Determinants of Chinese Listed Firms’ Response to Pressures Towards International Corporate Governance Standards: A Social Process Perspective

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ABSTRACT

The corporate governance context in China differs significantly from that found in Western contexts. This study adopts a social process perspective and investigates important factors influencing listed firms’ responses in facing change of expectations towards corporate governance in China. Integrating both institutional theory and upper echelons theory, we test our hypotheses using the sample of publicly traded firms from the Shanghai Stock Exchange. Our findings suggest that the role of the board of directors and managerial characteristics in promoting more stringent corporate governance may be limited in China by the dominant role of the state. Our results indicate that both market pressures and government influence may promote adoption of Western corporate governance in China, suggesting the complexity of the state role.

Keywords: Corporate governance, Institutional theory, Upper echelons theory, China

INTRODUCTION

Corporate governance context in China differs significantly from that found in Western contexts. Given the importance of corporate governance practices to firm performance as well as to a country’s whole economic system, there has been significant interest in the unique Chinese corporate governance context recently (Jiang and Peng 2011; Young et al., 2008; Chen, Li & Shapiro, 2011). Recognizing the challenges imposed by the Chinese context, scholars explored the effectiveness of external corporate governance principles, for instance, OECD-prescribed corporate governance practices (Chen, et al., 2011; Child & Tse, 2001) on corporate performance in China. However, corporate governance is a socially constructed concept, and interpretation of “good” corporate governance is subject to different historical, political, social, and organizational factors in a country (Hambrick, Werder & Zajac, 2008). Considering there is limited empirical evidence for the superiority of one global model of corporate governance (Carney, Gedajlovic & Yang, 2009), research on Chinese corporate governance in such a rapidly changing context is both timely and challenging.

Given lack of consensus on one single optimal corporate governance model, recently Hambrick et al. (2008) suggest the potential of the social process perspective on the study of corporate governance. When expectations towards corporate governance change, firms are faced with the challenge of responding to these changing expectations to gain critical resources, maintain legitimacy, and promote firm survival (Oliver, 1991). Thus it is significant to understand why and how firms engage certain corporate governance behavior in response to those pressures. Our paper addresses these issues and examines how publicly traded firms respond to changing societal expectations of corporate governance in China. We build upon the growing recognition of the importance of ‘soft law’ regulation (Aguilera et al. 2004) to investigate firms’ corporate governance in China from a new perspective, that is, how firms
respond to societal expectations of corporate governance voluntarily, not as a result of mandatory laws or regulations. In doing so, we identify important factors critical to success in corporate governance reform in China and shed new light on research on Chinese corporate governance.

As an emerging market, the Chinese environment differs in important respects from those of developed contexts, for example, the role and degree of development of financial institutions and financial markets and greater dependence on local stakeholders. The business system of Chinese economy is often characterized by greater dependence on non-market relationships, often to overcome shortcomings in the capital market or to benefit from informal ties (Hall & Soskice, 2001). Perhaps most significantly, despite moves toward privatization and market reforms, the Chinese government plays a central role in the economic and business sector (Firth, Fung & Rui, 2007). Thus, the Chinese context can be viewed as unique in many respects (Redding & Witt, 2009), which offers a unique opportunity to assess the extent to which corporate governance theory and research developed in Western contexts is generalizable to China.

EVOLUTION OF CHINESE CORPORATE GOVERNANCE

Corporate governance in China has been in the process of transforming from the “state” governance to the “corporate” governance during the past five decades (Li, et al, 2004). From 1949 to 1984, large Chinese firms were mostly State-Owned Enterprises (SOEs), in which the state not only owned but also governed the firms (Schipani & Liu, 2002). After the establishment of two major stock exchanges, the Shanghai Stock Exchange and the Shenzhen Stock Exchange in 1990 and 1991 respectively, the Chinese government has made substantial progress in improving the corporate governance of publicly traded firms. The Chinese government has issued a series of corporate governance laws and regulations. For example, in 1993 China issued the “Company Law”, which, for the first time, stipulates the governing bodies of corporations include shareholders, the board of directors, and the board of supervisors. In 1998 the Chinese government enacted the “Securities Law” and in 1999 the “Contract Law”, both further addressed capital market and related trading activities. Moreover, China Securities Regulatory Commission (CSRC) issued the Constitution Guidance for Listed Companies, which required listed companies to have independent directors. In 2002, CSRC also issued “Code of Corporate Governance for Listed in China”, further elaborating the board structure, shareholder rights, and disclosure requirements for listed firms.

In addition, ownership reform took place to achieve the goal of true “corporate” governance. Before 2005, listed firms in China adopt the split-share structure, including both non-tradable and tradable shares. Non-tradable shares include both state-owned shares and legal-person shares. Tradable shares include A-shares, B-shares, H-shares, and N-shares. Fan et al. (2007) report that a typical listed firm has on average 30 percent state-owned shares, 30 percent legal-person shares, and the remaining individual tradable shares. Moreover, due to the pyramid stock holdings, the government is often the controlling shareholder of the non-tradable shares. According to Yang et al. (2011), over 50 percent shares of listed firms were controlled by the government at the end of 2009. One disadvantage associated with this split-share structure is the potential asset appropriation of the controlling shareholders at the expense of other minority shareholders. To resolve this issue, in April 2005 the Chinese government started the non-tradable shares reform, requiring an agreement on the compensation scheme among the majority shareholders and gradually transferring non-tradable shares to tradable shares.

The focus of this study, the Shanghai Stock Exchange (SSE), is one of the two major mainland Chinese exchanges. It represents over 82% of the equity value of Chinese firms. Reflecting concern for
improved governance, in 2008 the SSE launched the “SSE Corporate Governance Sector Index” (CGSI) to help publicly listed firms “to improve their corporate governance and enhance the quality of listed companies, and to assist investors in identifying well governed firms”. Firms voluntarily apply for certification or membership in CGSI, which is based upon meeting CGSI standards for ‘good governance’. Applicants are assessed along four dimensions: operational compliance (for example, insider transactions), shareholder rights and responsibilities (for example, voting rights and procedures), director and senior management characteristics and responsibilities (for example, board election procedures), and disclosure (for example, auditing). Unlike certain other governance indexes which include capital market, environmental, or social criteria, SSE index focuses exclusively on governance criteria. Further, the CGSI expands upon existing voluntary corporate governance codes to include additional criteria based upon international benchmarks such as the OECD practices (Grimminger & Di Benedetta, 2013:7), a further indication of the relevance of ‘external’ governance benchmarks. After a rigorous process of self-evaluation, public assessment, and expert review, 199 firms out of the 255 applicants met the selection process.

We view CGSI membership as an acknowledgment of the growing importance and acceptance of Western corporate governance practices in China, rather than an indication or measure of ‘good governance’. As noted by Hambrick et al. (2008) and Zattoni & Cuomo (2008), definitions of ‘good governance’ are subject to multiple interpretations and change. Several authors have documented the gradual acceptance of western governance models in China (Tan, et al, 2007; Li et al, 2004. However, Chen et al. (2011) emphasizes that the appropriateness of OECD principles to the Chinese context is an open question. Firms may have applied for certification for symbolic or instrumental reasons (Li et al, 2004). Even such symbolic or instrumental motivations, however, reflect awareness of the evolution of expectations regarding corporate governance. Indeed, they highlight the importance of conforming to such external expectations. Conformity to institutional pressures may be driven by potential instrumental benefits (Sherer & Lee, 2002). Indeed, a cornerstone of institutional theory is that firms derive benefits from acceding to institutional pressures. For example, inclusion in a ‘good governance’ index may contribute to firm prestige (Grimminger & Di Benedetta, 2013).

Congruent with prior studies which have used adoption of particular corporate governance practices or values as indicating institutional pressures, CGSI membership provides externally recognized acknowledgement of the legitimacy of Western corporate governance practices. Indeed, we feel that this measure is particularly appropriate in that CGSI firms have voluntarily moved to signal their acknowledgement of the growing recognition of Western corporate governance practices.

THEORY AND HYPOTHESES

There is considerable evidence that firms are subject to institutional pressures regarding business practices (Buck & Shahrim, 2005; Fiss & Zajac, 2004). As a result, firms face possibly competing pressures to maintain traditional practices and to adopt alternative models (Sanders & Tuschke, 2008). Pressures toward adoption of international or Western models can arise from national level characteristics, such as market openness and liberalization, and political and regulatory reform. However, firms differ in their exposure and response to specific institutional models (Pache & Santos, 2010). Thus, research has highlighted the role of both external pressures toward change and ‘micro processes’ in which these pressures are reflected in the firm’s internal characteristics or procedures (Aguilera & Jackson, 2003; Oliver, 1992). Indeed, Battiliana (2006) notes the need to complement the existing focus on external and organizational characteristics with consideration of individual level characteristics. Accordingly, we
integrate both institutional theory and upper echelons theory to explain firm’s corporate governance behavior facing external pressures to change. We develop our hypotheses regarding the following three drivers of CGSI membership in China: upper echelon characteristics, ownership characteristics, and prior firm performance.

**Hypothesis 1:** There is a negative relationship between high level of CEO tenure and CGSI membership.

**Hypothesis 2:** The international education and experience of CEOS and the board members have a positive association with CGSI membership.

**Hypothesis 3:** The government affiliation of directors has a positive association with CGSI membership.

**Hypothesis 4:** Ownership concentration has a negative association with CGSI membership.

**Hypothesis 5:** Higher proportion of tradable shares is positively associated with CGSI membership.

**Hypothesis 6:** Higher foreign ownership is positively associated with CGSI membership.

**Hypothesis 7:** Firms with good prior firm performance are positively associated with CGSI membership.

**METHODOLOGY**

**Data & Measurement**

Our paper aims at examining determinants of how listed firms respond to the CGSI voluntarily, so we compare the 255 applicants with those eligible non-applicants. We used the matching process based on industry and firm size in order to better capture the ‘difference’ between the constituents of the CGSI in 2008 and a matched sample of eligible non-applicants that did not apply for CGSI in 2008. We test our hypotheses comparing these two groups.

Sources of data in this study included Shanghai Stock Exchange official website, the OSIRIS database; ADR database, annual reports, and China Finance Online, which is one of the leading companies that provide online financial data of Chinese listed companies, CSMAR database and the Chinese website http://finance.sina.com.cn/, which provided listed firms’ prior sanction records.

**Dependent variable**

The dependent variable in this study is firms’ Corporate Governance Sector Index membership. As this dependent variable is a dichotomous variable, a dummy variable is created. Firms that are listed on the Corporate Governance Index are coded as “1”; otherwise they are coded as “0”. Data were collected from Shanghai Stock Exchange website.

**Independent variables**

*CEO tenure* is calculated as the number of years that the CEO has been in that position till year 2006. *Board international education and experience* is calculated as the number of board members with international education and experience divided by board size. *CEO intentional education and experience* is measured by a dummy variable, codes as “1” if the CEO has foreign education or managerial experience and “0” otherwise. *Government affiliated directors* is calculated as the number of board members with government affiliation divided by the total number of board members. We measure *ownership concentration* by the ownership stake of the largest shareholder for the year 2006, as suggested by Ding, Zhang & Zhang (2007). We calculate the percentage of *tradable shares* using the China Finance Online database. We calculate the percentage of foreign ownership in year 2006 to measure a firm’s prior foreign ownership before the CGSI, using data from the CSMAR database. *Prior firm performance* is measured by ROA in 2006 using data from the Osiris database. We use year 2006 as the cut-off point because firms would likely have begun the application process in 2007 based on our communication with SSE officials.
Control variables

The following control variables are introduced to isolate the effect of other independent variables on firms’ applying for CGSI membership. We controlled for the natural logarithm of a firm’s total assets to measure firm size using data from the Osiris database. We calculated the number of years since the first IPO date using data from the SSE website. We included a dummy variable for cross-listing on the Hong Kong Stock Exchange. Firms cross listed in HK stock market were codes as “1”, and “0” otherwise. The prior sanctions records used in this study include public condemnation carried out by Shanghai Stock Exchange and CSRC. Data were collected from http://sina.com.cn. We controlled for use of an auditor affiliated with an international accounting firm. Firms adopt a western auditor were codes as “1” and “0” otherwise. We also controlled for the size of the board. We calculated the number of independent directors divided by board size. CEO duality would reinforce the power of the CEO, and consequently influencing important strategic decision making process. It is coded as “1” when a CEO is also board chairman “0” if not.

RESULTS

Descriptive statistics and correlations are displayed in Table 1. The table indicates that correlations among independent variables are generally low. Higher correlations generally involve control variables such as Western auditors, Hong Kong cross listing and foreign ownership. The negative correlation between tradable shares and ownership concentration is to be expected since both tap government control. To further reduce the threat of multicollinearity, we conduct multicollinearity test and assess VIF of all variables. The VIF for majority of variables are between 1-2, with none above 3. Therefore, multicollinearity is not a problem. Ancillary analysis excluding higher VIF variables yielded results similar to those presented.

Consistent with our binary dependent variable, we used logistic regression to analyze the models. Table 2 reports the results of the logistic regression analysis on CGSI. Model 1 tested the effect of the control variables on CGSI index membership. We tested the effect of our antecedents in the model 2. The chi-square statistics of all models are significant, indicating that overall significance of models. Goodness of fit of the logit model is assessed using Pseudo $R^2$ (Nagelkerke $R^2$).

Model 1 in Table 2 shows that among the control variables, as we expected, firm size has a significantly positive effect on firm’s CGSI membership, namely, the larger the firm is, the odds of that firm applying for the CGSI Index are greater. Prior sanction has also a positive effect on the CGSI membership, suggesting high market pressures for firms with prior sanction records to signal good governance to the market. Model 2 regressed CGSI membership on the control variables and all our antecedents. The positive coefficient of CEO tenure is only marginally significant and the coefficient runs contrary to our hypothesis, therefore, not supporting our H1. Results do not support our hypotheses regarding the international education and experience of the CEO and board (H 2). The coefficient for government affiliated board members in Table 2 is positive and significant, supporting Hypothesis 3. Overall, these results suggest that, except for the counter-intuitive results for government board members and marginal support of CEO tenure hypothesis, the board of directors has little association with corporate governance certification.

For our ownership pressure variables, ownership concentration is significant only at the marginal level, which does not support our hypotheses 4. Tradable shares have a positive and significant effect on CGSI membership, which supports hypothesis 5. As predicted, the positive effect of foreign ownership is also significant, supporting hypothesis 6. Hypothesis 7 postulated that strong prior firm performance is positively related to CGSI membership. The coefficient for ROA 2006 in model 3 is positive and significant.
### Table 1: Descriptive Statistics and Correlations

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<td>.05</td>
<td>-.05</td>
<td>.03</td>
<td>-.02</td>
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**. Correlation is significant at the 0.01 level (2-tailed).
*. Correlation is significant at the 0.05 level (2-tailed).

### Table 2: Results of Logistic Regression Models of Corporate Governance Index Membership

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<td>Nagelkerke R square</td>
<td>0.139</td>
<td></td>
<td>0.3</td>
<td></td>
</tr>
<tr>
<td>Hosmer &amp; Lemeshow test</td>
<td>p=0.080</td>
<td></td>
<td>p=0.327</td>
<td></td>
</tr>
<tr>
<td>Classification accuracy</td>
<td>64.50%</td>
<td></td>
<td>72.30%</td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>394</td>
<td></td>
<td>394</td>
<td></td>
</tr>
</tbody>
</table>

*p≤.10; p* ≤.05; **p ≤.01; ***p ≤.001

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DISCUSSION AND CONCLUSION

Theoretical implications

Our results reflect the pivotal role of the government in Chinese corporate governance reform. The insignificance of most TMT characteristics (CEO tenure, international education and experience, for instance) found significant in non-Chinese studies suggests that government influence may dampen or supplant CEO and board effects. This finding has significant theoretical implications for the application of upper echelons theory in Chinese research, as well as the role of upper echelons in transmitting institutional pressures. Further, the positive coefficient for government board members is intriguing. There is increased awareness of the ‘governance discount’ placed on government controlled firms by outside investors (Huang & Orr, 2007). Peng (2004) suggests that government intervention may encourage firms to at least appear to conform to external expectations. CGSI membership may be seen as a means of overcoming this discount. It might be argued that CGSI membership may serve ‘symbolic’ purposes for firms with higher government representation on the board. From a more political perspective, executives and directors with government ties may view adoption of international standards as an advantage in dealing with both government agencies and with external stakeholders (for example potential investors).

As we hypothesized, the higher presence of foreign ownership and higher proportion of tradable shares positively affected firms’ CGSI membership. Congruent with prior research, these findings suggest that ownership pressures toward CGSI membership were driven by exposure to capital markets in China. The finding that better performing firms were more likely to successfully apply for CGSI membership. This result is inconsistent with similar empirical study in Japan, which found a decline in financial performance was the antecedent to adoption of foreign models (Yoshikawa & McGuire, 2008). This pattern of results suggests that poorly performing firms did not seek CGSI membership to signal greater legitimacy through adoption of more stringent corporate governance.

Practical implications

This research carries several practical implications. If we view CGSI membership as indicative of a Western governance orientation, it may nevertheless be an important item of information for investors in evaluating firm level governance. Indeed, Huang & Orr (2007: 108-109) note in a recent McKinsey report that ‘…foreign investors will be able to focus their efforts more successfully. On some issues they'll have little leverage: for instance, on appointments of top personnel, at least for the foreseeable future, outside directors can express their views, but the party committee will make the final decision. On issues concerning company strategy or major deals, however, the party values the views of strategic investors more highly. A seat on the strategy committee can be crucial because it exposes outside directors to issues and their associated data before they come before the full board.’ Both market pressures and government influence may promote adoption of Western-style corporate governance in China, suggesting the complexity of the state role. Rather than avoiding investment in firms with significant government influence, outside investors may wish to make a more nuanced evaluation of the extent to which a firm is receptive to corporate governance pressures.

Limitation and future research

Like other empirical research, this study entails several limitations which point to areas of future research. Our measure of corporate governance, CGSI membership, is only one possible indicator of
international corporate governance model. Future research should include different measure of recognition or adoption of Western corporate governance standards, such as adoption of executive compensation practices. Other elements of board structure not examined in this study can also be considered, for example, board committee structure, voting procedures, or the expertise of board members.

Cheung et al., (2010) found a positive relation between adherence to OECD governance principles and firm performance as measured by Tobin’s Q. With the availability of lagged outcome variables, research can examine the implications of CGSI membership for performance and other outcome variables. However, firm performance may not be the only theoretically or managerially important outcome of corporate governance reform. For example, research can examine whether stronger corporate governance allows firms to attract foreign or other outside investors, or is associated with different strategic profiles. A shrinking government role may also imply the growing relevance of top management team characteristics. The evolution of the Chinese business system will likely represent an interesting context in which to examine the evolution of national business systems (Redding & Witt, 2009).

As noted earlier, future research can assess the government role in promoting standards of corporate governance in other contexts. Such research would provide insight into differences in the type and extent of the government role developing ‘soft law’ governance standards. Our finding that many hypotheses of antecedents of corporate governance change found significant in non-Chinese studies were not supported suggests two possible research streams. One direction of future research would be to examine other antecedents appropriate in the Chinese institutional environment. For example, “guanxi” play a pivotal role in business exchange (Xin & Pearce, 1996). Executive and board interlocks, and the role of creditors such as banks and other financial institutions are therefore directions for future research (Arslan & Karan, 2006). Our findings also suggest differences in upper echelon effects. Future research can investigate whether our findings can be generalized to other contexts where the state also plays a dominant role.

REFERENCES


