and promoting the growth of the socialist market economy (Article 1).

Table 2. The current legal and regulatory framework of Chinese listed firms

| Key Bodies | Roles | Key Documents |
|--|---|--|
| Applying to all firms: | | |
| National People's Congress | Legislature | The Constitution (Revised in 2004) General Principles of the Civil Law (Revised in 2009) Company Law (Revised in 2005) |
| Ministry of Finance | Government policy bureau that facilitates and coordinates initiatives to improve overall market quality; reviews and drafts proposed amendments; and acts as the administrator and law enforcer | Accounting Law (Revised in 1999) Securities Law (Revised in 2005) (for those offering shares and debentures to public) China Accounting System for Businesses (Issued in 2006) Several notices of the Ministry of Finance |
| State-owned enterprises (SOEs): | | |
| State-owned Assets Supervision and Administration Commission | Administering the state-owned enterprises and assets | Internal documents |
| The listing regime: | | |
| China Securities Regulatory Committee | Regulating, facilitating and encouraging the development of the securities and related markets | Regulations |
| Shanghai Stock Exchange and Shenzhen Stock Exchange | Operating and regulating a securities market Administering a disclosure-based regulation of listing | Listing Rules (currently 2012 version) issued by two exchanges Codes and regulations |

However, under the transformation from planned to market economy in China, political influence on the Chinese stock market and listed firms is still serious. Wong (2006) states that the Chinese stock market was organized by the government as a vehicle for her SOEs to raise capital and improve the operating performance of those SOEs. Where the state acts as the largest shareholder in a listed firm, it can in principle lead to the following agency problems:

1. conflict between managers and shareholders (Jensen & Meckling, 1976; Shleifer & Vishny, 1997); and
2. conflict between controlling shareholders and minority shareholders (La Porta et al., 2002; Jiang et al., 2010).

The public believes the institutional frameworks for the protection of investors' interest in China is weak and immature. Besides, Kaufmann, Kraay and Mastruzzi (2009) find that two Worldwide Governance Indicators, "Regulatory Quality" and "Rule of Law", in China are substantially lower than those in Greater China and other developed countries⁹ and are below average (i.e. less than zero).

Furthermore, even though Article 3 of Securities Law (2005) mentions the principles of *openness, fairness and impartiality* for Chinese listed firms, these principles have not been achieved in the Wuliangye case and other corporate scandals, as evidenced by (1) the governing bodies and officials rarely investigate and prosecute corporate scandals¹⁰; (2) the disclosure of information content in relation to the firm's operations and other important issues is incomplete (Lee & Song, 2009); and (3) most Chinese listed firms are integral parts of business groups of their controlling shareholders (see the Wuliangye case).

2.2. Corporate Governance Mechanisms

Jensen and Meckling (1976) illustrate the circumstances of contemporary listed firms and those with external finance because there is strong evidence of the separation of control and ownership. Fama and Jensen (1983) also identify that the efficient control of agency problems is strongly affected by the size and nature of the organization. However, studies focusing on common law jurisdictions have not been able to generalize their findings on countries with different legal systems, such as code-law countries, or to giant emerging markets, such as China, because the ownership structure of Chinese listed firms is highly concentrated as compared to that of Anglo-American listed firms (see Section 2.2.1).

Nevertheless, a number of studies of Chinese listed firms have found a positive association between the levels of corporate governance and enterprise valuation (Chen, Chen & Zhu, 2004; Bai, Liu, Lu & Song, 2004; Leung & Cheng, 2013). Liu and Zhang (2010) further classify contemporary corporate governance, by country-level, into (1) Anglo-American Model, (2) Continental Model and (3) Chinese Family Model as shown in Table 3:

In summary, corporate governance mechanisms (CGMs) can be divided into internal corporate governance mechanisms (consisting of ownership structure and internal management structure), and external corporate governance mechanisms as illustrated in the following diagram:

⁹For example, these two indicators, Regulatory Quality and Rules of Law for Hong Kong [and China] in 2008 amounted to 2.00 [-0.22] and 1.56 [-0.33], respectively.

¹⁰For example, in October 2005, the Ministry of Finance issued a notice concerning the quality of listed firms. This notice required that all advances made by the listed firms to their related parties had to be fully settled prior to December 31, 2006. However, in January 2007, there were 17 listed firms (including five firms controlled by SOEs) in which their related parties had not yet fully repaid the amounts due to those listed firms, but no administrative punishments nor prosecutions were made with respect of such non-compliance.

Table 3. Contemporary corporate governance mechanisms by country-level

| | Anglo-American Model | Continental Model | Chinese Family Model |
|------------------------------------|--|---|--|
| Ownership structure | Widely dispersed | Concentrated and mainly owned by institutional investors and/or banks | Concentrated and mainly owned by a single substantial shareholder |
| Board structure | One-tier | Two-tier | One board of directors (independent directors in listed companies), and supervisor(s) in the companies limited by shares (joint stock companies) |
| Incentive scheme | Appreciation of share price, dividend, and options | Esteem and loyalty | Mainly appreciation of share price and dividend |
| Corporate Governance ("CG") system | Market-oriented CG system; being taken over in case of failure | Bank-oriented CG system; infrequent MBO and takeover | Government-oriented CG system; being bankrupted in case of failure |

(Adapted from Liu & Zhang, 2010, page 273)

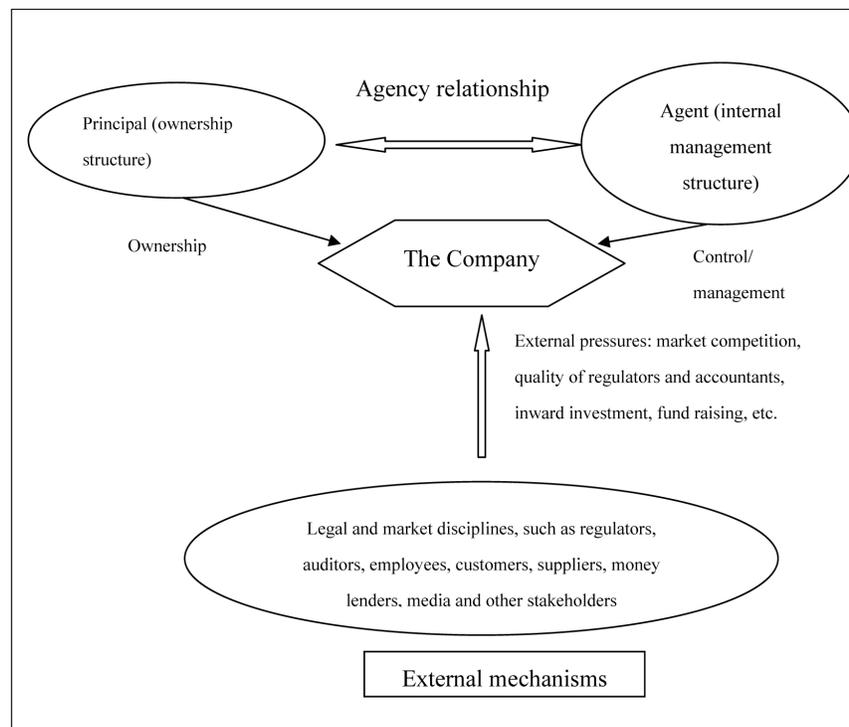


Diagram 1. Corporate governance mechanisms in contemporary listed firms.

2.2.1. Ownership Structure

Different from Anglo-American listed firms, the ownership structure of Chinese listed firms is highly concentrated and state ownership accounted for a significant portion. Tam and Yu (2011) state that where concentration of state control in Chinese listed firms is higher; the major governance problems are generally centered around the issue of state ownership, insider control and the weak enforcement of law and regulations.

La Porta, Lopez-de-Silanes and Shleifer(1999) reveal that the ownership structures of listed firms in common law jurisdictions are more dispersed than those of listed firms in code-law jurisdictions and emerging markets. Chen et al. (2004)described that ownership structure is a key corporate governance mechanism in Chinese listed firms.

The ownership structure of Chinese listed firms before the share reform is shown in Table 4. Before the share reform, about 60% of the shares of Chinese listed firms were held as non-tradable; and the controlling shareholders held 40% of them. More importantly, most Chinese listed firms were spun-off from the SOEs for IPOs and are then substantially held by the government, being the controlling shareholders of these firms. As the state (government) acts in two roles (as a controlling shareholder and a regulator), it is uncertain whether the state can effectively enforce the law and monitor the fraudulent acts of the controlling shareholders, which are unfavorable to other shareholders.

Further, in the study by Li and Zhang (2010), in 2001 to 2004 state ownership accounted for over 60% of the ownership structure of Chinese listed firms, while in other key capital markets it was less than 10% (see Table 5).

Table 4. The ownership structure of Chinese listed firms before the share reform

| | | |
|--------------------------------|--------------------------|--------------|
| All shareholders (100%) | | |
| Non-tradable shares (60%) | | Public (40%) |
| Controlling Shareholders (40%) | Other legal-person (20%) | |

(Source: the firm's data from 1999 to 2005 in CSMAR database)

Table 5. The percentage of firms with the state as the ultimate controller

| | China | HK | UK | Germany | Japan | France | Singapore |
|---------------|-------|-------|-------|---------|-------|--------|-----------|
| State (%) | 63.15 | 1.40 | 0.08 | 6.30 | 0.80 | 5.11 | 23.50 |
| Non-state (%) | 36.85 | 98.60 | 99.20 | 93.70 | 99.20 | 94.89 | 76.50 |

(Extracted from Li and Zhang, 2010)

SOEs are considered to be owned by the Chinese people but managed by politicians, resulting in a typical agency problem, i.e., the separation of ownership and control.

For administrative purposes, certain SOEs, particularly the largest ones (hereinafter central SOEs), are under the supervision of central government elements including the State Council, its ministries and the State-owned Assets Supervision and Administration Commission(SASAC). By contrast, many smaller SOEs (herein after local SOEs) are under the supervision of local governments and their respective SASACs.

Under current policy, both the central government and the various local governments are presumed to exercise investors' rights on behalf of the state.

In general, Chinese government establishes a specific regulator, SASAC, to govern the SOEs and state-controlled listed firms (SCLFs). The Research Centre of the Shanghai Stock Exchange(2006) states that the CGMs of central SOEs are better than those of local SOEs, because the largest shareholders of the former do not have strong incentives to expropriate profits and the central government, as the ultimate shareholder, has implemented restrictions on the activities of the largest shareholders.

Further, Leung and Cheng (2013) classified contemporary Chinese listed firms as central SCLFs, local SCLFs and non-SCLFs because their corporate governance mechanisms and those effects on the firm value are different in those three categories with respect to the government's *zhuadafangxiao*¹¹ policy on their governance structures. Some studies (e.g. Tai et al., 2007; Cheung et al., 2009)found that the probability of tunneling (and propping up) is closely related to the ownership structure of Chinese listed firms and the likelihood of the largest shareholders expropriating the listed firms increases in line with the size of the controlling proportion of ownership held by the largest shareholders.

Since January 2004, the State Council in China has been promoting the share reform of Chinese listed firms under which all their shares would become tradable on the stock exchanges.

Table 6. Ownership structure of Chinese listed firms in 2007 to 2011

| | Years | | | | | | | | | |
|---|-------|------|------|------|------|------|------|------|------|------|
| | 2007 | | 2008 | | 2009 | | 2010 | | 2011 | |
| | % | % | % | % | % | % | % | % | % | % |
| Average ownership of the largest shareholders | 36.2 | | 36.5 | | 36.4 | | 36.0 | | 35.7 | |
| Average ownership of the second to fifth largest shareholders | 15.7 | | 14.9 | | 13.8 | | 13.7 | | 13.2 | |
| Average ownership in non-tradable shares | 46.1 | | 39.3 | | 25.0 | | 17.6 | | 13.6 | |
| Average of state ownership | 25.1 | | 21.9 | | 12.8 | | 9.1 | | 6.3 | |
| Average ownership of directors | 2.9 | | 3.3 | | 2.7 | | 2.6 | | 2.5 | |
| | No. | % | No. | % | No. | % | No. | % | No. | % |
| Largest shareholder as government or under government control (SCLFs) | 819 | 57.6 | 778 | 55.2 | 472 | 32.8 | 344 | 24.2 | 267 | 18.6 |

(Source: thefirm's data from 2007 to 2011 in CSMAR database)

¹¹ In general, the business size of central SOEs (under the control of central government) is bigger than that of local SOEs (under the control of respective local governments). Therefore, the government's *zhuadafangxiao* policy means that central SOEs are subject to 'grasp the large' (*zhuada*) scheme in which the state owner retains control while local SOEs are managed under the 'release of the small' (*fangxiao*) scheme (Leng, 2009).

Tam and Yu (2011) state that the share reform is not only significant for freeing two-thirds of issued shares in Chinese stock markets, but could also diminish the dominant position of the state as the owner of listed firms and facilitate an active market for corporate control through mergers and acquisitions. More surprisingly, Table 6 presents that after the share reform, the ownership structure remained the same as the controlling (largest) shareholders still hold, in general, about 36% and it is likely that the controlling shareholders were rarely challenged by other shareholders on important issues since the aggregate of ownership of the second to the fifth largest shareholders is less than 16%. Therefore, the ownership of Chinese listed firms is still highly concentrated in the hands of the largest shareholders. However, the percentages of non-traded and state shares decreased from 46% and 25% in 2007 to 14% and 6% in 2011, as all or part of those ownerships in many listed firms have been restructured and converted into tradable shares under the share reform scheme. It is also noted that the number and proportion of the largest shareholders under state control decreased from 819 and 58% in 2007 to 267 and 19% in 2011.

2.2.2. Internal Management Structure

Internal management structure of a Chinese listed firm includes the boards of supervisors and directors and senior executives. Jensen and Meckling (1976) and Shleifer and Vishny (1997) describe that there is an agency relationship between the board of directors (agent) and the shareholders (principal). Chinese listed firms adopt a two-tier board structure, comprising a board of directors and a board of supervisors; the board of directors is the main decision-making authority while the board of supervisors only monitors the acts of directors and senior executives and calls for the shareholders' meetings if necessary. Since the role of the board of supervisors is not normally involved in the operations of Chinese listed firms, this chapter does not explain it in detail.

The board of directors of a Chinese listed firm is required to include several independent non-executive (external) directors. However, as Capaul (2003) suggests that in reality the majority shareholders appoint directors and believe that their responsibility is towards the constituency that elected them, rather than all shareholders. The average characteristics of the internal management structure of Chinese listed firms are shown in Table 7.

Table 7 presents that (1) not all Chinese listed firms (about 98% in 2011) meet the requirement from Guidance Opinion on Establishment of Independent Director Systems by Listed Companies, issued by the China Securities and Regulatory Commission, which requires at least one-third of the board members to be independent (Paragraph 1(3)); only 83% of these listed firms had the duality of chairperson and CEO as it is a professional recommendation to avoid the dual capacity by the same person; (3) further, the compensation and incentive available to the directors and senior executives was weak in view of the low percentage of shares held by these directors and senior executives, generally less than 3% and 3%, respectively, and most of them are politically appointed (and therefore unpaid) as they are also the directors and senior executives of the largest shareholders as it is evidenced that about one-fourth of directors are unpaid, consistent with Capaul (2003). The traditional agency theory calls for performance-based executive compensation to better align the interest of managers and directors (Tam and Yu, 2011).

Table 7. Internal management structure of Chinese listed firms from 2007 to 2011

| | Years | | | | | | | | | |
|---|-------|------|------|------|------|------|------|------|------|------|
| | 2007 | | 2008 | | 2009 | | 2010 | | 2011 | |
| | % | % | % | % | % | % | % | % | % | % |
| Average ownership of directors | 2.9 | | 3.3 | | 2.7 | | 2.6 | | 2.5 | |
| Average ownership of senior executives (excluding directors) | 3.2 | | 3.6 | | 2.9 | | 2.8 | | 2.8 | |
| Average proportion of external directors on the board | 35.9 | | 36.1 | | 36.4 | | 36.7 | | 36.9 | |
| Average proportion of unpaid directors on the board | 26.9 | | 26.9 | | 25.8 | | 26.3 | | 25.9 | |
| | No. | % | No. | % | No. | % | No. | % | No. | % |
| Separation of chairman and CEO | 1187 | 83.5 | 1188 | 84.3 | 1213 | 84.2 | 1196 | 84.1 | 1190 | 82.7 |
| The portion of external directors meets at least one-third of the board | 1362 | 95.8 | 1364 | 96.7 | 1406 | 97.6 | 1398 | 98.3 | 1406 | 97.6 |

(Source: the firm's data from 2007 to 2011 in CSMAR database)

Since 2005, CSRC issued measures to enable the use of stocks or stock options as incentive for directors and senior executives (e.g. Administrative Rules on Stock Incentives in Listed Companies (Trial)). However, as evidenced from Table 7, low ownership held by directors and senior executives and a higher proportion of unpaid directors may result in lower incentive for them to improve corporate performance.

2.3. External Corporate Governance Mechanisms

External corporate governance mechanisms are mainly the legal and market disciplines. Table 8 describes the descriptive statistics of those key factors of Chinese listed firms from 2007 to 2011.

The numbers and proportions of Chinese listed firms dual-listed in B- and H-shares were insignificant, about 80 (6%) and 50 (3%), respectively, implying that Chinese listed firms are less likely scrutinized by foreign investors who are commonly assumed to be more knowledgeable and experienced in corporate governance¹².

Table 8 presents that (1) less than 7% of Chinese listed firms engaged Big 4 firms¹³ as their auditors. Previously, Chen, Shome and Su (2001) find that the Big 5 (now Big 4) firms in China are more independent than the local audit firms. Simunic and Wu (2009) mention that the quality distinction between Big 4 and non-Big 4 audits is well established in international auditing, but in China, the market share of the Big 4 firms is quite low, and about 6% of Chinese listed firms engage Big 4 firms as auditors, possibly because the engagement of auditors is a highly political issue and Chinese listed firms prefer local

¹²For example, Sharpe and Banerjee (2008) argued that foreign takeovers could lead to improvements in management and corporate governance, even in the privatization of government-owned enterprises.

¹³The term, Big 4 firms, means any of KPMG, PricewaterhouseCoopers, Ernst & Young and Deloitte.

auditors as both the firms and the engaged auditors are in the same province and the local auditors are likely to issue clean audit reports favorable with the local government's influence (Chan, Lin & Mo, 2006). With the accounting convergence and the improvement of audit quality in China in recent years, twelve Chinese audit firms have been allowed to be engaged by Chinese firms listed in Hong Kong¹⁴, and more than 50% of them engaged Big 12 firms as auditors since 2011. Nevertheless, over 90% of their audit reports showed clean audit opinions and they might represent good corporate governance indicators for Chinese listed firms.

Table 8. External corporate governance mechanisms of Chinese listed firms from 2007 to 2011

| | Year | | | | | | | | | |
|--|------|------|------|------|------|------|------|------|------|------|
| | 2007 | | 2008 | | 2009 | | 2010 | | 2011 | |
| | No. | % |
| Dual-listed as B shares | 78 | 5.5 | 78 | 5.5 | 78 | 5.4 | 77 | 5.4 | 77 | 5.4 |
| Dual-listed as H shares | 41 | 2.9 | 44 | 3.1 | 44 | 3.1 | 45 | 3.2 | 47 | 3.3 |
| Engaging Big 4 firms as auditors | 88 | 6.2 | 85 | 6.0 | 81 | 5.6 | 86 | 6.0 | 95 | 6.6 |
| Engaging Big 12 firms as auditors | 321 | 22.6 | 343 | 24.3 | 728 | 50.5 | 719 | 50.6 | 794 | 55.2 |
| With clean audit report | 1397 | 98.3 | 1382 | 98.0 | 1415 | 98.2 | 1396 | 98.2 | 1422 | 98.8 |
| Under special treatment | 99 | 7.0 | 94 | 6.7 | 94 | 6.5 | 94 | 6.6 | 95 | 6.6 |
| Being registered in eastern coastal region | 807 | 56.8 | 818 | 58.0 | 825 | 57.3 | 814 | 57.2 | 822 | 57.1 |
| Profitability | | | | | | | | | | |
| Negative ROE | 133 | 9.4 | 251 | 17.8 | 198 | 13.7 | 132 | 9.3 | 158 | 11.0 |
| ROE not less than 0% and under 6% | 403 | 28.4 | 464 | 32.9 | 481 | 33.4 | 403 | 28.3 | 438 | 30.4 |
| ROE at 6% or more | 885 | 62.3 | 695 | 49.3 | 762 | 52.9 | 887 | 62.4 | 843 | 58.6 |

(Source: the firm's data from 2007 to 2011 in CSMAR database)

As also indicated in Table 8, more than 50% of Chinese listed firms are registered in a developed eastern region¹⁵ where the government's influence is less than those in other regions and where there are quite open commodities and senior personnel markets (Fan, Wang & Zhu, 2007). Therefore, those listed firms in the non-eastern region are likely more politically influenced and engage more in related party transactions with their controlling shareholders.

¹⁴ China incorporated issuers will be able to engage the services of Chinese audit firms who have been approved by the China Ministry of Finance and the China Securities Regulatory Commission as being suitable to act as an auditor or a reporting accountant for these purposes as announced by the Hong Kong Stock Exchange in December 2010. The Big 12 auditors are BDO China Shu Lun Pan, Tian Jian (Pan-China), BDO Guangdong Dahua Delu (Shenzhen), Shine Wing, Ernst & Young, Crowe Horwath, Grant Thornton Jingdu Tianhua, Pricewaterhouse Coopers, Deloitte, KPMG, RSM China and Daxin, which have been allowed by the Ministry of Finance and the Chinese Securities Regulatory Commission to conduct statutory audits on H-share listed firms since December 2010.

¹⁵ Gao and Kling (2008) consider that the eastern coastal area, namely Beijing, Tianjin, Shanghai, Jiangsu, Zhejiang, Fujian and Guangdong are the developed eastern coastal region, which might exhibit better governance structures.

Table 8 indicates that about 10% of Chinese listed firms were under special treatment (ST status)¹⁶ and these firms are subject to more stringent regulatory monitoring (e.g. they have to announce their quarterly financial results and their interim financial statements have to be audited) under ST status and will be involuntarily delisted when they have created losses for three consecutive years (i.e. one additional year after ST status). In accordance with Article 13 of Measures for the Administration of the Issuance of Securities by Listed Companies, a Chinese listed firm is required to meet the average rate of net profit on net assets for the latest 3 years of not lower than 6% for additional fund raising. As indicated in Table 8, about 40% of Chinese listed firms cannot reissue shares for fund raising for those years. Further, about 11% of Chinese listed firms are likely to be under ST status or they are subject to the threat of being delisted if they can no longer resume being profitable.

3. Related Party Transactions in Chinese Listed Firms

A related party transaction (RPT) is defined as a transfer of resources or liabilities between a listed firm (including its subsidiaries) and its related party (Cheung et al. 2009). This chapter reviews RPTs between Chinese listed firms (and their subsidiaries) and their largest (controlling) shareholders (including their controlled entities) because RPTs could constitute the potential for both tunneling and propping up activities by the largest shareholder. On one hand, RPTs may provide direct opportunities for related parties to extract economic benefits from listed firms through tunneling activities (Djankov, La Porta, Lopez-de-Silanes & Shleifer, 2008). On the other hand, RPTs can be used to prop up underperforming firms (Friedman, Johnson & Mitton, 2003), possibly because the largest shareholders have to maintain the listing status of their controlled listed firms and/or enable them for subsequent fund raising.

3.1. Rationale behind the Related Party Transactions and Their Underlying Potential Threats

After the establishment of the two stock exchanges in the 1990s, the Chinese government actively promoted the listing of SOEs for fund raising in order to help these enterprises overcome their financial difficulties. The quality of the assets held by SOEs was highly variable; so many SOEs restructured themselves and spun off their core and high-quality assets in order to implement an initial public offering (IPO), while leaving their non-core assets, debts, and surplus manpower in the residual SOEs. In this way, SOEs were able to improve their chances of a successful listing of the spun-off portion (i.e. listed firms). The residual SOEs (business groups) normally retained control of the newly listed entity as the largest shareholder; however, having spun off their core assets, they were often forced to rely on the listed firms for support. The listed firms could raise capital through subsequent placements and bank loans, and then re-lend the funds to their largest shareholders or their controlled business groups. Alternatively, the listed firm's products might be sold to the

¹⁶In accordance with Article 13.2.1 of listing rules of both Shanghai and Shenzhen Stock Exchanges, a Chinese listed firm that has a negative equity or has been creating losses for two consecutive years is labeled as a ST company.

business groups at unreasonably low prices, or the listed entity might make payments to the business group for “consulting services” when in fact no services had been provided. In some cases, the listed firms even provided collateral to help the business group obtain bank loans. The cost of these RPTs, which hurt the market value of the listed firms, was borne by the smaller shareholders holding tradable shares. Several scholars have addressed the expropriation of minority shareholders through RPTs with the largest shareholders of Chinese listed firms. Liu, He and Wei (2004) study the possible tunneling effect through RPTs at Wuliangye. Tai, Liu and Jian (2007) evidence that the higher the ownership of the controlling shareholders and the larger the size of the controlled firms, the more frequent was the tunneling effect from 2002 to 2004. Cheung et al. (2009) found that minority shareholders in Chinese firms seemed to be subject to expropriation through tunneling but also gained from propping-up (or more appropriately, earnings management) through RPTs in 2001 and 2002. Hu, Shen and Xu (2009) provided further evidence that the higher the level of RPTs, the worse the operating performance of Chinese listed firms from 2002 to 2006. The rationale for tunneling is clearly the expropriation of minority shareholders while that of propping up is to enable the survival of non-profitable listed firms and/or to enable them to meet the profit requirement for subsequent issues of shares for fund raising. Both tunneling and propping-up activities can be regarded as corporate frauds in substance, with the ultimate aim being the expropriation of minority interests¹⁷.

3.2. Overview of RPTs After the Share Reform

RPTs between a Chinese listed firm and its largest shareholder (or the controlled entity of its largest shareholder) can be classified as normal (ongoing or recurrent) and abnormal transactions. Abnormal RPTs include (1) the advances from listed firms to its largest shareholder, which are strongly prohibited in the rules and regulations promulgated by the CSRC and stock exchanges, and (2) the transfer of assets and businesses arising from corporate reorganization, of which material transactions are subject to tight administration procedures (e.g. independent valuation, approval from independent directors and shareholders, etc.) and therefore, they are unusual in principle. Normal RPTs include the sales and provision of services and purchases and receipt of services between a Chinese listed firm and its largest shareholder in the normal course of business because the listed firm and its controlling shareholder (or a business group), and those RPTs may result in tunneling or a propping-up effect. As mentioned in Appendix 1, more than half of the Chinese listed firms are engaged in the manufacturing sector, implying that RPTs may still be a significant bet. Chinese Accounting Standards (CAS) and Chinese Auditing Standards have been converged with International Financial Reporting Standards (IFRS) and International Statements on Auditing effective since 2007, and the disclosure of such RPTs and auditors’ works on RPTs seems to be consistent with international standards. In addition, CAS No. 36 further requests the enterprises to disclose the paid up capital of the related parties and pricing strategies for the RPTs and the auditors are also required to ensure the reasonableness, completeness and

¹⁷Tunneling is a direct expropriation because the firm’s resources are transferred out. Propping-up (or earnings management) is to inflate the firm’s profitability and the share prices for fund raising, and therefore, minority shareholders would have to pay more than the real value of the firm upon the subsequent placement of new shares.

Table 9. Summary of related party transactions from 2007 to 2011

| | Year | | | | | | | | | |
|---|------|------|------|------|------|------|------|------|------|------|
| | 2007 | | 2008 | | 2009 | | 2010 | | 2011 | |
| | % | % | % | % | % | % | % | % | % | % |
| (a) Total Chinese listed firms | | | | | | | | | | |
| Average proportion of downstream RPTs | 4.1 | | 3.8 | | 4.3 | | 4.1 | | 3.8 | |
| Average proportion of upstream RPTs | 4.5 | | 4.5 | | 4.5 | | 4.6 | | 4.4 | |
| | % | | % | | % | | % | | % | |
| (b) Chinese listed firms with downstream RPTs | | | | | | | | | | |
| Magnitudes of downstream RPTs | | | | | | | | | | |
| Maximum | 96.0 | | 92.2 | | 97.3 | | 98.4 | | 99.4 | |
| Minimum | 0.1 | | 0.1 | | 0.1 | | 0.1 | | 0.1 | |
| Average | 7.2 | | 6.8 | | 7.3 | | 6.9 | | 6.3 | |
| | % | | % | | % | | % | | % | |
| Analysis by nature: | | | | | | | | | | |
| Manufacturing sector | 538 | 66.2 | 510 | 64.1 | 537 | 63.1 | 527 | 61.9 | 530 | 61.6 |
| Non-manufacturing sectors | 275 | 33.8 | 286 | 35.9 | 314 | 36.9 | 325 | 38.1 | 330 | 38.4 |
| State-controlled listed firms | 552 | 67.9 | 511 | 64.2 | 337 | 39.6 | 253 | 29.7 | 194 | 22.6 |
| Non-SCLFs | 261 | 32.1 | 285 | 35.8 | 514 | 60.4 | 599 | 70.3 | 666 | 77.4 |
| Total number of listed firms with downstream RPTs (portion of total listed firms) | 813 | 57.2 | 796 | 56.5 | 851 | 59.1 | 852 | 62.7 | 860 | 63.0 |
| | % | | % | | % | | % | | % | |
| (c) Chinese listed firms with upstream RPTs | | | | | | | | | | |
| Magnitudes of upstream RPTs | | | | | | | | | | |
| Maximum | 88.1 | | 81.2 | | 86.0 | | 81.9 | | 91.0 | |
| Minimum | 0.1 | | 0.1 | | 0.1 | | 0.1 | | 0.1 | |
| Average | 7.5 | | 7.3 | | 7.3 | | 7.3 | | 7.0 | |
| | % | | % | | % | | % | | % | |
| Analysis by nature: | | | | | | | | | | |
| Manufacturing sector | 552 | 64.9 | 542 | 62.2 | 551 | 61.9 | 549 | 61.5 | 555 | 61.2 |
| Non-manufacturing sectors | 298 | 35.1 | 330 | 37.8 | 339 | 38.1 | 343 | 38.5 | 352 | 38.8 |
| State-controlled listed firms | 586 | 68.9 | 577 | 66.2 | 357 | 40.1 | 261 | 29.3 | 202 | 22.3 |
| Non-SCLFs | 264 | 31.1 | 295 | 33.8 | 533 | 59.9 | 631 | 70.7 | 705 | 77.7 |
| Total number of listed firms with upstream RPTs (portion of total listed firms) | 850 | 59.8 | 872 | 61.8 | 890 | 61.8 | 892 | 62.7 | 907 | 63.0 |

(Source: the firm's data from 2007 to 2011 in CSMAR database)

accuracy of the information content in the financial statements. The author expects that (1) the magnitudes of RPTs can be reduced; or (2) the tunneling (propping-up or earnings management) effect can be reduced even though the magnitudes of RPTs cannot be reduced. Table 9 indicates the summary of normal RPTs between Chinese listed firms and their largest shareholders from 2007 to 2011. Overall, the average proportion of downstream RPTs (sales

and provision of services from Chinese listed firms to their largest shareholders) and upstream RPTs (purchases and receipt of services from the largest shareholders to their controlling listed firms) is about 4% of the total sales of Chinese listed firms. However, the proportion of the number of Chinese listed firms engaged in downstream and upstream RPTs amount to about 60% of the total population from 2007 to 2011 for those with RPTs with the largest shareholders. The average proportion of downstream and upstream RPTs is about 7% of the total sales of Chinese listed firms and the maximum proportion of those RPTs is 99% of the total sales. Table 9 also indicates that the number of manufacturing and non-manufacturing firms, which engage in RPTs, is consistent over those five years even though there is a trend of privatization. This results in a decrease in the number of SCLFs while there is an increase in the number of non-SCLFs. The total number of those engaging in RPTs remains consistent over that period, and therefore, it is expected that those regulation policies do not restrict the magnitudes of RPTs.

Table 10 presents that SCLFs and those registered in non-eastern coastal regions engage in a higher proportion of RPTs than non-SCLFs and those in eastern coastal regions, respectively, indicating that maybe SCLFs are still, in substance, integral business parts of their largest shareholders. The political influence on Chinese listed firms in those areas is relatively high, consistent with Fan et al. (2007).

Table 10. Magnitudes of related party transactions by state-control and region

| | 2007 | | 2008 | | 2009 | | 2010 | | 2011 | |
|-----------------|----------------|--------------------|----------------|--------------------|----------------|--------------------|----------------|--------------------|----------------|--------------------|
| | SCLFs | Non-SCLFs |
| | % | % | % | % | % | % | % | % | % | % |
| Downstream RPTs | | | | | | | | | | |
| Average | 5.4 | 2.3 | 5.2 | 2.1 | 6.6 | 3.2 | 6.0 | 3.5 | 5.7 | 3.3 |
| Maximum | 96.0 | 93.6 | 92.2 | 89.9 | 97.3 | 95.0 | 96.1 | 98.4 | 99.4 | 87.5 |
| Upstream RPTs | | | | | | | | | | |
| Average | 5.9 | 2.5 | 5.9 | 2.7 | 6.9 | 3.3 | 6.3 | 4.1 | 5.3 | 4.2 |
| Maximum | 88.1 | 71.1 | 74.7 | 81.2 | 86.1 | 80.6 | 71.9 | 81.9 | 77.1 | 91.0 |
| | | | | | | | | | | |
| | Eastern-region | Non-eastern region |
| | % | % | % | % | % | % | % | % | % | % |
| Downstream RPTs | | | | | | | | | | |
| Average | 3.2 | 5.4 | 3.1 | 4.8 | 3.1 | 5.9 | 3.2 | 5.3 | 3.0 | 4.8 |
| Maximum | 85.8 | 96.0 | 88.4 | 92.2 | 91.0 | 97.3 | 91.0 | 98.4 | 78.5 | 99.4 |
| Upstream RPTs | | | | | | | | | | |
| Average | 3.4 | 5.9 | 3.6 | 5.8 | 4.0 | 5.2 | 3.8 | 5.7 | 3.5 | 5.7 |
| Maximum | 88.1 | 78.0 | 81.2 | 74.7 | 86.1 | 82.4 | 81.9 | 73.8 | 85.8 | 91.0 |

(Source: the firm's data from 2007 to 2011 in CSMAR database)

RPTs amount to a significant portion of the normal business activities of Chinese listed firms. It is the government's policy to restrict RPTs with tunneling effects, and permit arm's length RPTs in an open and fair manner. Most Chinese listed firms announce RPT mandates

to increase the transparency of these transactions to the public (i.e. the application of the fifth corporate governance principle of OECD – disclosure and transparency of information content about the company’s operations). These mandates disclosed the details and basis of these RPTs and the opinion of its independent directors on these RPTs.

For example, the material RPTs between a Chinese listed firm and its controlling shareholder has to be reviewed by an independent financial advisor and approved by the directors and shareholders who are not interested in those RPTs (i.e. the related directors/shareholders should abstain in those meetings in which RPTs are reviewed and approved). Most new Chinese listed firms have reorganized their corporate structure before the IPO in order to reduce the magnitudes of RPTs (i.e. the possibility of tunneling and earnings management) and enforce the independence of management hierarchy and business models from their related parties. For example, the core production facilities from the controlling shareholders are merged into the listed entity (holistic listing) to reduce the likelihood of RPTs after an IPO. There have been a number of practical examples in 2008 where Chinese listed firms modified their organizational structures to reduce the magnitudes of their RPTs, including: Shenzhen Auto Electric Power Plant (stock code: 002227), Anhui Jingcheng Copper (stock code: 002171), and Sichuan Chengfei Integration Technology (stock code: 002190). As shown in Appendix 2, the Wuliangye case provides a detailed explanation on the potential threats and the restructuring exercises used for the reduction of RPTs.

However, Chinese regulators and media recurrently report that Chinese listed firms and their controlling shareholders manipulated the profits for IPOs and those controlling shareholders expropriated listed firms through RPTs. For example, in 2013, CSRC investigated Henan Tianfon Energy-saving (an IPO applicant), its sponsor, auditor and lawyer for the submission of incorrect information in relation to IPO because Tianfon hindered several RPTs and its professional parties failed to investigate those transactions¹⁸.

Conclusion

Even though there have been a series of corporate scandals in China, especially those RPTs with tunneling effects, the Chinese Government and the regulators are regularly reviewing and revising the legal and regulatory framework to improve the corporate governance of Chinese listed firms with respect to the growth in the Chinese stock market. From the recent corporate reform, some Chinese listed firms have improved the disclosure of information content about their operations and reorganized their corporate structure to separate from their controlling shareholders (parties). Nevertheless, the following key points are worth noting:

First, as the ownership structure is a key corporate governance mechanism of Chinese listed firms and there is potential conflict as the government acts as the largest (controlling) shareholder and a regulator, the Chinese Government attempts to decrease the state ownership in these listed firms. With the share reforms and the increased turnover in the stock markets, the government is now able to dispose of its shares in Chinese listed firms, thereby decreasing

¹⁸ See the news “CSRC reports listed firms and the professional parties for the breach of rules and regulations” released by The Central People’s Government on June 23, 2013, available from the website: http://big5.gov.cn/gate/big5/www.gov.cn/gzdt/2013-06/23/content_2432224.htm, accessed on June 29, 2013. (in Chinese).

the state owned portion in these state-controlled listed firms. The diminishment of state-owned shares would also force the state to act solely as a regulator, and not a controlling shareholder, which would reduce the conflict of interests associated with these two roles and achieve the government policy of the “privatization of state-owned enterprises”. Nevertheless, from 2007 to 2011, the ownership of the largest shareholders in Chinese listed firms amounted to about 40%, similar to the percentage before the share reform.

Second, if the listed firms are independent of their controlling shareholders (parties), this will lead to positive competition in the product markets. Even when there are still significant RPTs with their related parties, the listed firms can bargain for more favorable terms and prices to improve their efficiency and profitability. Furthermore, professional managers are being employed to manage the affairs of state-controlled listed firms and to increase their efficiency and profitability.

Third and last of the all, Chinese regulators regularly reform the corporate governance framework, and introduce international professional practices and professional firms into the domestic stock market. We expect that the Chinese institutional framework will be more consistent with the Western model for the regulation of the positive development of the Chinese stock market and the protection of minority shareholders.

Appendix 1. Distribution by Industry of Chinese Listed Firms from 2007 to 2011

| | 2007 | 2008 | 2009 | 2010 | 2011 | Total | % |
|--|------|------|------|------|------|-------|--------|
| A - agricultural | 33 | 31 | 30 | 31 | 28 | 153 | 2.1% |
| B - mining | 30 | 33 | 37 | 39 | 45 | 184 | 2.6% |
| C - manufacturing | 827 | 818 | 824 | 803 | 820 | 4092 | 57.4% |
| D - production and supply of electricity and gas | 56 | 59 | 60 | 61 | 64 | 300 | 4.2% |
| E - construction | 33 | 33 | 34 | 30 | 29 | 159 | 2.2% |
| F - transportation and storage | 62 | 60 | 63 | 59 | 60 | 304 | 4.3% |
| G - information technology | 92 | 84 | 89 | 86 | 71 | 422 | 5.9% |
| H - wholesale and retail | 89 | 84 | 84 | 89 | 95 | 441 | 6.2% |
| J - property developer | 67 | 76 | 90 | 98 | 118 | 449 | 6.3% |
| K - social services | 45 | 45 | 46 | 46 | 45 | 227 | 3.2% |
| L - media | 12 | 12 | 12 | 11 | 18 | 65 | 0.9% |
| M- others | 75 | 75 | 72 | 69 | 46 | 337 | 4.7% |
| Total firm-year observations | 1421 | 1410 | 1441 | 1422 | 1439 | 7133 | 100.0% |

(Source: the firm's data from 2007 to 2011 in CSMAR database)

Appendix 2. Case Study on Wuliangye

Wuliangye Yibin Company Limited is listed on the Shenzhen Stock Exchange (stock code: 000858). Wuliangye and its subsidiaries are engaged in the sale and manufacture of wines under the name of “Wuliangye”, in Yibin, Sichuan, China. Although it is held under the name of the local government agency, Yibin State-owned Assets Management Co Ltd

(“controlling shareholder”), Wuliangye is, in fact, under the control of another state-owned enterprise, the Wuliangye Group Co Ltd (Wuliangye Group) as evidenced by:

1. The official website of the firm, www.wuliangye.com.cn, where the firm appears to be part of Wuliangye Group; and
2. The firm’s financial statements, which disclose a series of related party transactions (“RPTs”) between the firm and Wuliangye Group; and
3. Both the firm and Wuliangye Group are managed by the same management team.

Although a series of regular and irregular RPTs have been conducted between the firm and Wuliangye Group, unlike other Chinese listed firms which have been bankrupted, delisted or taken over, after being heavily tunneled by their controlling shareholders, Wuliangye is a profitable business and is still operating. Liu, He and Wei (2004) estimated that Wuliangye Group obtained private benefits of RMB 9.7 Billion from 1998 to 2003. Nevertheless, the firm’s financial statements and official website showed that:

1. The firm rarely paid a cash dividend, even though it has been profitable since the IPO in 1998;
2. The firm possesses a huge amount of cash and cash equivalents;
3. As evidenced from the RPTs, the firm and Wuliangye Group are integral parts of the same supply chain. Both the firm and Wuliangye Group also supply products with the same brand name.

Shares Held by the Controlling Shareholder

As indicated below, the controlling shareholder did not realize the firm’s shares for cash:

| | Million Shares | | | | | | |
|---|----------------|----------|---------|----------|---------|---------|---------|
| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| Shares held by the controlling shareholder, Yibin State-owned Assets Management Co., Ltd. | 1,947.6 | 1,817.8* | 2,544.9 | 2,218.8* | 2,128.8 | 2,128.8 | 2,128.8 |
| Ownership percentage | 71.80% | 67.00% | 67.00% | 56.07% | 56.07% | 56.07% | 56.07% |

*The reduction of the shares held is due to the share reform.

(Source: The firm’s annual reports from 2005 to 2011)

Financial Performance

The following table presents the financial performance of the firm from 2005 to 2011:

| | RMB Million | | | | | | |
|---------------------------------------|-------------|-------|-------|-------|--------|--------|--------|
| | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
| Turnover | 6,418 | 7,397 | 7,329 | 7,933 | 11,129 | 15,541 | 20,351 |
| Profit after taxation | 791 | 1,785 | 2,178 | 1,830 | 3,467 | 4,562 | 6,394 |
| Available cash balances | 1,971 | 2,786 | 4,060 | 5,925 | 7,544 | 14,134 | 21,551 |
| EPS (RMB) | 0.292 | 0.431 | 0.387 | 0.477 | 0.858 | 1.158 | 1,622 |
| Net profit on turnover | 0.120 | 0.240 | 0.300 | 0.230 | 0.311 | 0.294 | 0.314 |
| Cash dividend paid (per Share in RMB) | 0.100 | 0.060 | 0.000 | 0.050 | 0.150 | 0.300 | 0.500 |

(Source: The firm's annual reports from 2005 to 2011)

Magnitudes of the RPTs with Wuliangye Group

The following table presents the magnitude of the RPTs between the firm and Wuliangye Group in the past two years:

| | 2008 | | 2009 | | 2010 | | 2011 | |
|---|-------------|--------|-------------|-------|-------------|-------|-------------|-------|
| | RMB Million | % | RMB Million | % | RMB Million | % | RMB Million | % |
| Related purchases/Related purchases to total sales (%) | 2,132 | 26.9 | 1,043 | 9.4 | - | - | - | - |
| Related sales/Related sales to total of sales (%) | 4,165 | 52.5 | 4,603 | 41.4 | - | - | - | - |
| Related expenses/Related expenses to total sales (%) | 182 | 2.3 | 227 | 2.0 | 280 | 1.8 | 315 | 1.5 |
| Net advances to/(from) related parties/Net advances to/(from) related parties to total assets (%) | (369) | (2.70) | 66 | 0.30 | (122) | (0.4) | (92) | (0.3) |
| Acquisition of assets from related parties/ Acquisition of assets from related parties to total assets (%) | 3 | 0.00 | 3,827 | 18.40 | 54 | 0.2 | 4 | (0.0) |

(Source: The firm's annual reports from 2005 to 2011)

In view of the above proportions of sales and purchases, it is more likely that either the Wuliangye Group, or the controlling shareholder, received private benefits from the RPTs, even though the controlling shareholder received a relatively low dividend income and has not realized the firm's shares for cash in those years. Following the rules and regulations on corporate governance and RPTs from the CSRC and the Shenzhen Stock Exchange, in 2009, the firm announced the proposal for corporate reorganization to separate the core business from the Wuliangye Group and disposed of the non-business related investments to its controlling shareholder in order to improve investors' perception on the corporate governance¹⁹. Eventually, since 2010, the firm and Wuliangye Group undertook a reorganization and business structure to reduce the magnitudes of RPTs between them, and therefore, there were no normal RPTs (i.e. recurrent sales and purchases of raw materials and finished goods) between the firm and Wuliangye Group, and the magnitudes of other RPTs between them have decreased, and the potential tunneling effect was demolished.

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¹⁹See the firm's announcements in relation to the "Reform Proposal for Improvement of Corporate Governance Structure" released in 2009.

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