

Research Notes



Effective Corporate Board Structure and Agency Problems: Evidence from China's Economic Transition

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Abstract

This study investigates the determinants of Chinese board structure during the economic transition from the year 2000 to 2012. It uses principal component analysis with fixed effects estimation to test three hypotheses – the scope of operation hypothesis, monitoring hypothesis and bargaining hypothesis – using different subsamples. Explained without the use of mathematical rigor, the paper's main findings are that Chinese stock market liberalization and the ultimate controlling shareholder are important factors when constituting board structure. After the split-share structure reform, China tends to have an outsider-dominated board structure. While private-controlled enterprises are more efficient in constituting board structure, CEOs of state-controlled enterprises have more bargaining power over board structure.

Keywords: *China economic transition, corporate governance, board structure*

1. Introduction

The corporate board serves the most important role in corporate governance. Exploring factors influencing board structure are fundamental in understanding the role of board directors in improving corporate governance. Previous studies suggested that a corporate board is constituted jointly by reconciling two conflicting views (Boone *et al.*, 2007). One is the *efficient board hypothesis* that board structure is efficient and there is no need to regulate. The other is the *inefficient board hypothesis*, which argues that a corporate board is naturally structured inefficiently. Firms should adjust board structure according to the cost and benefit of board monitoring and firm-specific characteristics in order to achieve the optimal board structure. Based on these two competing views, previous studies were of the view that in most cases, the corporate board structure is jointly determined by the *scope of operation*

hypothesis, monitoring hypothesis and bargaining hypothesis (Hermalin and Weisbach, 2001; Arthur, 2001; Iwasaki, 2008; Combs *et al.*, 2007; Lehn *et al.*, 2009).

Studies of this topic on the developing economies are few. This is certainly the case for China, with some studies of Chinese board governance covering only the initial stages of Chinese economic transition (Chen and Al-Najjar, 2012). Recently, however, Chen's (2014) study on Taiwan, Germain *et al.*'s (2014) study on Malaysia and Iwasaki's (2008) study on Russia have begun to shed light on the developing and transforming countries with institutional settings and characteristics that differ from those in advanced economies. This study makes comparisons with existing studies by addressing particular issues related to Chinese board structure during the period from 2000 to 2012.

This study focuses on China because its corporate sector has grown to include some of the largest firms in the world,¹ and the country has been undergoing economic transition during the last three decades. Chinese economic transition is a gradual process and follows the path of partial privatization of state enterprises. The largest enterprises are also increasingly seeking listing in China's and foreign stock exchanges. While, Chinese listed firms are divided into state and private enterprises, there are also firms for which ownership is unclear (Cheong *et al.*, 2014). However, because this ownership ambiguity is hard to clarify, this paper has to rely on the official definitions of state-controlled and private-controlled enterprises. Still, China's split-share structure reform in 2005 that converted non-tradable shares into tradable shares has moved Chinese corporate governance closer to that characterized by market-orientation. In addition, agency theory-based government regulations towards hiring independent directors is another driving force for listed firms to adjust their board structure.

The structure of this paper is as follows. Section 2 reviews the literature on the determinants of board structure. Section 3 examines China's corporate governance issues, including the split-share structure reform and enterprises. Section 4 provides the specification of the research methods and the data used for estimation. Section 5 shows the empirical findings. Section 6 concludes by drawing several implications.

2. Literature Review

The literature on the determinants of board structure is generally framed by three basic theories, namely the resource dependent theory, agency theory and power circulation theory. The resource dependent theory argues that the main function of the corporate board is to give advice and information needed to facilitate the firm's decision-making and strategic choice (Hillman and

Dalziel, 2003; Pugliese *et al.*, 2014). From the agency theory's perspective, however, the corporate board functions to monitor the interaction between managers as the agent and shareholders as the principal, and on behalf of the latter (Fama and Jensen, 1983; Shleifer and Vishny, 1997; Hillman and Dalziel, 2003). The power circulation theory applied to corporate governance suggests that CEOs can gain power from a coalition dominated by themselves, however, their power is constrained by a coalition formed by rival directors and executives (Shen and Cannella, 2002; Ocasio, 1994; Henderson and Fredrickson, 2001).

Based on these theories, three basic hypotheses have been proposed. The *scope of operation hypothesis* proposed that board size and independence depend on the amounts of advice and resources needed for a firm's daily operations. As firms grow and diversify over time and space, the increased number of product lines and services require the firms to have a larger specialized board to conduct planning, auditing and advising tasks (Lehn *et al.*, 2009). In addition, firms with a larger scope of operation are usually faced with more serious agency problems than smaller firms, so that more outside directors need to be nominated to monitor managerial behaviour (Boone *et al.*, 2007; Coles *et al.*, 2008; Chen and Al-Najjar, 2012).

The *monitoring hypothesis* states that board size and independence are driven by the tradeoff between the cost and benefit of board monitoring. The cost of monitoring is related to the complexity of a firm's operating environment (Gillan *et al.*, 2003; Demsetz and Lehn, 1985). Firms with high growth potential and greater information asymmetries are costly for board to monitor (Linck *et al.*, 2008; Lehn *et al.*, 2009), while, the benefits of monitoring depend on the level of private benefits available to managers (Lehn *et al.*, 2009; Boone *et al.*, 2007).

The *bargaining hypothesis* postulates that board size and the proportion of outside directors are the result of a CEO's bargain with the rest of the board directors. A CEO's bargaining power comes from his/her potential ability to influence the appointment of board directors (Hermalin and Weisbach, 1998; Arthur, 2001). Directors appointed through the CEO are inclined to stand with the CEO. Arthur (2001) and Baker and Gompers (2003) suggested that the proportion of outside directors is negatively related to a CEO's power, since a powerful CEO faces less monitoring by outside directors. A CEO's influence on board structure may also be constrained when more powerful outside directors and shareholders exist.

Among the empirical works addressing these hypotheses, Guest (2008) studied the determinants of board structure in the UK and found that they varied across different institutional settings. The UK's board structure is less determined by monitoring related factors. However, the US board structure is determined by the tradeoff between the benefits of information brought by

Table 1 Summary of the Hypotheses and Effects

<i>Scope of operation hypothesis</i>	
Resource and advice needed (SCOPE)	Positive effects
<i>Monitoring hypothesis</i>	
Cost of monitoring (COST)	Negative effects
Benefit of monitoring (BENEFIT)	Positive effects
<i>Bargaining hypothesis</i>	
CEO's influence (CEO'S)	Negative effects
Constrains on CEO's influence (CEO LIMIT)	Positive effects

additional directors and the coordination costs engendered by them (Lehn *et al.*, 2009). In another study, Russia's board structure is primarily determined by bargaining-related variables and the country as a transition economy also has an influence on board structure (Iwasaki, 2008). Malaysia's board structure is determined by the scope of operation and only board size is determined by the monitoring factors (Germain *et al.*, 2014). Taiwan's board structure is determined by firm-specific and CEO characteristics as well as government regulations (Chen, 2014).

3. China's Corporate Governance Issues

In the case of China, its transformation from a centrally planned to market oriented economy since 1978 is likely to affect the relationships discussed in Section 2. In this process, corporate governance was transforming from a government-dominated to market-oriented corporate structure. The continuously changing institutional landscape is also an important factor. Two specific issues pertaining to corporate governance are the split-share structure reform and controlling shareholder.

3.1. The Split-share Structure Reform

The "split-share structure" reform in 2005 is an important milestone of China's privatization and transformation towards a market-oriented economy. Prior to the reform, less than one third of the total number of shares of enterprises could be traded freely in the stock markets. Because of this split-share structure, the benchmark of Shanghai Stock Exchange Composite Index had fallen substantially even though the economy was booming (Jiang *et al.*, 2008). Hence, the aim of this reform is to revitalize the depressed Chinese

stock markets caused by the split-share structure. To implement this reform, the China Securities Regulatory Commission (CSRC) announced that 84 listed firms would participate in the pilot reform program. For these firms, non-tradable shareholders had to negotiate with tradable shareholders for a satisfied compensation in order to gain liquidity in the stock market on April and June 2005. In August 2005, a full-scale reform including all the listed firms began and by the end of 2007, 1,254 companies representing 97% of the total “A” share² market capitalization had completed the reform (Li *et al.*, 2011).

The split-share structure reform had a major impact on corporate governance. Prior to the split-share structure reform, Chinese enterprises were less subject to stock market discipline. The controlling non-tradable shares were owned by the Chinese government, which was alleged to have little regard for the efficient use of capital. For example, transfers of funds had been made from profitable divisions to unprofitable divisions (Scharfstein and Stein, 2000). In addition, the Chinese government did not represent the interests of domestic investors. The conflict of interest between tradable shareholders and non-tradable shareholders brought difficulties for Chinese corporate governance. For example, first, the pricing mechanisms of these two kinds of shares were completely different. Non-tradable shares were valued at book value, so that non-tradable shareholders could not benefit from capital gains from the stock market. In contrast, tradable shares were valued at market price and traded freely among domestic investors in the stock markets (Liao *et al.*, 2014). Second, the Chinese government as controlling shareholder had non-market motives rather than profit maximization and shareholder’s protection. Economic growth, maintaining a higher employment rate and social stability were more important than domestic investors’ pursuit of profit maximization. The government as shareholder could use either political instructions or corporate control rights to divert the money invested by domestic investors to related parties for other uses. Third, most of tradable shareholders were opportunistic investors seeking short-term gains, as evidenced by its high turnover ratio and high stock return volatility (Liao *et al.*, 2014).

Since the China Securities Regulatory Commission (CSRC) as the main regulator of the Chinese stock market bore most of the corporate governance responsibilities of listed companies and security firms (Chen *et al.*, 2006), it issued in January 2001 the “Code of Corporate Governance for Listed Firms in China” (Oliver *et al.*, 2014) to try to deal with the above problems. The “Guidelines for Introducing Independent Directors to the Board of Directors of Listed Companies” stipulated that all Chinese listed companies must have at least two independent directors by 30 June 2002 and at least one third of independent directors on the board by 30 June 2003 (Yang *et al.*, 2011).

3.2. State Control versus Private Control

After the split-share structure reform, some state-owned enterprises (SOEs) were fully privatized, while others were still controlled by the Chinese government or its agencies through either retaining ownership before they went public, or purchasing the tradable shares from the open market (Li, 2010).

State-controlled enterprises enjoyed financial privileges not available to private-controlled enterprises, while private-controlled enterprises were more likely influenced by market forces and resemble their counterparts in developed countries (Wei *et al.*, 2014). Banks were willing to lend to state enterprises since the government would share the losses with the banks if the firms were unable to repay the loans (Liang *et al.*, 2012). The Chinese government also provided political and financial support, such as a reduced tax burden and debt-for-equity swap to reduce the enterprises' debt burden (Sun and Tong, 2003). Besides, state-controlled enterprises had better opportunities to enter the stock market to raise funds. Private-controlled enterprises enjoyed none of these privileges, were subject to market discipline, but had a free hand in pursuing entrepreneurial objectives.

State-controlled enterprises are alleged to select CEOs largely based on social or political objectives, while private-controlled enterprises choose CEOs largely based on their ability to maximize shareholder's wealth (Berkman *et al.*, 2012). CEOs of state-controlled enterprises are supervised by the Chinese government, their performance at least partly assessed by how well they comply with the government's economic, political and social objectives. Most of their incentives come from the opportunity to be promoted to the higher hierarchies in the government (Chen *et al.*, 2009). CEOs in state-controlled enterprises have been criticized for being more interested in pleasing government officials than acting in the best interest of the company (Li *et al.*, 2007). However, in private-controlled enterprises, large shareholders usually have better knowledge of the industry in which the firms operate. They prefer CEOs to be selected among themselves (Chen *et al.*, 2009).

4. Research Methods

4.1. Factors Specification

Quantitative methods are used to verify the above hypotheses in the China context. The specific method is the principal components analysis³. Board size, the number of directors on the board, and board independence⁴, the percentage of independent directors on the board, are specified as being determined by the following factors and sub-factors:

- SCOPE, resources and advice needed for the firm's operations and is used to test the scope of operation hypothesis. It is hypothesized that board

size and board independence increase with a firm's scope of operations. SCOPE extracted from the firm's age, its size and capital expenditure. Firm age is the number of years since the firm is established. Firm size is the natural logarithm of the firm's total assets. Capital expenditure is the ratio of firm's net change in fixed assets and depreciation divided by firm's total assets.

- COST, the cost of monitoring. The cost of monitoring is related to the firm's growth opportunity and information asymmetry. Firms with higher growth opportunities and higher information asymmetries are difficult to monitor. Since the management covered some firm specific information, that unknown to outsiders, thus, it is costly for firms to transfer this information to the corporate board.
- BENEFIT, the benefit of monitoring relates to the opportunities for managers to gain private benefits at the expense of shareholders' interests. Following Boone *et al.* (2007) free cash flow is an important source of discretionary expenditure that the managers may use to pursue private benefits rather than shareholders' wealth. Meanwhile, firms in a concentrated industry are subject to less market discipline. Therefore, managers find it easier to extract private benefits. Managers of firms with higher industry concentration could be subject to less market discipline and managers are better able to extract private benefits (Gillan *et al.*, 2004).
- CEO, the CEO's influence represents the CEO's bargaining power over corporate board composition. When CEO has the bargaining power, he/she would prefer less monitoring from independent directors, leading to a less independent board. Specifically, CEO duality indicates a phenomenon when CEO is the leader of both management team and the corporate board, that will increase CEO's power. In addition, CEO's ownership in the firm also gives CEO more power.
- CEO LIMIT, constraints on the CEO's influence represents the limitation of CEO's bargaining power over board composition. This factor is extracted from ownership concentration, and the supervisory board size. Ownership concentration represents the interests of large shareholders in the firm, it limits CEO's power in corporate board since large shareholders are more likely to involve themselves in the corporate board's decision making process. Besides, the supervisory board size is likely to constrain CEO's influence, since the key function of supervisory board is to monitor managerial behaviours.

These factors are themselves determined by a host of sub-factors, including firm size, firm age, the amount of capital expenditure, a firm's potential growth, free cash flow, industry concentration, CEO duality, CEO

ownership, ownership concentration, and the size of the supervisory board. Factors and sub-factors will be called independent variables. The analysis has been done for both the pre- and post-split-share reform periods.

4.2. Sample and Data

The sample for this study is the Chinese non-financial firms listed on the Shanghai and Shenzhen Stock Exchanges. 172 firms are selected and firms that are not continuously listed during the period between 2000 and 2012 are not included in the sample. Since the split-share structure reform took place in 2005, the sample for this study is divided into sub-samples, one pre-reform from 2000 to 2005 and the other post-reform from 2006 to 2012. In each subsample state-controlled enterprises with 625 observations are distinguished from private-controlled enterprises. Financial data and corporate governance data are available in companies' annual reports and collected by the China Stock Market and Accounting Research database (CSMAR). Data regarding controlling shareholders are collected from the CCER database and CSMAR database.

5. Findings and Analysis

5.1. Descriptive Analysis

Chart 1a and Chart 1b show the means of board size and independence during the periods between 2000 and 2012. Overall, board size has decreased slightly over time, the peak size being in 2002 and 2003, remaining at around 9 persons thereafter. The board size of state-controlled enterprises is larger than of private-controlled enterprises. Board independence increased significantly from around 3 per cent in 2000 to 33 per cent in 2003 and rising gradually thereafter, with private-controlled enterprises enjoying greater independence than state-controlled enterprises. Also, before the year 2005, board independence was significantly lower compared to later years. The split-share structure reform and government regulations covering corporate governance, increased board independence more than board size, meaning that Chinese corporate board structure was transformed from being insider-dominated to outsider-dominated.

Table 2 summarizes the results of statistical tests for differences in the above independent variables before and after the split-share structure reform, and for state-controlled enterprises and private-controlled enterprises. The figures show, interestingly, that the impact of reform was to increase resource and advice requirements, monitoring cost, CEO's influence and constraints on CEO behaviour, but to reduce the benefits of monitoring. As

Chart 1 Means of Board Size and Board Independence for Selected Chinese Enterprises, 2000-2012

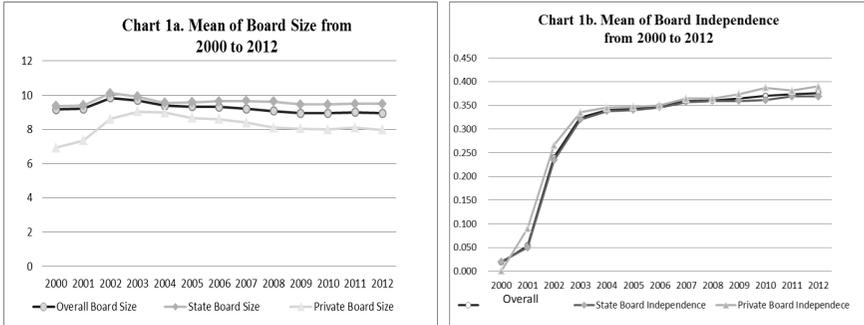


Table 2 Variations in Factors Before and After Reform, and Between State and Private-controlled Enterprises

Factors	After Reform	Private-controlled Enterprises
Scope	Increased***	Increased***
Monitoring cost	Increased***	Decreased***
Monitoring benefit	Decreased***	Increased***
CEO's influence	Increased***	Decreased***
CEO's limit	Increased***	Increased***

Note: *** indicates statistically significant.

between state-controlled enterprises and private-controlled enterprises, the latter required more resources, garnered more monitoring benefits, and their CEOs were more subject to constraints than state-controlled enterprises. The converse of these findings was that they entailed less monitoring costs and CEO influence.

5.2. Findings

Tables 3 and 4 show the estimated impact of the determinants of board size and board independence. By examining the statistical significance of coefficient estimates, the determinants of board size cannot strongly support the *scope of operation hypothesis*, *monitoring hypothesis* and *bargaining hypothesis* (Table 3). For the determinants of board independence, the *scope of operation hypothesis* and *monitoring hypothesis* can be supported, while, the *bargaining hypothesis* cannot (Table 4).

Table 3 Determinants of Board Size

<i>Factors</i>	<i>Full</i>	<i>Before</i>	<i>After</i>	<i>State Control</i>	<i>Private Control</i>
SCOPE	-0.0206	0.453**	-0.130***	-0.0418	-0.0206
COST	-0.0386	-0.140	-0.0175	-0.0322	-0.0310
BENEFIT	0.0870*	0.0998	0.0721	0.0581	0.122*
CEO	0.0260	0.0324	0.0538	-0.0915	0.0800
CEO LIMIT	0.495***	0.653***	0.507***	0.396***	0.574***

Note: *, ** and *** denote levels of statistical significance, *** being the highest.

Table 4 Determinants of Board Independence

<i>Factors</i>	<i>Full</i>	<i>Before</i>	<i>After</i>	<i>State Control</i>	<i>Private Control</i>
SCOPE	0.0276***	0.0830***	0.00898***	0.0242***	0.0207***
COST	-0.00874**	-0.138***	0.00139	0.00124	-0.0303***
BENEFIT	0.00689*	0.0143*	-0.000153	0.00271	0.0105*
CEO	-0.00172	0.00695	0.00177	-0.00135	-0.00269
CEO LIMIT	-0.0206***	-0.0862***	-0.00809**	0.00364	-0.0301***

Note: *, ** and *** denote levels of statistical significance, *** being the highest.

Specifically, for the *scope of operation hypothesis*, the greater scope of operation led to a more independent board rather than larger board. Although, according to the resource dependent theory, the greater scope of operation means more resources and advice needed for the corporate board to undertake monitoring and advising activities. However, a larger board size is not always effective, since a larger board size is slower in decision-making and more difficult in coordinating among directors. Whereas, independent directors should be more objective in monitoring managerial behaviour and can provide expert knowledge better than inside directors. Therefore, the greater scope of operation leads to a more independent board

For the *monitoring hypothesis*, the estimates suggest that when the firms have more information unknown to the outsiders, more independent directors are needed to guard against managers' self-serving behaviour. Even greater information asymmetry imposes a greater cost through the need for more outside director monitoring, firms will still want to add independent directors as long as monitoring benefits outweigh the costs. In addition, the estimates show that greater industry concentration led to a more insider-dominated board structure. Since an insider-dominated board structure makes it easier for managers to pursue self-interests in a concentrated industry where market discipline is lacking. Generally, board size and independence decrease with the cost of monitoring (COST) and increase with the benefit of monitoring (BENEFIT).

As for the *bargaining hypothesis*, the empirical results suggest that ownership concentration and supervisory board size as constraints of CEO's bargaining power (CEO LIMIT) play a substitute role to independent directors. As a result, board structure tends to be insider-dominated. However, CEO duality and CEO ownership of the firm, which reflect the CEO's bargaining power (CEOINFLU) over board structure was found to have no significant impact. Overall, CEO's bargaining power over board structure is quite limited, while those mechanisms constrain CEO's bargaining power tend to substitute the monitoring role played by independent directors.

As for the investigated subsamples, the main differences between the before and after reform periods are the relationships between resources and advice needed (SCOPE) and board size, as well as the link between monitoring (COST&BENEFIT) and board independence. The estimates suggest that with the liberation of the Chinese stock market, the listed firms tend to reduce their board size, even though the scope of their operations must have been growing. This is likely because a large board size has many disadvantages such as the high direct cost of director's compensation, slower decision-making and difficulty in coordinating among the board directors. Thus, after the reform, with the greater influence of stock market, domestic investors and a smaller government role, firms have chosen to reduce the

board size to save costs and improve efficiency. In addition, prior to reform, board independence was limited by monitoring cost. However, after reform, board independence is not significantly reduced by monitoring cost. This is likely because the role of independent directors in corporate governance is more pronounced after reform.

In terms of control, private-controlled enterprises are more concerned about the tradeoffs between cost and benefit of board monitoring when constituting board structure. This is because private-controlled enterprises are more profit oriented. State-controlled enterprises are less concerned because they enjoy government support and find it easier to get capital from banks. Another difference between state-controlled enterprises and private-controlled enterprises is the constraints of CEO's influence (CEO LIMIT). Ownership concentration tends to substitute for the monitoring role played by independent directors in private-controlled enterprises more than state-controlled enterprises, suggesting a less independent board structure in these firms.

6. Conclusion

Chinese economic transition and state enterprise reform are hotly debated issues. Among the widely discussed approaches, China appears to prefer the property rights approach in terms of its policy of "*holding to the large and letting go of the small*". The government keeps control rights over major state-controlled enterprises, but their objective of strengthening efficiency is within the government's strategic objectives. The smaller state-controlled enterprises go public through the issue of shares with efficiency maximization the most important objective (Li, 2010).

The establishment of the Shanghai and Shenzhen Stock Exchanges in the 1990s and the split-share structure reform in 2005 are important milestones in the Chinese privatization process. Chinese corporate governance reform, especially corporate board governance reform is a step in this direction. This study contributes to this discourse by taking into account the specific reform measures, split-share reform and the strategic shift from ownership to control.

The split-share structure reform that converted non-tradable shares into tradable shares greatly liberalized ownership in the Chinese stock market. It subjected Chinese listed firms to more stock market discipline and domestic shareholder's monitoring. This study showed that the role of independent directors in corporate governance gained more prominence after this reform. Firms opted to reduce inside directors rather than add independent directors to save cost. This is a clear indication that firms recognize the value of independent directors' monitoring.

This study also found that with assured financial and political support from the government, state-controlled enterprises are less efficient in constituting board structure than private-controlled enterprises. Private-controlled enterprises are more concerned about the cost and benefit of board monitoring than state-controlled enterprises. Besides, CEOs of state-controlled enterprises have more opportunities to pursue self-interests through their bargaining power when constituting board structure. Therefore, state-controlled enterprises usually have an insider-dominated board structure with fewer independent directors when their CEOs hold considerable power.

Given that the objectives of state-controlled enterprises and private-controlled enterprises do not fully coincide, it is neither possible nor appropriate to pass judgment on either. Nevertheless, these major reforms have achieved the objectives of greater accountability and better performance even in the state-controlled enterprises. Although one may quibble about the pace of reform, the findings of this study support the ongoing approach of government control applied to only strategic enterprises while retaining ownership in others. Even for the latter, there is an increasing trend towards professionalization of corporate boards (Cheong *et al.*, 2014).

Notes

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1. Such as Sinopec Group, China National Petroleum and State Grid which were listed on Fortune Global 500 in 2014.
 2. “A” share is a share issued by Chinese firms that are listed on Chinese stock markets and is only allowed to be traded among domestic investors.
 3. Details of the quantitative methods used are available upon request. Principal components analysis is a factors reduction method used to extract key information from several sub-factors.

4. According to the CSRC, independent directors are those who have no other positions in the company and have no relationships with the company's major shareholders that might affect their independent and objective judgment.

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