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EAST MEETS WEST? DETERMINANTS OF CHINESE FIRMS' RESPONSE TO PRESSURES TOWARDS INTERNATIONAL CORPORATE GOVERNANCE STANDARDS

A Dissertation
Submitted to the Graduate Faculty of the
Louisiana State University and
Agricultural and Mechanical College
In partial fulfillment of the
Requirements for the degree of
Doctor of Philosophy

in

The Interdepartmental Program
in Business Administration (Management)
in
The E. J. Ourso College of Business

by
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ABSTRACT

The diffusion of corporate governance standards globally has received special attention from researchers in an increasingly globalized economy. This topic is particularly significant in emerging economies as they encounter both economic pressures to adopt international governance standards and pressures to conform to local institutional resistance to change in governance. Drawing on multi-theoretical perspectives including agency theory, resource dependence theory and institutional theory, this study examines the role of CEO and board characteristics, ownership structure, prior firm performance, and firm's selection of accounting standards and auditing firms in determining Chinese publicly listed firms' responses to pressures to adopt international governance standards.

This study finds that (1) Chinese publicly listed firms with better prior performance measured by ROA are more likely to be early adopters of international governance model; (2) in general, the antecedents of CEO and board characteristics are not significant predictors of firms' adoption of international governance standards; (3) direct (ownership) and indirect links to Chinese government play significant roles in shaping firms' governance standards and practice; and (4) firms' ownership structure particularly proportion of tradable shares and presence of foreign ownership are significant predictors of firms' corporate governance orientation, while ownership concentration is not. This research enriches the bodies of international corporate governance literature and contributes to institutional change literature by empirically testing how firms facing similar political pressure, functional pressure, and social pressure (Oliver, 1992) produce heterogeneous strategic responses in an emerging context. It also contributes practically to the development of government business policy and effective management of firm strategies in China.

CHAPTER 1 INTRODUCTION

The diversity of global corporate governance practices has fostered scholars' interest in understanding causes of this variation and a debate about a trend of diffusion of cross-border corporate governance practices (Bradley, Schipani, Sundaram & Walsh, 1999; Guillen, 2000; Aguilera & Jackson, 2003; Fiss & Zajac, 2004, 2006; Aguilera & Cuervo-Cazurra, 2004). The focus of much extant literature is on comparing and contrasting two rival corporate governance systems: shareholder-oriented model (the Anglo-American model or international model), and the stakeholder-model (mostly in Asian and Continental European countries). The former is said to view the purpose of corporate governance as maximizing shareholder value, while the latter considers the interests of not only shareholders, but also those of creditors, suppliers, customers, employees, and the society at large (Mitchell, Agel & Wood, 1997; Chizema & Buck, 2006). In addition, the two models are described to be differently featured in that Anglo-American model is based on dispersed ownership, independent board, transparent disclosure, established legal infrastructure, and active takeover market control, whereas the latter is characterized by concentrated ownership, insider board, limited transparency and disclosure, weak legal system, and significant role of families and banks in financing (Rosser, 2003; Bai et al., 2004).

Furthermore, some scholars argue that there is a global trend of convergence towards Anglo-American model of corporate governance (Bradley et al., 1999; Coffee, 1999; Hansmann & Kraakman, 2001). The most cited rationale for this line of argument is that the increasing global competitive pressures promote the adoption of North American model of corporate governance so that such adopting firms can gain access to low-cost capital internationally (Hansmann & Kraakman, 2001; Useem, 1996). Alternatively, opponents such as Roe (1994; 2003) argued that historical events and politics in a country matter in terms of shaping the

development of national corporate governance systems. Thus, according to path dependency theory, convergence towards American corporate governance model is not likely imminently due to the existence of different cultural, political, legal, and economic systems across the world (Schmidt & Spindler, 2002). Or, at best, convergence can be said to be “more adaptive in function, and more persistent in form” (Gilson, 2001:332).

This dichotomous description of variation of cross-national corporate governance practices and the debate about diffusion of North American corporate governance model have provided insights and unveiled myths in understanding potential determinants of such variation and diffusion process in different countries (Coffee, 2000; Fiss & Zajac, 2004; Chizema & Buck, 2006). However, one limitation of such a dichotomous description is that it only partially fits some regions of the world, particularly in advanced capitalist economies (Aguilera & Jackson, 2003). Less attention has been given to the diffusion of governance practices between those advanced economies and emerging economies. Given that governance institutions differ enormously between the two camps (Kaufmann, Kraay & Mastruzzi, 2007), there is a great need to examine the impact of local institutional factors apart from globalization pressures on the diffusion of corporate governance practices. Indeed, Schmidt & Spindler (2002) pointed out that even advanced economies such as Germany and Japan sustained a “seemingly inefficient” corporate governance system in contrast to the North American model, indicating the importance of ‘ complementarity’ of all institutional elements in shaping the national development of corporate governance system.

Indeed, the interplay of local institutional pressures and global economic pressures can sometimes make it unlikely for a country to preserve its traditional governance practices, nor to adopt a foreign governance model completely. In other words, the binary argument may

overlook the viability of a third alternative such as a hybrid corporate model (Yoshikawa, Tsui-auch, & McGuire, 2007) as a result of non-linear evolution of corporate governance system. Simply concluding that there is a global trend of convergence towards Americanized governance model ignores the important role of local institutional factors in shaping national evolution of governance systems. It also suggests the importance of exploring interactive effects of both local institutional factors and global economic pressures on the national development of governance practices.

In line with the above debate and discussion, researchers have devoted considerable theoretical and empirical attention to a comprehension of the determinants in this cross-border diffusion of corporate governance practices. For instance, the business systems approach developed in the 1990s (Whitley, 1992; 2000) posits that organizational strategies, structures, and performance are deeply shaped by the institutional contexts where firms are embedded (Whitley, 2003). In the case of corporate governance system, Whitley (1992) stressed that the institutional underpinnings among relationships of owners and managers shape the development of governance practices. Recently, scholars have furthered this approach by focusing on the relationship between national institutional contexts and international processes (Morgan, Kristensen, & Whitley, 2001). The 'actor-centered' institutional approach (Aguilera & Jackson, 2003) examines cross-national diversity in corporate governance by looking at how different groups of stakeholders' roles are shaped by various institutional mechanisms. Specifically they argue that "multiple institutions exert interdependent effects on firm-level outcomes" (Aguilera & Jackson, 2003:448). Similarly, Fiss & Zajac (2004) developed a sociopolitical framework on the transportation of national corporate governance practices. Their approach goes beyond the efficiency pressures as the major explanation; rather it alerts us to the important role of political,

social, and psychological factors in explaining the diversity of corporate governance practices. These theoretical approaches stress the role of both national and international pressures and have shed new light on the factors that influence the diffusion of corporate governance practices internationally.

On the practical side, the debate of diffusion of corporate governance models in different terrains is especially meaningful in recent times that have just seen the Asian Financial Crisis of 1997 and the scandals of Enron and WorldCom in the new millennium. Is the American model of corporate governance "the end point of corporate governance evolution" (Hansmann, & Kraakman, 2001)? From financial (Rubach & Sebora, 1998; Bradley et al., 1999) and product-market pressure perspectives (Khanna & Palepu, 2001), adoption of North American governance model can bring numerous benefits, including better investor protection and higher investor confidence (La Porta et al., 2000), greater firm performance (Bhagat & Bolton, 2007) and development of equity market (Johnson et al. 2000). Indeed, some empirical studies have shown evidence that adoption of North American corporate governance model took place in different contexts (Yoshimori, 1995; Shleifer & Vishny, 1997; Wojcik, 2004; Collier & Zaman, 2005; Bozec, 2007). However, inconsistent results were also reported. For example, some countries adopted European models (Khanna, Kogan, & Palepu, 2006), some stuck to the traditional national corporate governance model (Rosser, 2003), and still others maintained a hybrid corporate governance model (Yoshikawa et al., 2007).

The mixed empirical results suggest that factors other than financial and market pressures play important roles in national corporate governance systems and that the evolution of national corporate governance systems is indeed "more complex than a simple convergence-divergence debate" (Yoshikawa & McGuire, 2008: 16). On the one hand, national institutions of corporate

governance systems influence a nation's response to external pressures on governance practices. On the other hand, the international spheres of corporate governance developments engender important implications for a country's domestic development in corporate governance. Admittedly, it might be fruitless to try to identify the "best" corporate governance form (Mayer, 1996). However, it is rewarding to understand the forces influencing firm's choice of governance elements in a particular context. Such an understanding not only contributes to the development of new theoretical frameworks in analyzing international diversity of corporate governance, but also produces significant practical implications for firms competing in an increasingly globalized business environment.

This research develops a multi-theoretical framework to analyze pressures of 'change and continuity' (Yoshikawa & McGuire, 2008) of corporate governance system in the Chinese context. The choice of the empirical context is based on the following reasons. First, more studies on international corporate governance have been conducted in the setting of developed countries such as USA, Germany, Japan or other OECD members (O'Sullivan, 2000; Chizema & Buck, 2006; Rubach & Sebora, 1998), and fewer studies have been done in the context of developing countries mostly due to limited data availability. Hence, this study will join and enrich the bodies of research that "…complement studies of evolution within national systems with analyses of the interaction between internal realignment of domestic systems of governance and international developments" (O'Sullivan, 2000:155). Second, China, as one of the largest emerging economies, is experiencing some fundamental domestic institutional changes in corporate governance systems. As a member of World Trade Organization (WTO) since 2001, China also absorbs and complies with many external corporate governance practices as efforts to achieve harmonization with international standards in corporate governance. Publicly listed firms

in China, thus, confront both institutional pressures internally and global pressures externally. As such, it is appropriate to employ the setting to examine how publicly listed firms respond to corporate governance reform in China. Third, though the study is conducted in Chinese context, the implications from this study may be applied to other similar developing economies. Lastly, this study takes advantage of the unique opportunity represented by the launch of "The Corporate Governance Index" to examine adoption (at least in form) of western corporate governance practices.

Adoption of appropriate corporate governance model is especially important for China, which is facing daunting tasks of attracting investment, improving performance of state-owned enterprises (SOEs), and curbing rampant corporate scandals. Before the economic reform in 1978, China was dominated with SOEs. During the last decade, around 80% of small and medium-sized firms have been privatized, that is, they were sold to employees or outside investors. During the same period, China's stock markets have grown rapidly, with a total of over 1,500 publicly listed companies on the Shanghai Stock Exchange and Shenzhen Stock Exchange at the end of 2006**.** However, the state still owns a considerably high proportion of shares in these listed firms (Qiang, 2003). Liu & Sun (2005) reported that around 84% of the publicly listed firms were controlled by the state, with 8.5% directly and 72.5% indirectly by pyramid shareholding schemes (Braendle, Gasser & Noll, 2005). In this sense, these publicly listed firms can still be considered as SOEs.

The primary stakeholders of these SOEs include public officials, local and central government bureaucrats and top-managers appointed by the government, with employees and foreign investors holding less than 10% shareholders (Hua, Miesing & Li, 2006). Under such a corporate governance model, the state has considerable control of firms' resources and the

allocation of firms' retained earnings (Keister, 2004). Political considerations still has significant weight in determining the appointment of top managers (Naughton, 1995). Also, unlike American model of corporate governance in which ownership is dispersed, ownership in China is concentrated, with a reported of five largest shareholders holding 58% of shares (Xu & Wang, 1999). This traditional governance model entails important implications and consequences.

One of the serious problems that these state- owned publicly listed firms in China face is poor operating performance (Xu & Wang, 1999; Sun & Tong, 2003). The reform of SOEs has been one of the most important aspects in Chinese economic reform since 1978 when China adopted its open-door policy. However, though the national productivity is growing rapidly, the performance of SOEs is far from satisfactory, and the number of loss-making SOEs is increasing (Chen, 2004; Cao, Qian & Weingast, 1999; Lin & Zhu, 2001). Table 1.1 shows that over 50% of SOEs suffered from profit loss during the period of 1997-2001.

Table 1.1 Firm Performance of Chinese SOEs 1997-2001

Items	**1997**	**1998**	**1999**	**2000**	**2001**
Sales revenue	6,813,200	6,468,510	6,913,660	7,508,190	7,635,550
SOE profits	n.a.	328,020	329,070	467,980	480,470
SOE losses	n.a.	-306,650	-214,490	-184,600	-199,360
Net profits	79,120	21,370	114,580	283,380	281,120
Net profitability	1.20%	0.30%	1.70%	3.70%	3.70%
Percentage loss-making	65.90%	68.70%	53.50%	50.70%	51.20%
Profitable SOEs	89,000	74,000	101,000	94,000	85,000
Loss-making SOEs	173,000	164,000	116,000	97,000	89,000
Total SOEs	262,000	238,000	217,000	191,000	174,000

Source: Financial Yearbook of China, 2002

Poor governance in China also entails financial scandals. In 2001, the largest shareholder of Meierya embezzled over 40 percent of its total equity, and in 2002 the same type of scandal happened to Sanjiu Pharmacy, in which 96% of its equity was extracted by its largest shareholder

(Bai, Liu, Lu, Song & Zhang, 2004). The lack of profitability and the rampant corruption scandals resulted from poor governance have made corporate governance reform one of the top priorities for the Chinese government (Tai & Wong, 2003). Moreover, the Chinese government has been trying to address the problem of SOEs by avoiding privatization of large SOEs, but rather by focusing on piecemeal measures such as corporate governance reforms. This has made publicly listed firms' response to such reforms more salient in gauging the significant role of corporate governance in China's economic reform.

To address these issues, China has initiated series of reforms on corporate governance. China has been trying to take a top-down legalistic approach in corporate governance, which means China has to 'transplant the basic structures from the external market based model found in Anglo-American systems' (Tam, 2000). Table 1.2 displays a brief history of the most important laws in governance in China since early 1990s. As indicated by Lau, Fan, Yong & Wu, (2007), China's corporate governance reform was based on a variant of the Anglo-American model, and Chinese corporate governance systems were designed to model after globally accepted practices (Mar & Yong, 2001; Tam, 1999).

Table 1.2 Milestones in the Development of Chinese Corporate Laws and Regulations

1994	Enactment of "Company Law (passed in 1993)", established a modern enterprise system, specified rights of shareholder, boards, and management.
1998	Enactment of "Securities Law", addressed capital market and related trading activities.
1999	Issuance of "Contract Law", assigned rights and securities to all parties.
2002	China Securities Regulatory Commission (CSRC) issued "code of corporate governance for listed companies in China" addressing board structure, shareholder rights, and disclosure requirements.

Reflecting this ongoing attention to corporate governance reform in China, Shanghai Stock Exchange (SSE), which is the leading stock exchange with around 82% of the equity value of all listed firms, launched the “SSE Corporate Governance Sector” on January 1, 2008. The aim of this sector is to help publicly listed firms to improve their corporate governance and promote the rational investment of investors. It is the first time for China to introduce such criteria to assess corporate governance of publicly listed firms.

The SSE founded the Expert Consultative Committee for Corporate Governance Sector Appraisal in September 2007 after years of its study of international governance experience. The appraisal indicator system designed was based on the principles of the “Corporation Law”, the “Securities Law” and the “Rules for Listed Companies”. The appraisal system covers four categories of indicators: the operational compliance indicators, the shareholder’s behavior indicators, the directors and senior management indicators, and the informational disclosure indicators. These four indicators were further subdivided into 20 indicators, addressing all major elements of corporate governance. The appraisal measures adopted the principle of voluntary application, which was designed to promote stronger self-regulation and a better market image. Finally, the appraisal system involved the public assessment. The public (investors) appraised the listed firms’ governance based on the published application material on the website. Also, professional research institutions were invited to assess the governance of those applicants.

Among 255 voluntary firm applicants for the “Corporate Governance Index” (CGI), 199 firms were chosen to be constituents of the index after a rigorous process of self evaluation, public assessment, and expert review, and it is expected to exert considerable pressures on listed firms to increase their efforts to meet social expectations of corporate governance practices in China. First of all, the CGI influences firms’ governance structure and behavior by

establishing norms that define “legitimate means to pursue valued ends” (Scott, 2001:55). Failure to adhere to these norms can engender undesirable social and economic sanctions such as isolation from the group, discontinuity of social relationship or refusal of future economic exchange (Ingram & Silverman, 2002). Second, the CGI functions like certified management standards (CMS) such as ISO 14001 environmental management standard and the SA 8000 labor management standard, promoting socially desired governance behaviors (Terlaak, 2007).

Listed companies’ voluntary application for the CGI indicates their willingness to meet more stringent standards of corporate governance. However, firms can also choose to apply for membership just for symbolic reasons. Empirical studies have provided evidence that firms claimed to support shareholder-oriented model, but in fact chose not to change in governance (Fiss & Zajac, 2004). So it is important to point out that the CGI membership in China does not necessarily indicate they are better-governed firms, particularly at the early stage of this sector.

Following prior studies such as Fiss & Zajac (2006), I interpret and argue that application for membership of the CGI suggests firms’ willingness to initiate ‘functional change’ to North American governance model. First, though the laws that the appraisal indicator system were based on reflect North American governance principles, they also take into account local institutional environment. For example, a two-tier board system instead of one-tier board was selected considering unique agency problems in China (Chen, 2005). Second, institutional form is constrained by initial starting point of Chinese corporate governance system (Gilson, 2001). Chinese government has initiated reforms on governance avoiding radical policy of privatization (Aivation, Ge & Qiu, 2005). These factors determine that China can’t wholly adopt ‘formal’ North American governance standards. However, an examination of those appraisal indicators show that the CGI membership indicates firm’s recognition of international corporate

governance standards. To increase the validity of such arguments, I conducted a phone interview with China Securities Index Co., Ltd (CSI), which affirmed the above interpretation and argument.

The CGI provides a good testing ground to investigate the determinants of publicly listed firms' responses to corporate governance reform in China. Through a comparison of the 199 firms (being accredited on the list) with a matched number of firms from the rest of non-applicant firms, this study examines the impact of a dichotomy of local and international pressures to predict firms' action of applying for the CGI. I develop the first set of hypotheses pertaining to CEO and board characteristics, proposed antecedents including CEO tenure, CEO education and experience, CEO duality, board size, board education and experience, and boards from government. The second antecedent predicts how firms' prior performance measured by ROA impact a firm's response to the CGI. The third set of hypotheses examines the effect of ownership structure including ownership concentration, proportion of tradable shares, and foreign ownership on firms' governance behavior. Lastly, I develop hypotheses about how the choice of a firm's selection of accounting standards and auditing firms predict their governance orientation. Overall, the general theoretical framework of this study posits that when an antecedent taps global pressures on firms, it increases a firm's likelihood of applying for the CGI membership. In contrast, predictors that tap local institutional pressures decrease the likelihood of such actions.

The rest of this research is organized as follows: Chapter 2 provides background about corporate governance in China. It describes history and evolution of governance systems in China, main features of its current governance system, and major problems in its current governance model. Chapter 3 reviews the theoretical perspectives adopted in this research and

develops hypotheses about the determinants of firms' applying for the CGI membership. In brief, it highlights reasons that agency theory won't apply so as to resolve the agency problem in China. I focused more on a detailed review of resource dependency theory and institutional theory, and how these two theories complement each other in explaining firms' responses to adopt international corporate governance standards. Chapter 4 describes the source of data and measurement of variables. Chapter 5 discusses the analytic approach taken and reports the results from the analyses. Finally, Chapter 6 discusses the implications of the findings, contributions and limitations of this study and concludes with future avenues for research.

CHAPTER 2 CORPORATE GOVERNANCE IN CHINA

In order to better understand the local Chinese institutional factors that influence publicly list firms' responses to corporate governance reform in China, this chapter provides background of corporate governance systems in China. It first outlines the history of corporate governance systems since 1949 when PRC was founded. Then it highlights current key features of Chinese governance regime including board structure, ownership structure and evolution, and also major problems in Chinese corporate governance systems. Finally, this chapter concludes with a description of the general institutional environment in China.

Evolution of Corporate Governance in China

Schipani & Liu (2002) depicted the development of corporate governance systems in China as three distinct models in three different periods: traditional model of SOEs (1950s-1984), transitional model (1984-1993), and modern corporate model (1993-present). From 1950s till 1984, China was dominated with SOEs, and under this model of corporate governance, the state not only enjoys the paramount ownership, but also managerial power. As the owners, the state has multiple-ties of governments, and often has conflicting goals and interests. Also, the managerial goal of the SOEs, unlike modern corporations, was not to 'maximize shareholder value', but to meet demands of the state plans such as employment and social stability.

The transitional model lasts from 1984 till 1993, the year in which the Chinese Corporate Law was passed. After experiencing the problems of traditional corporate governance model, the state wanted to reform the traditional mode of governance. During this period, the governance of reform of SOEs mainly followed the principle of "separation of government (ownership) from management" (Berle & Means, 1932) and aimed at reducing governance interference in firm management (Hassard, Cheehan & Morris (1999). The contract responsibility system was also

introduced during this period. It allowed firm to have more rights in terms of allocating profits, setting wages, and making investment plans. However, the state still had retained great decision power in terms of corporate governance, and many of government efforts failed to address the endemic problems of SOEs such as lack of profitability and corruption scandals.

The modern model of corporate governance started from 1993, when the concept of corporate governance has been formally introduced. The major goal of corporate governance reform since then was to convert SOEs into western-type corporate entities. To clearly clarify the property rights of corporations, the Company Law was passed in 1993 and put into effect in 1994. The goal of the governance restructure is "to meet the needs of establishing a modern enterprise system, to standardize the organization and activities of companies, to protect the legitimate rights and interests of companies, shareholders and creditors, to maintain the socio-economic order and to promote the development of the socialist market economy" (Hua et al., 2006:404). According to the Company Law, modern corporations in China are required to have three governing bodies: 1) shareholders; 2) the board of directors, and 3) the board of supervisors. The law stipulates the rights and responsibilities of each governing bodies, clearly established ownership, and further reduced government intervention in corporate governance. It is the first time since 1978 that SOEs has greater operational autonomy.

Two-tier Board System

Like Germany, China adopts a two-tier board system, which consists of the supervisory board and the executive board. Both boards are appointed by the shareholders' meeting, and have to submit their reports to the shareholders' meeting for review and approval (Chen, 2004).

The supervisory board (SB) is to oversee the executive board of directors. SB should have at least three members, with at least one member representing the minority shareholders.

SB is independent of the executive of directors. One of the implicit duties of the SB is to review the financial affairs of the company and thus to oversee the financial statement (Firth, Fung, & Rui, 2007). The supervisory board shall "supervise the corporate finance, the legitimacy of directors, managers and other senior management personnel's performance duties, and shall protect the company's the shareholders' legal rights and interest" (CSRC, 2001). Supervisors are required to have "professional knowledge or work experience in such areas as law and accounting" (CSRC, 2001). Though in theory, the supervisory board has the power of supervising the executive directors as well as the managers, there is a lack of provisions concerning "rules of procedure, rules of voting, and rules of proposing, and holding meetings of the supervisory board" (Chen, 2004:88). In addition, besides representing employees, the supervisory board often includes quite a few government appointees, and thus they are representative of large shareholders in practice (Wei, 2007). As a result, the function of supervisory board in implementing such powers and duties is very limited. For this reason, this study will only study the effect of the executive board of directors on firm's governance structure and behavior.

The executive board of directors is very similar to boards in developed countries. Directors usually have contracts for three years, which can be renewed after the original contract expires. Shareholders have to approve the appointment of the directors. Boards should include both executive and non-executive directors and since 2003 at least one-third of the directors have to be independent. Also, the CSRC strongly encourages firms to separate the roles of the chairman and the CEO. However, in practice, board of directors in China face a serious 'insider control' problem, since most directors are managers inside the firms. What is more, independent

directors do not usually carry out their duties effectively either due to a lack of professional knowledge and expertise (Wei, 2002).

Independent Directors

Previously, only those Chinese firms listed on overseas markets appoint independent directors. The guidelines issued by China Securities Regulatory Commission on August, 16th, 2001 required all listed companies in China to have at least two independent directors by June 30th, 2002, and at least one third of the board must be independent directors by June 30th, 2003. According to the guidelines, an independent director is one who holds no posts in other company other than the position of director, and who maintain no relations with the listed company and its major shareholder that might prevent them from making objective judgment. Specific requirement include: "

He/she must not hold a position in the listed company or its affiliated enterprises, nor can their direct relatives or their major social relations hold such position in such enterprises;

He/she must not hold more than 1% of the outstanding shares of the listed company directly or indirectly;

He/she must not hold a position in a unit which holds more than 5% of the outstanding shares of the listed company directly or indirectly, or of the unit which ranks as one of the five largest shareholders of the listed company;

He/she must also not satisfy any of the above conditions in the immediate proceeding year;

He/she must not provide financial, legal or consulting services to the listed company or its subsidiaries;

He/she must not be the person stipulated in the articles of association as someone who is inappropriate to take up such position;

He/she must not be the person determined by the CSRC as an inappropriate person for such post." (Wang, 2005)

Evolution of Firm Ownership in China

Before China adopts the open-door policy in 1978, there are four major types of enterprises: State-Owned Enterprises (SOEs), foreign-invested enterprises (FIEs), township and village enterprises (TVEs), small and midsize enterprises (SMEs) or family businesses. Among them, SOEs accounted for about three-fourths of total industry output (Hua, Miesing, & Li, 2006). Typically, the central government owns and runs the large SOEs, and local governments run SMEs (Huchet & Richet, 2002).

Table 2.1 Development of China's Stock Markets 1992-2000

Year	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Total number of listed firms	53	183	291	323	530	745	851	949	1088
Capital Raised (billion yuan)	9.4	31.4	13.8	11.9	34.1	93.4	79.5	100	142.8
Market capitalization (billion Yuan)	104.8	353.1	369.1	347.4	984.2	1752.9	1950.6	2647.1	4809.1
Market capitalization/GDP (%)	3.9	10.2	7.9	5.9	14.5	23.4	24.9	32.3	54.0
Number of investors (million)	2.2	7.8	10.6	12.4	23.1	33.3	39.1	44.8	58.0
Total book value of assets (billion Yuan)	48.1	182.1	330.9	429.5	635.2	966.1	1240.8	1610.7	1796.0
State share as % of total shares	41.4	49.1	43.3	38.8	35.4	31.5	34.3	36.1	38.9
Legal Person shares as % of total shares	27.9	23.1	23.5	25.0	28.4	32.7	30.4	27.7	24.5

Source: Chen, 2004

In 1984, the first shareholding transformation of SOEs started. Many SOEs were sold to the public, and the state diminished its ownership greatly. By 2003, the state share reduced to about one-quarter of total industrial output (Morrison, 2003). In 1990, China set up the first stock exchange, Shanghai Stock Exchange, and in 1991, the Shenzhen Stock Exchange was established. Since then, the total number of listed firms, market capitalization, and the number of investors has increased rapidly. Table 2.1 shows that from 1992 to 2000, the total number of listed firms has increased from 53 to 1088, and the percentile of market capitalization over China's Gross Domestic Product (GDP) increased from 3.9% to over 50%.

On paper, there are six types of shares in those publicly listed firms: state, legal person, foreign, management, employee, and individual (Firth, Fung, & Rui, 2007). Although all shares have the same voting rights and cash flow rights, management, employee, and foreign shares each accounts for a very small percentile of the issued share capital. Accordingly, Table 2.2 indicates that a publicly listed firm's ownership can be split into three major types: 1) state shares; 2) legal person shares; and 3) tradable A-shares (Qiang, 2003). On average, each type accounts for about one-third of a firm's issued shares. State shares are owned by the central and local governments, and are usually represented by state asset management bureaus. Legal person shares are held by non-bank institutions such as securities companies, trust and investment companies, foundations and funds and so on. Both state shares and legal shares are not tradable, though they are transferable to other institutions under approval of China Securities Regulatory Commission. The high proportion of nontradable shares creates a major barrier for China to fully develop its capital markets, a pre-condition for potentially effective external governance control (Tam, 2000). Most tradable shares are domestic A-shares. Other tradable shares are

Table 2.2 Share Structure of Chinese Listed Firms 1994-2000

Type of shares	Brief Description	1994 (%)	1996(%)	1998(%)	2000(%)
State shares	Held by the state and its various ministries, bureaus, and regional governments, in exchange for the capital contribution made by the state. Non-tradable; transferable to other institution, under the approval of CSRC	43.31	35.42	34.25	38.9
Legal person shares	Owned by domestic institutions, defined as non-individual legal entity; commercial banks excluded by law; non-tradable; transferable to other institutions under the approval of CSRC	22.44	27.18	28.35	23.82
Tradable A-shares	Held and trade mostly by domestic individuals and institutions; in IPOs, tradable A-shares should account for no less than 25% of total outstanding shares	33.02	35.25	34.11	35.72
Employee shares	Offered to workers and managers of PLC, usually at a substantial discount	0.98	1.2	2.05	0.64
Shares denominated in foreign currency	Including B-shares and H-shares. Till 2000, B-shares available exclusively to foreign investors, separated from A-share market; H shares are listed and traded on Hong Kong market	12.02	13.33	10.05	7.28

Source: Qiang, 2003

foreign shares such as B-shares and N-shares (listed in New York), and they are owned by foreigners and domestic investors who have foreign currency. According to CSRC, 65% shares issued in Shanghai Stock Exchange and Shenzhen Stock Exchange are not tradable. This implies that the state possess sufficient decision power regarding major corporate issues (Huang & Fung, 2005). An empirical study by Hu and Yang (2004) confirmed that non-tradable shares are indeed the firm controller in the sense that they influence the appointment of the chairman, the CEO, and more than half of the board members.

Problems of Corporate Governance in China

The major problem of Chinese corporate governance system is the concentration of ownership and control. Though the aim of reform of SOEs is to decrease state ownership, the government still has the important decision rights in such issues as appointing CEOs and disposing of firms' assets and earnings (Chen & Strange, 2004). In addition, the low ratio of tradable shares constraints the role of individual shareholders in monitoring, only with a reported 11% of the total public shareholders taking part in the annual shareholders' general meeting (Hua, 2005; Shi & Weisert, 2002). These attributes of ownership systems in China often disadvantage minority shareholders.

The second major problem is the ineffective board system in China. The CEO has excessive power in controlling and managing the company. According to the Company Law, the CEOs are to be elected by shareholders, but in practice the controlling shareholders (the State in many SOEs) appoint the executives, and often the appointment is politically determined. Though the board is supposed to play a significant monitoring role in corporate governance, its function is limited by the board structure in China. The two-tier board structure does not specify how board members are nominated and by whom should they are nominated, though the Company

Law stipulates that board members are appointed by shareholders. In fact, according to one survey by Integrity Management Consulting and the Research Center of the Shanghai Stock Exchange (2000), about 69 % of all directors were appointed by state and legal person shareholders (see Table 2.3, indicating the extreme power and influence of controlling shareholders. The appointment of both CEOs and boards by controlling shareholders (often the state) creates insider control problem and the interests of minority of shareholder are not well safeguarded. Meanwhile, the effectiveness of supervisory board is even worse. In practice, the supervisors are seen as subordinates of directors and executives, contrary to what is expected for the function of supervisory board.

Table 2.3 Ownership and Control in China PLC (%)

Shareholder type	**Ownership**	**Control (board seats)**
State	24	21
Legal persons	44	48
Employees	2	3
Common A-shares	30	4
Total	100	76

Source: Survey by Integrity Management Consulting and the Research Center of the Shanghai Stock Exchange (2000).[1]

The third problem is a lack of incentive system. When managers are appointed by the government, they sometime don't have the required managerial skills. Executives of listed firms are traditionally underpaid (Rui et al., 2002). Thus, the link between management and performance is weak. Rather, factors such as the ownership characteristics and geographic location play critical role in determining the income of the senior management (Lin, 2001). Lin

[1] In the survey; a total of 10,560 questionnaires (out of which 9,600 were individual questionnaires, 480 were enterprise questionnaires and 480 were financial data questionnaires) were sent out to the management personnel, namely the directors, supervisor and senior managers of all companies listed in the Shanghai Stock Exchange. The response rate was 41%, 54%, and 50% for the individual, enterprise and financial data questionnaires respectively. Thus, extensive information with regards to the corporate governance was obtained for these 257 listed companies.

(2001) reported that the pay of senior management in companies located in coastal regions is generally higher than those in inland regions. Also, the incomes of CEO in a publicly listed firms which were previously SOEs or whose largest shareholders is the State are usually lower than other listed companies. Managerial compensation systems in China also lack transparency and disclosure. Many firms do not disclose such information. The payment method is complex due to the use of 'subsidized social provisions such as housing, health care, etc' (Lin, 2001: 16) besides monetary incomes. All these factors make it hard for shareholders to ascertain the exact extent of managerial remuneration.

The fourth problem of corporate governance in China is a lack of transparent information disclosure. The powerful CEOs circumscribe the role of the auditors, especially those insider auditors, which results in low transparency of the auditing process. A case in point is that in 1997 external auditors voiced negative opinions on the annual reports of 93 publicly listed firms. Frauds in accounting and financial reporting are also believed to be pervasive. According to the China National Audit Office, financial management of many firms is 'chaotic and inaccurate'. As a result, the information reported are sometimes said to be inaccurate, incomplete, and not timely (Lin, 2004; Ma, 2005). In addition, lack of training and knowledge of international accounting standards and practices make adequate financial reporting difficult. Thus, there is an urgent need for more qualified external auditors and a need for enhancement of reliability and accuracy in financial reporting.

Fifth, law enforcement is still weak. The rudimentary development of laws and the cultural aversion to litigation has made it difficult for law enforcement. Also as seeking legal remedies entails high cost, the legal rights of minority shareholder are often overlooked.

Moreover, the local people's Courts are reluctant to accept cases that they see as "internal" to a firm that involves disputes between shareholders, managers, and employees (Lin, 2001).

Lastly, China lacks a strong external control mechanism for corporate governance. The markets are still not mature and competitive enough so that the force of active take-over can control the governance. This is especially true in industries such as telecom, transport, power, steel, which has nearly a total state ownership control.

Institutional Environment in China

Kaufmann, Kraay & Mastruzzi's Worldwide Governance Indicator (WGI) research project (2007) provides a bird's-eye view of institutional environment of corporate governance in China.

Table 2.4 Governance Indicators in China 2006

2006 Comparison of China with Other Countries in Governance Indicators						
Governance Indicator	China Percentile Rank (0-100)	Japan Percentile Rank (0-100)	USA Percentile Rank (0-100)	Britain Percentile Rank (0-100)	Germany Percentile Rank (0-100)	France Percentile Rank (0-100)
Voice and Accountability	4.8	75.5	83.7	92.8	95.7	92.3
Political Stability	33.2	85.1	57.7	61.1	75	61.5
Government Effectiveness	55.5	88.2	92.9	94.8	90.5	85.8
Regulatory Quality	46.3	87.3	93.7	98	91.2	82.9
Rule of Law	45.2	90	91.9	93.3	94.3	89.5
Control of Corruption	37.9	90.3	89.3	93.7	93.2	91.7

Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2007: Governance Matters VI: Governance Indicators for 1996-2006

Using over 30 data sources, their data covered 212 countries and territories from 1996-2006 and measured governance in the following six dimensions: voice and accountability, political stability, government effectiveness, regulatory framework, rule of law, and control of

corruption. Table 2.4 provides a comparison of China with other major countries in the six dimensions of governance in 2006 (Appendix 1).

One condition that constrains the accountability in China is that the state is the major shareholder. As Tenev & Zhang (2002) described it, “nobody owns the corporate entity as it is owned by everyone”. The agents (managers) are not held accountable to other minority shareholder such as individual shareholders, foreign shareholders, or employee shareholders. Likewise, employees do not subject themselves accountable to managers either since managers do not own the entity. Though the Company Law (1994) and CSRC (2001) stipulated rules and established corporate governance model based on Anglo-American model, the weak legal protection and enforcement in law further lowers the accountability due to a lack of penalties for malpractices. This creates a problem of extremely low voice and accountability score when surveyed by World Bank. Table 2.4 shows that compared with other countries such as Japan, USA, Britain, Germany and France, China lags far behind in voice and accountability.

In political stability, China scored 55.5, which is much lower than most other countries did in this item. This is partly due to the one-party political system, and partly due to some potential social problems such as corruption, unemployment, and income disparity that China is facing. However, we need to be cautious in interpretation of this score as the item is based on the western perceptions of what constitutes political stability and may not apply to China.

In government effectiveness, the traditional role of “guanxi” in Chinese society is perceived by westerners as a great hurdle. For example, scholars have noticed the negative consequences such as personal indebtedness by executives, domino effects during firm failure, and collective blindness when environment changes (Gu et al., 2008). Also the traditional culture of promotions based on seniority and connections in China is not congruent with merit-

based, equal opportunity employment practices in Western countries. The rampant phenomenon of corruptions and bureaucracy also lowers the score of Chinese government effectiveness.

In contrast to a comprehensive and well-established regulatory body such as Securities Exchange Commission (SEC) in USA or Financial Services Authority (FSA) in the UK, the main regulatory institution (CSRC) in China is relatively new and is weak in enforcing its rules. Accordingly, opaque in transactions and malpractices are still persuasive in China. These factors resulted in a low score in regulatory quality compared with other countries.

Rule of law in China is very ineffective. In form, China has improved greatly in terms of promulgation of laws and regulations similar to western counterparts. However, justice and enforcement are hampered by a lack of independence of judicial from the executive.
China has a much lower score in control of corruption compared with other countries. Corruption can be important barrier to an effective governance because it decreases transparency and disclosure and increases transaction cost. The seriousness of corruption in China is a result of these factors: lack of independent judiciary, weak enforcement in laws, lack of transparency and disclosure, and traditional Confucian value of "returning favor" in business exchange.

Current Legal Framework of Corporate Governance in China

Corporate governance laws and regulations in China include the Certified Accountant Law (issued in 1993), Audit Law (1994), Company Law (1994), People's Bank of China Law (1995), Commercial Bank Law (1995), Securities Law (1998), and Accounting Law (1999) (Shi & Weisert, 2002). Among them, the company law is the most influential in the sense that it stipulates that the company has three control bodies: the shareholders' general meeting, the boards (supervisory board and executive board), and management. The significance of this law

is that it reduced government intervention considerably by encouraging transforming state shares to tradable shares at stock exchanges (Nee et al., 2007).

The major regulatory body of corporate governance in China is CSRC, which was established in 1992, and it was supervised by the State council. Other regulatory bodies include the State Economic and Trade Commission, the Ministry of Finance, and the People's Bank of China. One of the distinct features of Chinese governance system is that the Chinese Communist Party (CCP) retains influential rights among these governance bodies. In addition, the local party committee consists in another important channel of governance involvement, which is usually carried out by appointing 'internal party member' to positions in a firm. For example, Article 17 of the Company Law specifies 'the activities of the local branch units of the CCP in a company shall be carried out in accordance with the Constitution of the CCP'. Bian et al. (2001) reported that local party committee is entitled to the rights of "supervise party cadres and any other personnel". As such, party members "involved in all domains of corporate decision making" (Nee et al. 2007, 27).

Tam (2000), in the description of the internal structure and links among various governance bodies associated with publicly listed firms (Figure 2 below), vividly showed that the CCP and other government ministries dominated the governance process. From the figure, we can see that the largest two blocks of shares, state shares and legal person shares, are heavily regulated by government agencies such as Supervisory Ministries and State Administrations, creating a major barrier to the development of free capital market in China. The close ties between government and firm operation reduce the independence of firm governance, diminishing the role of boards and managers in carrying out associated duties and responsibilities. The second feature of governance structure in these listed firms is that top

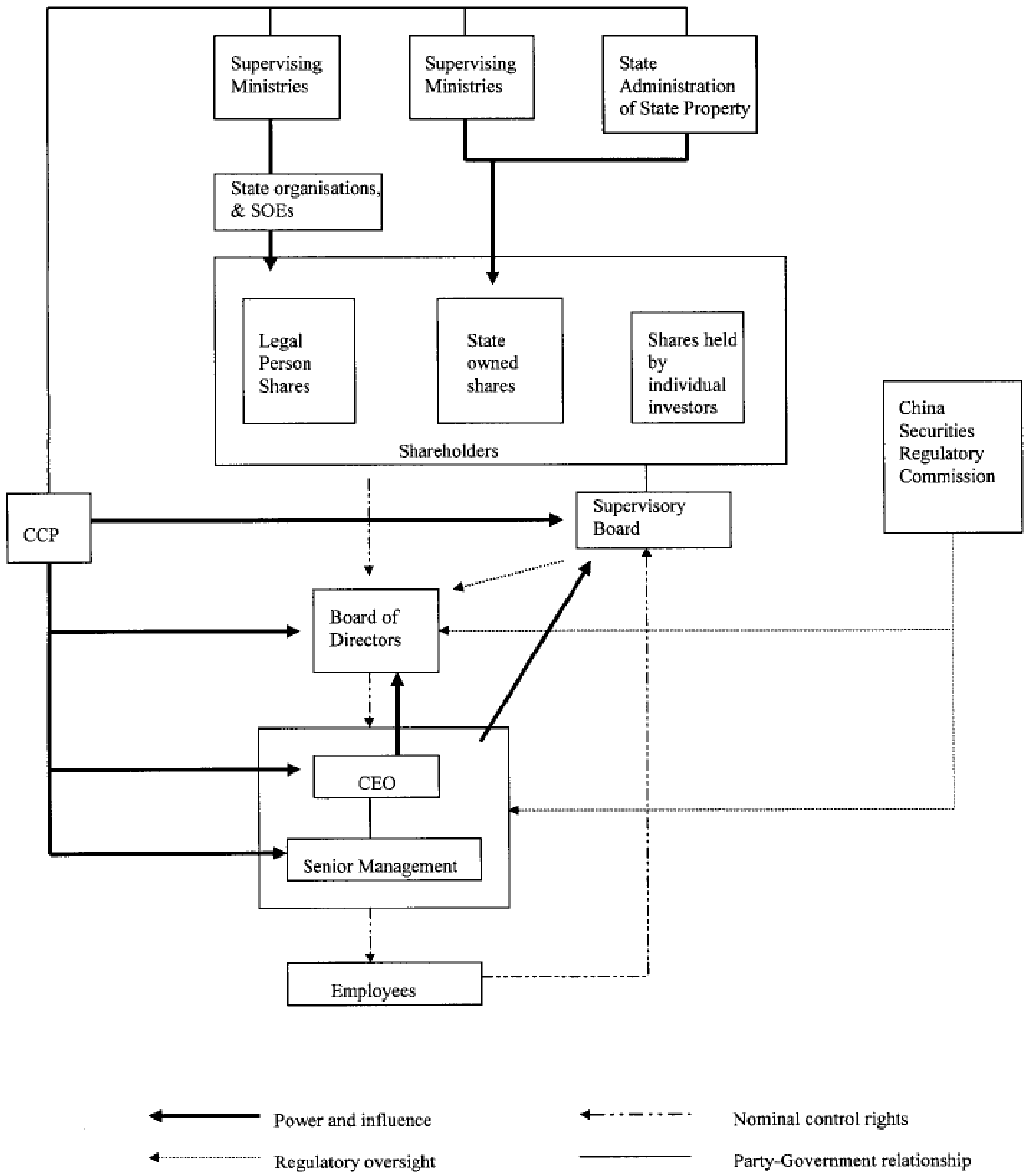

Figure 2.1 Internal Governance Structures of Chinese Listed Firms (Source: Tam, 2000)

management teams (board, CEO and senior management) are to a large extent influenced and controlled by the government (CCP in the Figure). The Supervisory board has limited influence on TMTs. On the contrary, CEOs dominate the supervisory boards.

To sum up, the institutional environment and framework of governance in China show that publicly listed companies have a different ownership forms, business and financial environment from other governance systems (Tam, 2002). This suggests that publicly listed firms, in choosing governance components, are shaped by factors at both macro and micro levels in China (see Figure 2). At the macro level, listed firms face pressures from governance laws and regulations, economic and business policies and the fact of substantial government involvement in firm governance. At the firm level, forms of ownership, board and senior managers, and other firm features such as industry, size, and history of IPO are significant in shaping firm's governance structure and behavior.

CHAPTER 3 THEORIES AND HYPOTHESES

Theoretical Frameworks

Explaining the variation of corporate governance practices in various contexts is just like the parable elephant. We may see parts of the elephant through a different theoretical lens. Broadly speaking, pertinent theories try to explain the diversity in governance practices in two perspectives. One is from efficiency aspect, and the other is from institutional respect. The former, such as agency theory (Jensen & Meckling, 1976; Fama, 1980), and resource dependence theory (Pfeffer & Salancik, 1978), focuses on financial or market pressures on firms. The latter, such as institutional theory (Oliver, 1992; DiMaggio & Powell, 1983), sociopolitical approach (Fiss & Zajac, 2004), and national business system approach (Whitley, 1992), stresses the role of institutional pressures on firms. To get a whole picture of the "elephant", we need to integrate both perspectives. This research draws on multi-theoretical perspectives, including agency theory, institutional theory, and resource dependence theory, to examine Chinese publicly listed firms' response to various sources of pressures on corporate governance practices.

Recently, scholars have called for a multi-theoretical perspective on corporate governance research for a more complete and comprehensive understanding (Muth, & Donaldson, 1998; Hillman, Cannella & Paetzold, 2000, Udayasankar, Das & Krishnamurti, 2005; Dalton, Daily, & Ellstrand, 1999; Peng, 2004). Such an approach is particularly warranted in the case of international governance because of the trend of globalization of economics and the existence of plethora of distinct yet unique national systems of corporate governance across the globe. Though agency theory provides a powerful lens as the tool in examining corporate governance issues in China, agency problems are not the right diagnosis for the Chinese

corporate governance, nor does agency theory provide the right cure for the problems (Clarke, 2003). Corporate governance system in China is embedded in a unique and complex institutional environment (Peng & Heath, 1996; Lin, 2001). Agency theory is “under-socialized” in the sense that it overlooks the complexity of institutional domains (Chizema & Buck, 2006). The complexity of driving forces from the institutional environment influencing governance change in content and in direction justifies the adoption of institutional theory in explaining firms’ governance reform (Aoki, 1994). Indeed, Ahmadjian & Robbins (2005) suggest that firm’s responses are determined by ‘the nature and degree of their embeddedness within societal and organizational contexts’. Furthermore, accessing both financial and nonfinancial resources play significant role in shaping listed firms’ governance structure and behavior especially in a context of enormous state ownership and significant cultural role of guanxi in business. Resource-dependence theory comes into play in this respect, accounting for the heterogeneity of governance practices and structures (Pfeffer & Salancik, 1978). Each of these three theoretical perspectives is discussed in more details below.

Agency Theory

The origin of the important idea of separation between ownership and stewardship can be traced back to Adam Smith’s *The Wealth of Nations* (1776), in which he believed, because of potential conflicts of interest between ownership and control, that, in his words, “negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company (joint-stock company)”. This principal-agent problem was highlighted by Berle and Means (1932) in their classic book *the Modern Corporations and Private Property*, in which they noted that the numerous shareholders (owners) were overpowered by much smaller number of corporate executives (agents) who run the companies and made all important decisions for

them. Though in theory shareholders can depend on the board of directors to safeguard their interests, in practice the executives dominate the effectiveness of supervisory role of boards. Thus, as Berle and Means wrote, the separation of ownership and control "destroys the very foundation on which the economic order of the past three centuries".

Agency theory was further developed later on and has provided theoretical bases for numerous studies that have tried to explain the nature of conflicts and to find ways to resolve them (Jensen & Meckling, 1976; Fama, 1980; Fama & Jensen, 1983; Baiman, 1990; Eisenhardt, 1989). Agency theory makes certain assumptions about people (self-interested), organizations (profits-seeking), and information (asymmetric commodity). Agency theory proposed that two major problems exist due to information asymmetry and human nature of maximizing utility (Nilakant, & Rao, 1994). The first one is agency problem stemming from the conflicting goals of the principal and the agent, and the second problem is 'risk-sharing' due to different attitude towards risk between the principal (risk-neutral) and the agent (risk-averse).

In an effort to resolve such problems, agency theory proposes a variety of internal and external control mechanism to minimize agency costs such as monitoring, bonding, and other related costs (Jensen & Meckling, 1976). The internal mechanism includes ownership concentration, board of directors and executive compensation. The external mechanism depends on market control. Both internal mechanism including salaries, commissions, stock options and external market control mechanism have been postulated to ensure the commitment of the agent (Nilakant & Rao, 1994), and the board is asserted to play the most important role as the internal control mechanism, monitoring and ensuring managers behave properly (Barnhart, Marr & Rosenstein, 1994).

Agency theory provides an insightful yet narrow perspective (Eisenhardt, 1989). In the case of international governance, agency theory seems not be able to account for the differences in the governance mechanisms used across countries. For instance, external market control is the major governance mechanism in the USA and Britain, while banks and families play an important role as "internal control" mechanism in Japan and Europe (Aguilera & Jackson, 2003). Agency theory is undersocialized in the sense that it overlooks that governance mechanisms are embedded in local contexts (Dacin, Ventresca & Beal, 1999), and that institutional effect such as cultural, political, social, and psychological relations in a local context can't be isolated in analysis of economic actions in organizations.

In applying agency theory to the context of Chinese corporate governance, agency theory is constrained by some of its theoretical assumptions. First of all, it overlooks important principle-principle relationship in China besides the principle-agent relations. The Chinese SOEs have multiple tiers of principles such as central, provincial, and municipal governments. However, there is no clear-cut among the three levels of governments, which inevitably results in duplication of ownership function (Lin, 2001). In addition, central and local governments often have different opinions with regard to how to maximize public interests. Policies that are believed to benefit local constituents can be in conflict with those from the central government. Furthermore, as government plays critical role in publicly listed firms, a neglect of such important relationship will not be helpful to solve agency problems in China.

Second, the nature of principal-agent relationship in China is different from that in western countries. Instead of individual or institutional investors as the principals, the state has high ownership in publicly listed firms in China (Aivazian, Ge & Qiu, 2005; Xu & Wang, 1997). Under such a system of ownership, no "real owners" or "real agents" exist. While the state

represents owners of the public, it does not bear correspondent risks in using and controlling SOE's assets and retained earnings. On the other hand, the individual public, as true owners, are too dispersed and thus are ineffective in monitoring the performance of SOEs (Lin, 2001). Thus, the absence of ultimate principal increases potential agency costs, creates more obstacles in monitoring (Clarke, 2003; Shleifer & Vishny, 1997). In addition, agency theory assumes that principals (owners) are rational in the sense that they would seek maximization of their profits. This assumption is especially problematic when the principals are not individual owners, but the state, which is believed to be 'second-order agents' of true owners (Lin, 2001, p.7). The state has multiple goals other than profits but employment level, control over critical industries, and social stability (Clarke, 2003).

In addition to ownership structure, agency theory is also problematic in specifying the role of board in the context of China. Agency theory mainly assumes that the board plays the role of monitoring, ignoring other possible roles such as service, and resource dependence role (Zaha & Pearce, 1989; Hillman & Dalziel, 2003). According to agency theory, the effectiveness of monitoring role is associated with board characteristics such as independence and compensation. However, resource-dependence theory views the board as resources providers. The resource role of the board is especially important in Chinese culture because guanxi (personal connections) has been deeply embedded in the Confucian values in China for thousands of years (Yang, 1994). guanxi is the social capital, and critical intangible asset that firms use to 'manage organizational interdependence, and to mitigate institutional disadvantages, structural weakness, and other environmental threats' (Park & Luo, 2001:456). Given that China lacks a strong legal environment, guanxi is particularly salient in its role of facilitating business activities (Alston,

1989). Consequently, it is important for top management teams or boards to be capable of developing strong and viable business relationships or guanxi.

In sum, the above discussion suggests that agency theory provides rich insights on firms' governance structure and behavior. However, in explaining diversity of international governance practices, agency theory is 'undersocialized' in that it overlooks the embeddedness of organizations in the local institutional environment. Caution is also warranted when we apply agency theory to different contexts where different sets of agent-principle problems and principle-principle problems exist. The different nature of these agency problems in different contexts demands a broader perspective than the one focusing on the agent-principle relationship. The following sections provide theoretical perspectives that particularly recognize the role of institutional factors in explaining organizational structure and actions.

Institutional Theory

In explaining the role of institutions in the diffusion of organizational practices, institutional theorists postulate that institutions are socially-constructed and socially-accepted rules that individuals and organizations must follow in business transactions (North, 1990). Institutions create various social identities and provide shared meaning to organizations (Scott, 1995). These institutions exert pressures on organizations to conform to the rules and be congruent with the take-for-granted nature of institutions in considering and implementing strategic change (DiMaggio & Powell, 1991).

To survive in the institutional environment, organizations not only compete for resources, but also for legitimacy and power (DiMaggio & Powell, 1983; Suchman, 1995). Legitimacy is the one of the central concepts in institutional theory that has been used to account for the homogeneity and heterogeneity of organizational forms, structures, and strategic choices (Meyer

& Rowan, 1977; DiMaggio & Powell, 1983; Suchman, 1995). Legitimacy is "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs and definitions" (Suchman,1995: 574). Organizational legitimacy affects organizations in several important respects. First, legitimacy can provide the firm with capacity and capability to obtain the needed resources (Oliver, 1991). Second, 'legitimate' firms are armed with greater strategic flexibility in dealing with uncertain environment. With high level of resources, legitimate firms have the power or the structural politics of institutionalization (DiMaggio, 1988) to influence and even change institutional rules.

Different institutions generate distinct sources of pressures on organizations in seeking and maintaining legitimacy. To better understand the impact of institutions on organizations, organizational researchers conceptualize institutions along the dimension of formality (Scott, 1995; Peng & Heath, 1996, Young et al., 2001). The most formal pillars of institutions are those regulative institutions including laws and regulations. Regulative institutions convey organizational legitimacy by assessing whether new business practices and standards comply with existing laws and regulations. Less formal than laws and sanctions are normative institutions. Normative institutions are often displayed as codified professional standards that constrain organizational behavior and practices. Professional firms such as consulting firms and universities can disseminate organizational practices and standards, and firms' adoption of these practices and standards suggest congruence with societal values and thereby gaining normative legitimacy. Lastly, the most informal institutions are cognitive institutions including traditions, cultures, and take-for-granted customs and practices (Scott, 1995; Bruton & Ahlstrom, 2003).

When organizational practices are in line with those take-for-granted cognitive rules widely held in the institutional environment, they have cognitive legitimacy.

Institutional theory explains not only why and how organizations conform to the institutional environment for the purpose of legitimacy, it also answers the question of how new organizational practices replace old legitimate practices or how institutional change occurs. Institutional change has been puzzling organizational researchers with the dilemma of “how can actors envision and enact changes to the context in which they are embedded” (Greenwood & Suddaby, 2006: 27). As institutional changes transgress old practices and run counter to existing legitimacy standards, they are risky to be implemented. Therefore, it is important to understand why and how firms engage in institutional change.

One perspective in explaining the institutional change process is through institutional isomorphism, which posits that institutional change across firms is similar as a result of concern over legitimacy in dealing with uncertain environment (DiMaggio & Powell, 1991). In particular, DiMaggio & Powell (1983) came up with the three mechanisms for institutional isomorphism: coercive, mimetic, and normative isomorphism. Coercive isomorphism explains how organizations respond to pressures exerted by other powerful organizational upon which they are dependent and by social expectations from the institutional environment. Mimetic isomorphism occurs when organizations imitate other organizations viewed as successful and legitimate in coping with uncertain environment. The third mechanism of institutional change is through normative isomorphism, which results from a convergence of organizational structures and practices to standards set by professional organizations.

The institutional isomorphism explains how firms become similar in organizational structure and behavior. However, it does not specifically address the paradox of “institutional

embeddedness of agency" (Seo & Creed, 2002: 223). Solutions to this puzzle focus on the dynamic relationship between institutions and active players (North, 1991; Greenwood et al., 2002; George et al., 2006). In particular, Seo & Creed (2002) proposed a dynamic framework involving the interplay of institutional contradictions and praxis. Institutional contradictions are conflicts and inconsistencies within the established social system, preparing for the occurrence of institutional change. They also identified four sources of institutional contradictions, including functional inefficiency, low adaptability, institutional incompatibilities, and conflict in interests. These four dimensions of institutional contradictions are not mutually exclusive; rather, they are interwoven over time.

The existence of institutional contradictions does not inevitably lead to institutional change. Praxis comes into play as the bridge between institutional contradictions and institutional change. Praxis refers to active agents who initiate institutional changes. These active agents interpret and understand the institutional contradictions of the institutional environment, and question the legitimacy of established organizational practices.

In addressing possible sources of institutional contradictions, Oliver (1992) summarized three sources of pressures (political, functional, and social pressures) in addition to entropy and inertia pressures at both organizational and environmental levels as antecedents of deinstitutionalization. These factors predict the deinstitutionalization process, namely, how the institutionalized practices discontinue as a result of erosion of legitimacy. These factors will be elaborated below.

Political pressures within the organization refer to performance crisis and a shift of power and interest of organizational members internally. Political pressures stemming from the external environment involve a change of critical relationship with other key constituencies. Deteriorating

performance can raise doubts on effectiveness of existing organizational practices and increase dissensus over legitimacy of such practices. Internally, a change of power can increase the chances of deinstitutionalize the existing organizational practices.

Functional pressures emerge when existing organizational practices do not meet organizational technical or functional expectations. For example, a practice that is conflict with organizational goals of efficiency will raise functional pressures to question the validity of such a practice.

Lastly, social pressures are triggered by conditions of ‘normative fragmentation’, ‘disruption of historical continuity’, ‘changes of laws and societal expectation’, and structural changes (Oliver, 1992:575). A change of these conditions raise social dissensus over the utility and legitimacy of existing practices.

One of the important contributions of Seo & Creed’s dialectical model of institutional change is that it can be applied to various types of institutional changes across contexts. Still, one question left underexplored in the dynamic institutional change process is the time and pace of institutional change (Lawrence et al., 2001). For instance, some organizations act as pioneers of institutional change, while other organizations follow their lead at a much later period (Leblebici et al., 1994; Zucker, 1987). Institutional researchers explain this pattern of change in two ways. First, Lawrence et al., (2001) link the temporal dynamics of institutionalization with four power mechanisms: influence, force, discipline, and domination. Different patterns and pace of institutional change occur under each power mechanisms. A case in point is that large powerful organizations have the legitimacy to differ from existing standards and practices and can pioneer the changes (Sanders & Tuschke, 2007; Sherer & Lee, 2002). The prestige and resources allow these organizations to try new practices that have not been legitimated. Sherer &

Lee (2002), for example, found large law firms are often the early adopters of contested human resource practice. Second, institutional theorists recognize that organizations face an increasingly complex institutional environment featured with incredible pace of globalization and technological development. Indeed, organizations' institutional environment is multidimentional, including both the primary institutional environment (e.g. local context) and others they encounter (e.g. global context). What is more, not all organizations are equally subject to institutional pressures that come from this multi-dimensional institutional environment. Multinational enterprises (MNEs), for instance, encounter complex institutional environment including home and host countries, and therefore face more complex organizational legitimacy issues (Kostova & Zaheer, 1999). In addition to the multi-dimensionality of institutional environment, organizations have to face different identities of institutions such as government agencies, laws, and professions, and international organizations which often have distinct demands on a particular interest group. These features of the institutional environment account for different patterns of institutional change in organizational fields.

Corporate Governance Reform as Institutional Change

As a part of national business systems (Whitley, 1992), corporate governance system is embedded in the local institutional environment, yet it is also subject to institutional pressures globally. Thereby, the legitimacy of governance practices is affected by at least three levels of institutional factors. At the highest level, governance legitimacy is impacted by governance standards and norms from global institutions. Next, firm's governance legitimacy is shaped by peer firms in the organizational fields. Lastly, corporate governance legitimacy is influenced by actors such as individuals or groups, including important decision-makers like top management teams. Corporate governance reform, thus, has to deal with the same problem of 'institutional

embeddedness of agency' since actor's ability to change in governance practices is shaped by institutional rules in which governance is embedded. In this respect, researchers have identified the following major drivers of corporate governance reform.

The first driver of change is pressure stemming from embeddendess. Broadly defined, embeddedness refers to the on-going contextualization of economic exchange in social structures (Granovetter, 1985). The institutions are embedded in various social domains such as culture, politics and the economy (Dacin et al., 1999; Zukin & DiMaggio, 1990). The embeddedness factors could suggest the possibility of conflicting pressures, power imbalance, resource dependencies in a specific context (Durand & McGuire, 2005; Fiss & Zajac, 2004), and more importantly the very source of institutional change (Kim, 2005). As noted previously, the institutional contradictions constitute potential antecedents to institutional change (Seo & Creed, 2002).

Corporate governance is a socially constructed concept, and different contexts value government regime differently. For example, in a context of formal governance system (developed context), emphasis is placed on the determining power of legal sanctions and remedies. While in an informal governance system (developing context with weak legal protection), social sanctions are important instruments used to protect shareholders (Zahra, 2007). This embeddedness of governance system in a specific context has important implications for governance reform. For example, in the context of developed economies with a strong focus on arm's length transaction, there are strong regulative pressures to adopt more transparent, and stringent governance practices. In contrast, in developing contexts, the dominant role of government and other interest groups such as banks and families results in a governance system

protecting these key stakeholders at the expense of other minority shareholders (Huchet & Richet, 2002; La Porta et al., 2000).

The second driver of governance change is performance pressures. Prior studies have shown that that firms use performance (e.g., most successful firms) as the reference group to compare and assess organizational behavior (Haveman, 1993; Fligstein, 1991). Good performing firms are chosen as the reference group because legitimacy providers perceive them as gatekeepers for organizational legitimacy. To gain legitimacy and resources, firms with poor performance tend to mimic their practices and structure.

In the case of corporate governance reform, studies have shown that not only governance affects firm performance, but prior firm performance also leads to change in governance practices. Firm performance can result in change of governance practices such as appointment of outside directors (Peng, 2004) and CEO compensation (Kato & Kubo, 2004; Chizema & Buck, 2006), and selection of CEO and board of directors (Daily & Dalton, 1994).

The third driver to change derives from agency, that is, actors who have the motivation and creativity to change the scripted behavior. Though agency is embedded in the context of institutional domains (Beckert, 1999), actors can actively engage in sensemaking behaviors by reconstructing, framing, filtering, and creating situations (Dorado, 2005) in additional to sticking to habitual behaviors. As organizations face fragmented environments, they frequently face conflicting beliefs and demands associated with the institutional rules (Meyer & Rowan, 1977). In responding to such demands, the mental model of important decision makers is critical in determining and assessing how a change in practices affects organizational legitimacy. In health care industry, for example, D'Aunno, Sutton & Price (1991) found that mental health treatment units and drug abuse treatment units are associated with different models regarding practices

such as type of professional to be hired, diagnoses tests and techniques, methods of treatments and other services provided. Thus, those ‘hybrids’ (units serving both sectors) face conflicting practices and demands, and react based on how the mental model assesses the hierarchy of institutional demands. Other studies also show that when organizational practices have not been legitimated, and in particular when the new practice is the ‘institutionally contested practice’, institutional change may involve different processes than isomorphic and regulatory mechanisms. Sanders & Tuschke (2007) found that under those conditions, learning from other institutional contexts and learning from prior experience are important mechanisms that drive institutional change. Organizations exposed to more different practices in a different context will be more likely to adopt contested practices. Likewise, organizations find it easier to adopt a new practice when they have prior experience in other similar situations.

In governance practices, empirical studies have also shown that the existing mental models of executives are important factors in governance change. Fiss & Zajac (2004) find that executives with a background in economics or law in Germany are more likely to espouse a shareholder-oriented governance model. Similarly, in studying the antecedents of adoption of stock option pay in Germany, Sanders & Tuschke (2007) find that CEOs with graduate business education increase the likelihood to adopt stock option pay.

These key drivers of governance change, in particular, the embeddedness of corporate governance in the local context, reminds us of the complex institutional environment in which a governance system is in. To fully understand the institutional change process in governance, we need to comprehend both endogenous and exogenous institutional pressures on organizations. The following section first discusses the local intuitional pressures on Chinese corporate

governance practices, and then it describes the global institutional pressures that Chinese listed firms encounter from the global institutional environment.

Local Institutional Pressures on Chinese Corporate Governance

In the Chinese context, regulative pressured on corporate governance stem from the state, which promulgates various laws and codes of governance practices for listed firms. As described in both chapter 1 and chapter 2, important governance laws and rules of regulations model after North American governance laws (Tam, 2000; Mar & Yong, 2001). Thus, the coercive pressure not only creates immediate regulative legitimacy of appropriate governance practices in China, it also produces considerable influence on cognitive and normative legitimacy afterwards. However, the still rudimentary legal infrastructure and weak enforcement of laws in China makes regulative pressure much less pronounced. Related to laws and sanctions, regulative pressures are also reflected in politics, which influence governance control by a shift of interests and power of important players (Fligstein, 1996). The dominant key political players influence governance control by issuing laws and regulations to accommodate the particular interest group. For instance, Chinese privatization policy (Chen, 2005) and soft budget constraints (Qian & Roland, 1998) have been shown to affect governance control and transparency of the governing process.

There are several norms of business practice that produce normative pressures on Chinese corporate governance practices. Chinese firms have been reported to have hierarchical organizational structures, centralized top-down decision making and limited disclosure (Young et al., 2001). This norm is against the principle of international governance standards, which stresses equal rights of all shareholders, outside scrutiny, and transparency. Second, the traditional practice of having iron-bowl job (lifetime job) in employment is replaced with

modern contract system. This has new implications in selecting executives in firms and it also produce influence on how executives implement governance practices. Third, as influenced by external forces, CSRC issued professional norms regarding governance practices of listed firms. As explained in the first chapter, these professional norms generate great influence on a firm's governance structure and behavior.

The take-for-granted cognitive pressures on corporate governance in China are reflected in the important role of guanxi in business society. China has been documented with the importance of building and maintaining connections and using them in business transactions (Kao, 1993). In fact, the cultural practices of using guanxi to get things done serve as a surrogate market and legal system in China (Braendle et al., 2005). It works as a complement to contract law (Luo, 2002). Guanxi derives its source from collectivist culture and durable kinship value systems (Gu et al., 2008). Unlike *Keiretsu* in Japan, which values corporate clan loyalty, guanxi in China stresses family loyalty or other kinship ties. This means doing business with families and friends is deemed as appropriate business behavior even though it does not imply economic efficiency or competitiveness. As an example discussed by Gu et al., (2008), when person A did a favor to person B in business exchange, Person B is obliged to return the favor. Otherwise, person A feels a loss of "face" or disrespect. This cultural practice of reciprocal relationship in businesses can help buffer a firm from external influences in uncertain environment. For example, Peng found that resource role of outside directors is more pronounced in Chinese context because it has a norm of depending on personal relationship (guanxi) to secure resources and get things done. Empirical studies such as Au, Peng & Wang (2000), Park & Luo (2001) have also shown that board interlocks in China have a positive effect on firm performance. On the other hand, the tremendous role of guanxi in business, together with a family-oriented cognitive institutions in

the Confucian-based culture (Backman, 1999), can be detrimental to firms in that firms can overlook alternative external governance models and potentially be insulated from outside scrutiny, thereby increasing the chance of the deviation from international governance standards and practices.

In the respect of deinstitutionalization pressures in the Chinese context, the political pressures mainly come from the deteriorating performance of SOEs, which affects the interests of a variety of stakeholders. As noted in previous chapters, the state still involves in SOE's operation, and government bureaucrats and politicians are seen to prioritize staying in power by maintaining and securing political support (Nee, Opper & Wong, 2007). On the other side of the coin, the firm has to burden state plans such as job creation and resource allocation. As such, SOEs' performance crisis resulted in conflicting political and economic interests among different parties. Under such performance pressures, the institutionalized rules of appropriate conduct tend to break down (Oliver, 1992: 569). Political pressures also derive from listed firms' power affiliation with the state. The tremendous dependence on the state for resources makes it more likely for firms to be constrained in their autonomy of governance.

In terms of functional pressures on corporate governance in China, the traditional goal of SOEs (such as maintaining employment level) clashes with that of modern privatized firms (maximizing profits). Firms (especially SOEs) start to question the institutionalized governance practices and structure. For example, one of the demands that can potentially increase firm efficiency is lowering the state ownership in publicly listed firms. Less government interference in governance is also seen as more desirable norm. Another example of functional pressure may come from the role of independent directors, which is more and more considered as good governance in China.

With regard to social pressures on Chinese corporate governance, one major source of social pressures in China is that people come to realize that the old concept of “iron-bowl” job (life-time job) is incongruent with modern enterprise goals. This change of social expectations on employment increases the awareness of appropriate governance practices (such as appointment of top management teams by a contract system), and it also raises questions about old governance practices in the SOEs. Social pressures also result from China’s more exposure to outside world. A case in point is that CEO with foreign education and experience may be more willing to accept alternative governance practices. Exposure to the global environment also increases people’s awareness of international standards of governance practices such as OECD principles, and the World Bank guidelines.

As described in previous chapters, Chinese ownership structure is characterized by high state ownership, concentrated ownership, and weak legal protection. These ownership features can also produce local institutional pressures on firms. Since organizations are arenas in which different players compete for dominance (Palmer, Jennings, & Zhou, 1993), high state ownership enables the government to converts relative interests into access and allocation of important organizational resources. The state is associated with existing institutions and thus high government control in markets represents a deviation from market capitalism, creating barriers to the development of equity market. For example, different levels of governments foster principle-principle agency problems, and high involvement of government in management such as board and management selection works against the principle of international governance standards such as board independence and transparency of business practices. High concentration of ownership and weak legal protection can disadvantage minority shareholders in that they are overpowered by large shareholders’ interests. On the other side of the coin, China has also been

trying to transform state ownership to tradable shares. Part of this task is completed through privatization, and partly due to the increasing power of institutional investors and individual shareholders. With more tradable shares, there is a perceived need for more effective governance system.

Collectively, the attributes of state ownership, concentrated ownership, privatization and important role of guanxi in an environment of poor legal protection suggest that firms in Chinese context face pressures to conform to local constituencies and local business norms and practices. These local pressures can have great impact on a listed firm's governance structure and behavior.

Global Institutional Pressures on Chinese Corporate Governance

In addition to these local institutional pressures, China faces external global institutional pressures. As described in chapter 1, China's privatization and opening-up reform policy have aiming at developing its domestic financial markets and attracting foreign investment since early 1980s. This has increased the need to improve its corporate governance system to compete in the global financial market. Studies have shown that counties with better governance systems are more attractive to foreign investors (La Porta et al., 1998). Thus, effective governance system can foster the development of competitive firms, increase both local and foreign entrepreneurial activities (Porter, 1990). To increase competitiveness, China has issued serious of governance laws based on western governance laws and regulations since early 1990s. The reinvention of these legal systems indicate an important source of global pressure on China to compete for foreign firms and resources by designing and improving its governance system in this increasingly globalized financial market.

Globally, different countries have created many codes of good governance, exerting great normative institutional pressures on national corporate governance systems. For example,

Aguilera & Cuervo-Cazurra (2004) have documented a total of 72 codes of good governance from both developing and developed countries by the end of 1999. These codes of good governance are sets of "best practices" of governance that cover all important dimensions of governance including board of directors, top management teams, auditing and accounting practices. Though governance standards and practices vary across the globe due to distinct institutional environment, these codes of good governance increase the normative pressures on other countries lacking similar codes.

In addition to governance standards issued by individual countries, international organizations have also released common standards in governance and helped to assess corporate governance at the firm level. To better understand the source of normative pressures from international organizations, the follow section describes several major international organizations and the governance standards issued by them.

- OECD Principles of Corporate Governance

In 1999, as a response to an increasing awareness of the vital role of corporate governance in investor confidence and national economic performance, the Organization for Economic Co-operation and Development **(**OECD) published the first international code of good corporate governance. The principles aimed at not only improving the 'legal, institutional, and regulatory framework' of the corporate governance regime, but also at providing 'practical guidance and suggestions for stock exchanges, investors, corporations, and other parties" (OECD, 1999). After the meltdown of the Enron and WorldCom and Parmalat, OECD Principles have been revised and in 2004 a new version of OECD Principles was released. It includes two parts: the OECD Principles of Corporate Governance and Annotations in the second part. The issues addressing corporate governance include: (1) ensuring the basis for an effective corporate

governance framework, (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. These principles have been widely adopted as the benchmark for good corporate governance practices, and also as key standards used by international organizations such as the World Bank and Financial Stability Forum.

- World Bank's Guidelines of Developing Corporate Governance Codes of Best Practices

Using OECD principles of corporate governance as the benchmark, the World Bank launched the 'Global Corporate Governance Forum' and worked with the International Monitory Fund in helping countries to assess the institutional framework and corporate governance practices by issuing the guidelines for developing best practices codes of corporate practices (World Bank, 2005). As stated, the purposes of this guideline include: "

- Corporate governance committees or task forces in the process of developing a corporate governance code of best practices at the country level;
- Professional organizations, business associations, and regulators taking the leadership in developing or implementing corporate governance code of best practice;
- Government agencies seeking to improve corporate governance standards and practices at the country level;
- Corporate governance committees and organizations monitoring, reviewing, and updating existing corporations" (Toolkit, The World Bank, 2005)

The focus of the World Bank corporate governance guidelines, which resembles OECD principles, is on shareholder rights, stakeholder rights, disclosure and transparency and disclosure, and rights of management and board.

- Standard and Poor's Corporate Governance Scores

Since 1998, Standard & Poor's has established Corporate Governance Services to enhance corporate governance standards. The Corporate Governance Evaluation Service calculates a company's corporate governance score based on both the company governance and the country environment. The company governance is internal to the company, including the 'effectiveness of interaction among management, board, shareholders and other stakeholders'. The country environment is external to the company, which encompasses 'the effectiveness of legal, regulatory, and informational infrastructure'. Standard & Poor's used "Corporate Governance Score" (CGS) scale, with CGS-10 highest and CGS-1 lowest, to assess a company in four dimensions: ownership structure and influence, financial stakeholder relations, financial transparency and information disclosure, and board and management structure and process.

- The Governance Rating of Credit Lyonnais Securities Asia (CLSA, 2001)

In April, 2001, CLSA produced governance rating for 495 firms across 25 emerging countries. CLSA sent out questionnaires to analysts in each country in those firms. The questions were designed to have binary answers (yes/no) to enhance objectivity. The questionnaires assessed the companies in 57 issues adopting the following seven key criteria: management discipline, transparency, independence, accountability, responsibility, fairness and social responsibility. The first six criteria were given an equal of 15% weight and the last criterion was given 10% due to split responses from fund managers. Since then, CLSA governance ratings

have been frequently in academic studies and exerted much influence on governance in emerging economies.

Entailing this global normative pressure for international corporate governance standards is the increasing cognitive acceptance of such international standards. Studies have suggested that there is an increasing awareness of alternative governance standards (Fiss & Zajac, 2004; Aguilera & Cuervo-Cazurra, 2004), and the academic debate of convergence or divergence in governance further fosters this cognitive awareness. Peng (2004), for example, observed that there has been a quite strong cognitive awareness of global corporate governance practices particularly from scholarly opinion and press coverage in the Chinese context. The cognitive awareness of alternative governance models worldly constitutes another important source of global institutional pressures for change in corporate governance in China.

Another dimension of displaying the global institutional pressures on China is to examine how Chinese institutional environment differs from those in other countries. In other words, organizations' addressing global corporate governance legitimacy can be affected by institutional distance, which is defined as "the difference/similarity between the regulatory, cognitive, and normative institutions of the two countries" (Kostova, 1996).

This construct of institutional distance is important in understanding how publicly listed firms respond to corporate governance reform in China. Kostova & Zaheer (1999) suggest that organizations respond to legitimacy requirements better when they are dealing with similar institutional profiles. For example, CEOs with foreign education and managerial experience are more likely to accept external legitimacy of foreign governance practices because that experience can reduce to a certain extent the institutional distance. Likewise, firms' prior experience of

adoption of international accounting standards can help such firms to accept similar governance beliefs, practices and systems.

To summarize, an increasingly competitive global financial market, growing global normative pressures as wells as increasing cognitive awareness of alternative governance standards fabricated in an increasingly pace of globalization constitute the global institutional pressures on Chinese corporate governance.

Strategic Responses to Institutional Pressures

Institutional theory posits that organizations need to interpret and respond to the institutional pressures they are facing (Dacin et al., 2002). Appropriate interpretation and responses are critical because the institutional pressures are complex and involve a dynamic impact on firms. A case in point is that the established institutional rules and practices can undertake changes themselves (Scott, 2001; Greenwood et al., 2002; Oliver, 1992), and sometimes abandoned due to erosion of legitimacy. In responding to these institutional pressures, firms face strategic choices associated with various extent of passive conformity or active resistance. For example, Oliver (1991) proposed five different types of strategic responses: acquiescence, compromise, avoidance, defiance, and manipulation. As discussed previously, organizations need resources and legitimacy to survive. Acquiring legitimacy and resources are not necessarily mutual-exclusive for organizations. Rather, the relationship is interdependent and complementary. Organizational compliance with institutional norms and rules can be rewarded with “increased prestige, stability, legitimacy, social support, internal and external commitment, access to resources, attraction of personnel, fit into administrative categories, and invulnerability to questioning”, while noncompliance behavior is associated with benefits such as “ability to

maintain discretion or autonomy over decision making, the flexibility to alter or control the environment in accordance with organizational objectives" (Oliver, 1991: 150).

Figure 3.1 shows that in the case of corporate governance reform in China, listed firms are facing decisions as to whether to apply for the Corporate Governance Sector Index. Listed firms facing this same event respond to this legitimacy-related threats and opportunities differently (George, et al., 2006). Firms interpreting the application of the CGI as threats to established governance practices may choose to not comply with this action. In this way, firms may potentially gain more control in governance but may damage its legitimacy, which ultimately leads to a loss of resources. On the other hand, firms interpreting the application of the CGI as opportunities to change governance practices may choose to comply with this action.

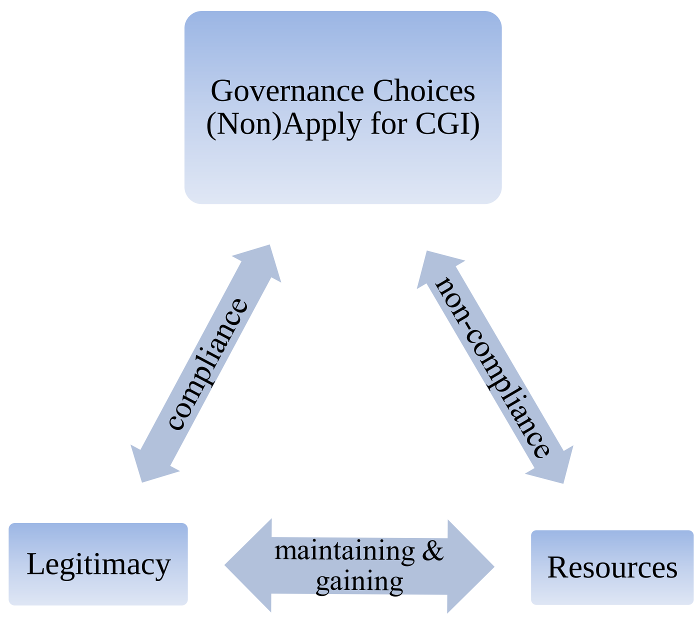

Figure 3.1 Implications of Acquiring Legitimacy and Resources

In short, in explaining corporate governance, institutional theory complements agency theory in that it recognizes that efficiency is not the sole determining factor in the development of national corporate governance system. Rather, it views corporate governance beyond the

efficiency-focused owner-management-board relationship. But it is deeply embedded in a nexus of cultural and political ties (Meyer & Rowan, 1977; Oliver, 1991; Roberts & Greenwood, 1997). Corporate governance systems, as part of these socially-constructed (Berger & Luckmann, 1966) institutions, are composed of shared cognitive, normative, and regulative rules (Scott, 2001). These formal and informal rules can play dual roles in shaping the development of national corporate governance system. As parts of shared beliefs and collective understanding of the country, they preserve and reinforce established governance codes, practices, and structures. On the other hand, national institutions also exert pressures to change in governance at times when these institutions are in the process of 'deinstitutionalization' (Oliver, 1992) or when they are overpowered by external pressures (Scott, 2001).

Resource-dependence Theory

Though institutional theory contributes to organizational research by emphasizing the significant role of constraining institutional forces from the institutional environment in shaping organizational actions (DiMaggio & Powell, 1983), it has difficulty in solving the puzzle of how to" reconcile technological imperatives with institutional constraints" and that of " how new practices replace established ones" (Leblebici, Salancik, Copay, & King, 1991:335). In this perspective, resource dependence theory complements institutional theory in addressing organizational choices by stressing the pressures from the task environment (Oliver, 1991). In other words, in addressing environment uncertainty, institutional theory focuses on organizations' passive role of conforming to and abiding by established practices and rules so as to gain legitimacy and survival (DiMaggio & Powell 1983; Meyer & Rowan, 1977), whereas RDT emphasizes organizations' active role in managing and controlling resources critical to organizations' success and survival (Pfeffer, 1972; Pfeffer & Salancik, 1978).

Resource dependence theory suggests that organizational change is shaped by how resources are made scarce in the process of adopting of a widespread standard (Leblebici et al., 1991). When more participants are going to adopt a standard, the resources will become scarcer due to increasing intensity of competition of seeking these resources. As the supply of the resources is neither infinite nor evenly distributed, firms conforming to the standard face different consequences. Some firms are able to enact the standard, some fail to do so, and some end up choosing different practices. Thus, resource dependence theory shows us the dynamic process of how firms compete and respond to organizational change in terms of the input or resource dimension. For example, firms compete for foreign investment will deem foreign capital as critical resources, and they are more likely to adopt international governance standards to make that happen. On the other hand, firms compete for local dominance may regard relationship with government and powerful social networks or guanxi as more significant resources than capital resources. Accordingly, these firms are more likely to choose governance practices that meet expectation of local institutional actors.

From the perspective of principle-principle relationship in governance regime, organizational resources also play important role in firms' governance structure and behavior. As noted earlier, China face quite a different nature of agency problem in that it has different levels of principles, which have various extent of demands as well as control of resources. For example, the central government and local government, representing different principles of listed firms, control different sets of financial and other organizational resources. Meanwhile, these principles may have different expectation about corporate governance practices. Thus, depending on the intricate relationship with these principles, listed firms respond differently in facing pressures to change in governance.

Corporate governance choices not only affect how the resource are gained, but also influence how firms utilize their resources. Even though a firm may have valuable, rare, costly to imitate, and nonsubstitutable resources (Barney, 1991), a lack of effective governance system (incentive or monitoring system, for instance) may render the resources not fully utilized. Organizational resources, on the other hand, influence a firm's governance practices too. Organizations tend to choose governance practices deemed as legitimate to those resource providers. For example, in the Chinese setting, firms would choose prestigious board members as they increase legitimacy to the firm (Young & Ahlstrom, 2001). Such is also the case for selecting independent directors, who can signify legitimacy to those key constituencies, particular those who provide critical resources. Likewise, the choice of appropriate governance structure and practices can send signal to foreign investors who have the capital China needs.

In applying resource dependence theory to corporate governance, scholars have stressed the important role of the board of directors in securing and providing resources to firms. Pfeffer & Salancik (1978) point out that boards can generally provide four major benefits: (1) advice and counsel, (2) legitimacy, (3) channels for communications between organizations and the environment, and (4) access to endorsement and resources. In particular, both inside and outside directors play an important role as resource providers. Inside directors can provide internal information about the organization (Baysinger &Hoskisson, 1990). Outside directors can provide counsel and advice (Lorsch & MacIver, 1989; Johnson et al. 1996). Hillman et al. (2000), in their study of resource dependence role of directors, argue that the traditional agency role of directors such as insiders and outsiders could not completely capture the resource dependence role of directors. This is because the agency role mainly focuses on how directors can alleviate agency problem by monitoring management on behalf of shareholders. But resource dependent

role of directors not only serve to cope with environment uncertainty, but also bring resources such as ‘information, skills, access to key constituents, and legitimacy’ (2000: 238).

In a similar study, Hillman & Dalziel (2003) integrate both agency theory and resource dependence theory to propose that board of directors is related to firm performance. In particular, they bring the concept of ‘board capital’ to link control role and resource role of directors. In their view, board capital include both human capital (knowledge, experience, expertise), and relational capital (network of ties). They provide a model that links board capital to both monitoring role and resource role, and ultimately to firm performance. In sum, these empirical studies on western boards have shown that organizational governance elements can be explained by how firms perceive and acquire resources.

Boards of directors in East Asia are described to execute these basic board functions differently due to a very different institutional environment. Special emphasis is placed on board’s resource role. Young et al. (2001), for instance, found that board of directors in Hong Kong and Taiwanese Firms execute their functions through their interlocking board memberships. This is because the connections with important people gain and maintain a firm’s legitimacy and help access resources. This has important implications for creditors and investors dealing with Asian firms.

Hypotheses Development

The above theoretical discussions suggest corporate governance in Chinese publicly listed firms may be subject to two sources of pressures. One stems from local factors that are embedded in its institutional environment in China. The other comes from external influences such as global pressures to change in governance. The multi-theoretical perspectives explain how publicly listed firms in China respond to both exogenous and endogenous pressures on

governance change. The forces that embedded in the local institutional context can potentially reinforce the established governance practices, while international forces exert more economic pressures on firms to adopt North American model. More importantly, these two sources pressures can produce a dynamic impact on firms' governance structure and practices. On the one hand, global economic pressures may initiate change in governance laws and regulations at a country level. On the other hand, governance in a particular context can either reinforce or defy the legitimacy of governance standards globally. Together, these two sources of pressures eventually impact governance practices at a firm level.

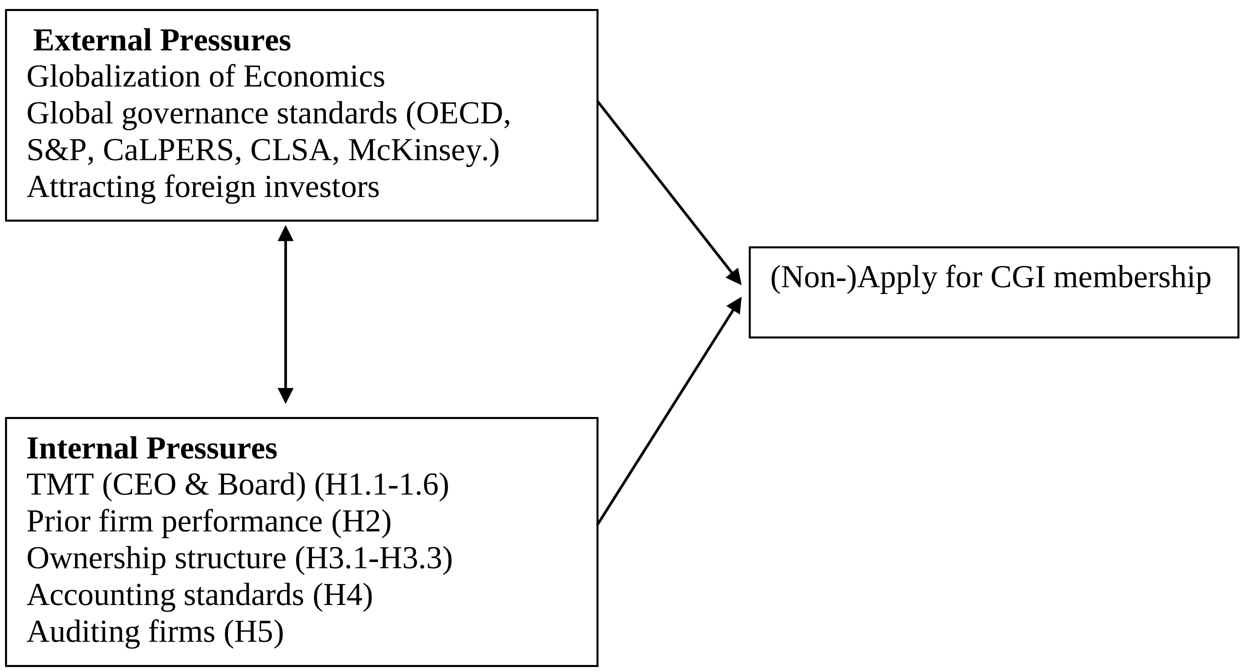

Figure 3.2 A Conceptual Map of Chinese Listed Firms' Responses to Governance Reform

Based on the conceptual model (Figure 3.2), this study examines four groups of antecedents that affect a firm's responses to institutional pressures: 1) CEO and board characteristics; 2) ownership characteristics; 3) a firm's prior performance, and 4) accounting standards and auditor firms. These antecedents tap into one or more dimension of the three key drivers of governance change: embeddedness, performance, and mental model of agents.

CEO and Board Characteristics

Previous institutional researchers have explored factors that explain both conforming and non-conforming behavior in organizational practices, beliefs, and structure (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Dacin, Goodstein, & Scott, 2002; Powell, 1991). However, those studies have mostly examined external factors that trigger institutional change (Edelman, 1990; Oliver, 1992). Recently, researchers have also started to investigate factors within the organizations that shape organizational responses to external pressures (George, Sitkin, & Barden, 2006). Particularly, increasing attention has been given to the significant role of individuals in perpetuating or adapting organizational situations (Zilber, 2002; Elsback & Sutton, 1992; Peng & Health, 1996). In the case of corporate governance, a firm's chief executive and board of directors play dominant roles in formulating and implementing corporate strategy including organizational daily operations, investment plans, organizational structure and personnel policy (Westphal & Fredrickson, 2001).

From functional pressure perspective, top managers influence organizational outcomes because they determine the overall strategic direction of the firm (Westphal & Fredrickson, 2001). A firms' chief executive is important because CEO is " … someone who has primary responsibilities for setting strategic directions and plans for the organizations, as well as responsibility for guiding actions that will realize those plans"(Gioia & Chittipeddi, 1991: 434). The boards of directors play predominant roles in control, service, and resource dependence (Daily & Dalton, 1993; Johnson, Daily, & Ellstrand, 1996).

Institutional theorists have called for "the cognitive micro-foundations of institutional theory" (George, Sitkin, & Barden, 2006:347) to examine how decision makers interpret environmental pressures and take actions. Scott (2001) suggests that external cultural

frameworks shape internal interpretative processes, and this “cultural-cognitive pillar” might be critical to the further development of institutional theory. To explain the process, George et al., (2006) propose that individual decision makers perceive environmental pressures as either legitimacy threats or opportunity and correspondently respond with either isomorphic actions or non-isomorphic actions. The legitimacy perceptions are associated with resources and control. Tolbert & Zucker (1983), for example, suggested that adoption of civil service reform can gain legitimacy, which ensured resources. On the other hand, losing legitimacy can impede organizations’ capability to control. Zilbert (2002), in the study of an Israeli rape crisis center, showed that legitimacy is related to key players’ ability to control the center.

Common demographic features of top management teams include age, tenure, industry experience, and functional background heterogeneity (O’Reilly & Flatt, 1989). Given that this study aims to explore the potential impact of top management teams on orientation of corporate governance models in Chinese context, which emphasize the role of guanxi in business, this study stresses the following characteristics of CEO and board: 1) CEO tenure; 2) CEO education and experience; and 3) CEO duality. Board characteristics focus on proportion of independent boards, the size of board, directors from government officials, and director education and experience.

CEO Tenure

Longer tenures imply more established individual networks (guanxi) as well as inter-organizational networks, both of which are deemed as the lifeblood of Chinese business society (Xin & Pearce, 1996). It also means established ‘legitimacy’ in dealing with both horizontal relationships such as suppliers, buyers and with vertical connections such as governments and regulatory bodies (Park & Luo, 2001). The instrumental-personal-ties cultivated are also

believed to provide “structural support” that normally stems from government and law. Thus from institutional perspective, firms with longer-tenured CEOs are more deeply embedded in a nexus of local formal and informal business rules and practices.

In addition, institutional persistence and changes have been shown to link with individual cognitive underpinnings (George et al., 2006). The longer a chief executive is in the position, the cognitive patters tends to grow more rigid. Empirical studies showed that top management tenures were negatively associated with strategic change (Boeker, 1997; Finkelstein and Hambrick, 1996). Likewise, in facing pressures on corporate governance, it is more likely that long-tenured executives would perceive new corporate governance codes and practices as threats to extant legitimacy of old practices that they have been used to. Hence, when subject to external pressures to change in corporate governance practices, longer-tenured CEOs tend to succumb themselves to local established institutionalized business practices and beliefs, defending legitimacy of such old practices.

Hypothesis 1.1: Publicly listed firms with longer-tenured CEO will be less likely to apply for the Corporate Governance Sector Index Membership.

<u>CEO/ Board with International Education and Experience</u>

In general, researchers believe that education is associated with “cognitive ability, capacity for information processing, tolerance for ambiguity and propensity or receptivity to innovation” (Datta & Guthrie, 1994:572). TMT’s international education exposes them to more complete paradigmatic perspectives (Johnson, Hoskisson, & Hitt, 1993), and increases their knowledge and expertise (D’Aveni, 1990), which supplies them with necessary expert and prestige power to initiate strategic restructuring (Finkelstein, 1992).

Experience links knowledge base and perspectives. Limited experience can constrain one's perspectives. As Hambrick & Mason (1984:200) put it: "executives who have spent their entire careers in one organization can be assumed to have relatively limited perspectives". Finkelstein & Hambrick (1996) has shown that top management's experience is associated with both the likelihood and content of organizational change. For instance, empirical evidence shows that strategic changes initiated by a new CEO are more likely to resemble the CEO's prior employer (Westphal & Fredrickson, 2001; Boeker, 1997 a). Sambyarya (1996) proposed that Top management teams' international experience is a critical element in affecting corporate strategy because of three related reasons: 1) international experience help reduce uncertainty; 2) it expands one's cultural knowledge; and 3) it prepares TMT in responding to forces of 'expanding global economy and markets'.

Empirical evidence has suggested that the level of international orientation stemming from education and experience is associated with international activities (Kobrin, 1994; Dichtl, Koeglmayr & Mueller, 1990). TMT's international education and experience creates a sense of global mindset, which constitutes important part of mental models that influence decision-making in governance changes. Research has provided support that such mental models play important role in integrating new information and prior knowledge (Daft & Weick, 1984). Coupled with these mental models, top management teams are more aware of the international norms in corporate governance, and they see a greater need of seeking legitimacy to conform to such international standards. Because of the international experience, executives may feel the institutional distance between China and foreign countries are closer, thereby are more likely to accommodate the personal legitimacy to external governance practices. Fiss & Zajac (2004) showed that executive educational background made a difference in determining whether the

firm espouses a shareholder value orientation governance model in Germany. Furthermore, the global perspective derived from international education and experience weakens existing mental models about domestic norms and practices. From resource dependence perspective, conforming to new governance models and gaining legitimacy to such external constituencies also help firms access to critical resources required for firms (Oliver, 1991; Arthur, 2003). Therefore, I propose:

> *Hypotheses 1.2: Publicly listed firms with CEO and board members having more international education and experience will be more likely to apply for Corporate Governance Index membership.*

<u>CEO Duality</u>

CEO duality means the chief executive of a firm simultaneously takes the position of chairperson of the board. There are two opposing views regarding the potential effect of CEO duality on corporate governance. On the one hand, CEO duality can entrench a CEO, diminishing a board's ability to perform its monitoring duties (Mallette & Fowler, 1992). On the other hand, stewardship theory argues that CEO duality promotes and enhances unity of command, and quality of decisions (Donaldson & Davis, 1991). Prior empirical research has also produced mixed results as to how CEO duality affects firm's performance (Finkelstein & D'Aveni, 1994).

In Chinese context, the CEO has dominating power in managing and controlling the firms. Though in theory, the executives should be elected the shareholder's meeting, in practice they are often appointed by controlling shareholders. This results in a phenomenon of "one-man rule" (Lin, 2001:13), and the duality makes CEOs even more powerful. The CSRC guidelines

encourage but not require the separation of CEO and board chair, indicating the desirable norm of separating CEO and the board chair.

This ‘one-man rule’ creates potential governance problems. As Jensen (1993) pointed out, the CEO duality makes it ‘extremely difficult for the board to respond early to failure in its top management team, and when the chief fails, the board cannot effectively perform its key functions”. CEO duality reduces the extent to which the firm is subject to outside scrutiny. Zhong (2002) found the CEO duality significantly reduced the independence of boards and increases the discretion of CEOs.

Daily & Daton (1994) reported that a lack of dynamic relationship between the CEO and the board led to threat-rigidity responses (Staw, Sandeland, & Dutton, 1981), conservatism and reliance on past policies, increases in centralization and formalization, and resistance to strategic change (Dutton & Duncan, 1987). Therefore, I propose:

Hypothesis 1.3: Firms with CEO duality will be less likely to apply for Corporate Governance Index membership.

<u>Board Size</u>

There are two competing arguments about the effect of board size on the likelihood of strategic move. Resource dependence perspective suggests that larger boards are related to breadth of perspectives, larger pool of expertise, and resources (Pfeffer & Salancik, 1978). Goodstein, Gautam & Boeker (1994) described board size as a measure of organizational capability to form links that extract critical resources from environment. The second argument posits that too large board size suffers from ‘social loafing’ (Janis, 1989; Latene, Williams & Harkins, 1979), and the ‘free-rider’ problem on the board makes it inefficient and ineffective in carrying out its duties and responsibilities (Ocasio, 1994; Zahra & Pearce, 1989). For example,

Judge & Zeithaml (1992) found that large boards were less likely to involve in strategic decision making.

In US context, it is generally believed that small board is more efficient (Lipton & Lorsch, 1992). For instance, Jensen (1993:865) notes that "when boards get beyond seven or eight people they are less likely to function effectively and are easier for the CEO to control". Firstenberg & Malkeil (1994:34) voiced a similar view that a board with eight or fewer members "engenders greater focus, participation, and genuine interaction and debate".

In China, the significant role of guanxi in Chinese business society suggests that more board members who have the social capital of networking can provide the firms with critical resources (Park & Luo, 2001). What is more, having close ties with the government constitutes very important dimension of the social capital because the government controls critical organizational resources. Thus, though it is likely that firms with large board have more social capital to cope with uncertainties in the environment, dependence on the government for resources constrain how the social capital is utilized. From resource dependence perspectives, firms with large board may be less likely to consider change in governance practices to seek external resources. From institutional perspective, preserving local governance standards is more likely to be congruent with local business norms, and thereby more likely to acquire resource needed. Thus, I propose the following hypothesis:

Hypothesis1.4: Firms with a large board will be less likely to apply for the CGI membership.

Independent Directors

An independent director is not necessarily the same as outside directors. Johnson, Daily & Ellstrand (1996:417) defined outside directors as "non-management members of the world".

This definition does not rule out that outside directors can have family or other professional relationship with the firm. In China, an independent director has a more stringent requirement that "who holds no posts in other company other than the position of director, and who maintain no relations with the listed company and its major shareholder that might prevent them from making objective judgment" (Wang, 2005).

Independent directors can bring valuable resources to the firm according to resource dependence theory (Pfeffer, 1972). In the study of the effect of independent directors on firm performance, Peng (2004) found that those affiliated independent directors have a positive relationship with the firm performance. From institutional perspective, there is a growing regulative pressure for listed firms to have independent directors on the board. Traditional SOEs do not have board of directors (Tenev & Zhang, 2002), and then the reform of SOEs rules that only joint-stock with a board can list shares in stock exchange. Recently, there are greater coercive pressures for more independent directors on the board. The regulatory body, CSRC (2001), mandates that publicly listed firms have at least two independent members on board by 2002. There is also great normative pressure from scholar's opinions and press coverage (Xu & Wang, 1999). Thus, having more independent directors on board suggest that such firms are aware of western corporate models, it also shows their attempt to conform to such norms.

In carrying out the monitoring role, independent directors can potentially resolve conflicts of interests between managers and shareholders at a lower cost duo to the independence status quo they maintain from the firms. Empirical studies found support that those independent directors protected external shareholders (Brickley & James, 1987; Benkel et al., 2006). Independent directors compete in labor markets (Fama & Jensen, 1983), which entice them to develop personal reputations as monitors and experts in governance. Thus, superior governance

not only aligns shareholder interests with firm performance, it also in the best interests of independent directors. This suggests more awareness of global governance standards from independent directors is in lining with both coercive and normative pressures faced by listed firms in China. Therefore, I expect:

Hypothesis 1.5: Firms with higher ratio of independent board members will be more likely to apply for the Corporate Governance Index membership.

Directors from Government Officials

SOEs have a long-standing history of government intervention (Nee et al. 2007). One of the most common means of intervention is that the government appoints executives and board members. Though the Company Law stipulates that the top management teams must be elected by shareholder's meeting, the government, as the controlling owners in many of these publicly listed firms, has great power in influencing the election process. In their study of the effect of government intervention on firm performance, Nee et al. (2007) surveyed 257 listed firms at the Shanghai Stock Exchange to rate the level of decision-making power of shareholders, boards of directors, managers and state. The survey confirmed that government bureaus and party committees still directly involved in the decision-making. They found support that government intervention has negative effect in decision making aspects such as personnel and financial decision making. Further the study found no positive economic benefits of state intervention.

Other researchers have reported that there are benefits associated with having government officials (including former government officials) as corporate directors (Lester et al., 2008). These benefits include advice and counsel, communications channel to government, influence over policy decision, and legitimacy (Hillman, 2005; Nohria & Eccles, 1992).

In impacting firms' governance behavior, firms with more directors from government officials may see less need to acquire external resources and legitimacy since they can have access to state-controlled resources. Accordingly these firms will be less likely to change in governance for fear of losing legitimacy of old governance practices. In addition, the fact that directors from government officials is a normal means for the state to control listed firms suggest that such firms will consider the interests of state at the expense of other shareholders. Therefore, I expect the following:

Hypothesis 1.6: Firms with more board members from government officials will be less likely to apply for membership of the "Corporate Governance Index Sector".

Ownership Characteristics

<u>Ownership concentration</u>

Porter (1990) highlighted the importance of ownership structure in *The Competitive Advantage of Nations* that "Company goals are most strongly determined by ownership structure, the motivation of owners and holders of debt, the nature of corporate governance, and the incentive processes that shape the motivation of senior managers"(1990:110). Likewise, ownership structure is a key determinant of governance structure (La Porta et al., 1998; 2000). As described in previous chapters, the ownership structure in China is substantially different from that in the USA. Most large Chinese companies were originally state-owned. After these companies were structured into publicly listed firms, the typical ownership consists of the state shares, legal person shares, and individual shares. Both the state shares and the legal person shares are non-tradable. Listed firms in China also have high concentration of ownership. Xue (2001) reported proportions of shares of all listed firm by the end of 2001. The largest shareholder controls 44.10 %, the largest five and largest ten control 58.57% and 61.03%

respectively. In short, high state ownership, high concentration, and limited tradable shares comprise major characteristics of ownership structure in China.

Under this ownership system, the largest shareholder (the state in most cases) has substantial control on major corporate decisions. It appoints chairman of the board, CEO and other board members (Hu & Yang, 20004).

Table 3.1 Ownership Concentration in Chinese Listed Firms 2001

Ownership Concentration	**Proportion (%)**
Top1 shareholder	44.10
Top 5 shareholders	58.57
Top 10 shareholders	61.03

Source: Xue, 2001

The rights of minority shareholders are not fully represented and protected as they do not have the voice heard at the shareholders' meeting. Minority shareholders have to bear high cost of acquiring information withheld by the controlling shareholders. Shleifer & Vishny (1997) hold that large shareholders (exceeding a threshold of ownership) tend to pursue private benefits disregarding the interest of minority shareholders. La Porta et al. (2000) and Filatotchev et al. (2001) supported similar results. In China, concentrated ownership gives the large shareholders dominant power in managing and using resources at their discretion. It also makes "tunneling" easier (Classens, Djankov & Lang, 2000). Chen & Lin (2007) showed that ownership concentration making fraud more likely, with little control of "insider trading" (Lin, Cai, & Li, 1997).

The shareholder-oriented model, on the other hand, generally has a diffuse ownership. Under an effective incentive alignment system, concentrated ownership can mitigate conflicts between controlling shareholders and minority shareholders by disclosing timely and accurate

firm information. Also pertaining laws assure that controlling shareholders do not opportunistically exploit non-controlling shareholders (Hansmann &Kraakman, 2001). However, China lacks a strong legal framework to protect minority shareholders (Clarke, 2003). Accordingly, the positive role of ownership concentration is very likely to be dominated by entrenchment behavior of controlling shareholders.

In sum, the controlling shareholders in a concentrated ownership system in China can enjoy benefits associated with “informed trading” and are less constrained by laws. Thus from institutional perspective, such ownership concentration suffer low coercive pressure and legitimacy pressures to change in governance practices. From resource dependence perspective, since the state, as the controlling shareholder, has access to important resources, it suffer low pressures to seek external resources that otherwise be critical for firms. Hence, I hypothesize firms with high ownership concentration will be less likely to initiate changes on governance.

Hypothesis 2.1: Publicly listed firms with more highly concentrated ownership will be less likely to apply for the CGI membership.

<u>Tradable Shares</u>

Qiang (2003) reported that a listed firm in China has three major types of shares 1) state shares; 2) legal person shares; and 3) tradable A-shares. Both state shares and legal person shares are not tradable. State shares are those owned by the central government and local governments. Xue (2001) indicated that only 6 percent of listed firms in China do not have state ownership. And the state controls around 30.9% of outstanding shares in the publicly listed firms, compared with 0 % in the United States, 0.7 % in Japan, and 5.0 % in Germany (Xu & Wang, 1997). Empirical studies have demonstrated that state ownership is negatively related to firm performance (Xu & Wang, 1997; Wei & Varela, 2003), because the high proportion of non-

tradable shares create governance problems. The state, as the ultimate controller, is entitled to the right of appointing directors, managers. In addition, the state ownership creates the problem of weak-control, because the firms do not have the absolute ownership of the property rights, and the state does not exercise its rights to monitor management. Also, the state is burdened with other responsibilities such as promoting employment and maintaining economic stability, compromising a firm's goal of profits maximization.

On the other hand, the high proportion of tradable shares suggests less government intervention, and the firm's governance is subject to higher level of public scrutiny. Shareholders have more autonomous rights in appointing executives and directors, and more discretion in organizational daily operation. Thus, large proportions of tradable shares can signify 'good' governance to investors, particular foreign investors.

Hypothesis 2.2: Firms with a higher proportion of tradable shares will be more likely to apply for Corporate Governance Index membership.

Foreign Ownership

The regulatory requirements and level of disclosure of information are different between firms with foreign ownership and those with only domestic ownership. For example, firms with foreign ownership are required to provide financial reports complying with International Accounting Standards (IAS). Prior research has shown that foreign ownership is positively related to governance transparency and negatively associated with information asymmetries (Kang & Stulz, 1997; Kim & Yi, 2008). The result makes sense especially in emerging market such as China, where investor protection is relatively weaker (La Porta et al., 1998) and endemic inside trading reduces participation in equity markets (Ausubel, 1990; Leland, 1992).

Foreign ownership, to a certain extent, accommodates the interest of foreign investors and their objectives. A firm's percentage of foreign ownership is associated with correspondent degree of control over foreign investments (Bennedsen, Gosgerau, & Nielsen, 2003). Filatotchev, Stephan & Jindra, (2006) used a sample of firms from five transitional countries and found that foreign ownership was linked with control over a range of strategic decisions, and also influenced export intensity. Firms with foreign ownership in Asian countries are found to be more productive than those firms without foreign ownership (Doms & Jensen, 1998). This is because foreign ownership matters in corporate governance practices. For example, Jackson & Moerke (2005) reasoned that since foreign investors typically have arm's-length business relationship with local firms, they seek higher return in investment and demand more shareholder-oriented governance practices.

To attract foreign investors, firms with foreign ownership are generally believed to have closer corporate governance practices to the global governance practices. These include aspects such as disclosure and transparency practices, accounting and auditing, and listing rules. Empirical studies have provided evidence that foreign ownership can exert considerable pressures on firms to adopt more globalized or 'Americanized' governance model (Yoshikawa & Gedajlovic, 2002; Useem, 1998). Theoretically, firms with foreign ownership are more aware of the international standard governance practices, and they are more likely to seek and maintain the legitimacy of conforming to such standards.

Hypothesis 2.3: Firms with foreign ownership will be more likely to apply for Corporate Governance Index membership than those firms without foreign ownership.

Prior Firm Performance

Oliver (1992) proposes that mounting performance crisis is one of the key potential antecedents of deinstitutionalization of organizational practices. Performance problems threat

firm's legitimacy and survival, and raise doubt on established practices. Poor performance also renders it more 'legitimate' to make any corporate restructuring (Finkelstein & Hambrick, 1996). This institutional perspective is consistent with behavioral theory of the firm, which posits that unsatisfactory firm performance can act as inklings that actions need to be taken (Cyert & March, 1963). When firm performance is lower than aspiration level, it triggers problem-searching activities and strategic changes (March & Simon, 1958).

Poor performance not only accelerates real organizational change as a catalyst (Ahmadjian & Robinson, 2001; Kiesler & Sproull, 1982), but it may also lead to symbolic management (Suchman, 1995; Fiss & Zajac, 2006). In facing crisis, organizations need to convey to the public the message that remediation is undertaken. The applying for the "Corporate Governance Index Sector" communicates such message to investors that the firm has been trying to adopt "good" governance, hence complying with both internal and external expectations.

Of course, it is also expected that good performing firms may better meet the CGI standards. Thus good performing firms having nothing to lose by applying for the CGI, instead, they can acquire the legitimacy of being viewed as "good governed" firms associated with the CGI membership. Given that the CGI is a voluntary process, and listed firms are facing a serious performance crisis, I expect poorly-performing firms have more incentives to apply for the CGI membership. Therefore, I hypothesize

Hypothesis 3: Firms with poor prior performance will be more likely to apply for membership of the Corporate Governance Index Sector.

Accounting Standards

The financial reporting system play important role in investment because investors generally rely on such accounting information to screen firms, assess potential risks and make

investment decisions (Wright & Robbie, 1996; McGrath, 1997). Accounting statements also provide crucial information for board members and shareholders to perform their monitoring duties (Fama & Jensen, 1983). The local Chinese accounting standards (CAS) significantly deviates from international accounting standards such as GAAP (Generally Accepted Accounting Principles) or IAS (International Accounting Standards) in several respects (Bruton & Ahistrom, 2003). First, Chinese accounting rules stress production management instead of asset valuation (adopting different method of calculating costs), so it is more difficult to obtain accurate and timely information (Peng, 2000). Second, there is reported variation of terms defined in different industries, ownership forms (Chen et al., 1997) or different regions in China (Broadman, 1999). Third, regulation and enforcement in accounting rules are weak (Becker, 2000). Thus, selection of accounting standards makes a difference in the quality of information provided to the investors (Healy & Palepu, 2001).

Both GAAP and IAS require more disclosure than local Chinese accounting rules. Whereas CAS resides in a financial market involving endemic insider trading and "hidden information" (Chen & Tran, 1995), Tuschke & Sanders (2003) show that both GAAP and IAS are closely linked to shareholder-oriented governance practices. The local Chinese accounting rules have been shown to benefit firms with high state control (Chen et al., 1997). These powerful owners may be against adopting more transparent governance standards for fear of having to disclose important information to their competitors.

The above discussion suggests that listed firms that have already adopted international accounting standards are should have less concern of more disclosure of information than required by CAS since they have been doing so. Mentally, these firms are more ready to adopt corporate governance practices congruent with more stringent requirements. In fact, applying for

CGI implies can bring benefits to firms such as signifying 'legitimacy' of governance to investors, especially to foreign investors. Thus, I hypothesize the following:

Hypothesis 4.1: Firms adopting international accounting standards (GAAP or IAS) will be more likely than those firms adopting local accounting standards to apply for Corporate Governance Index membership.

Auditing Firms

In most North American countries, auditing firms are independent, private and self-governed. However, auditing firms in China are heavily regulated by state agencies such as the Ministry of Finance and the State Audit Administration. The state also involves considerably in the auditing process (Chow et al., 1995; Graham, 1996). The Chinese CPA firms have to be approved by the state in order to audit listed companies (Lin & Chan, 2000). The foreign firms are not allowed to audit directly, but they are allowed to have joint ventures with Chinese CPAs.

Selection of audit firms is associated with the quality of accounting information and also constrains the choice of accounting standards (Firth et al., 2007). In China, the problem of "inside trading" is serious. The Confucian values of filial piety, reciprocating good deeds is endemic in Chinese business (Alston, 1989). In choosing audit firms, consideration of guanxi makes 'obtaining customers', 'securing credit' important criteria rather than the reputation and quality (Xin & Pearce, 1996; Yang, 1994). Auditing work in China is often based on industry-oriented accounting curriculum (Tang et al., 1994). Also as China has a strong culture of high uncertainty avoidance (Hofstede, 1980), auditing rules adopt a conservative approach and auditor reports lack professional judgment which requires "freedom" and "uncertainty" in reasoning (Lin & Chan, 2000). In this sense, the local CPA firms face issues of credibility in auditing.

On the other hand, selection of an auditing firm affiliated with one of the large North American accounting firms assures certain extent of independence (Solomon, 1995) and quality in auditing (Craswell, Francis, & Taylor, 1995; Hope, 2003). To both domestic and foreign investors, the high quality of auditing can boost their investment confidence especially in weak legal contexts (Fan & Wong, 2005; Choi & Wong, 2007).

In line with the above arguments, I suggest that firms that selected auditing firms affiliated with North American firms are more aware of alternative governance practices externally. Such choices in auditing firms also exert considerable pressures to meet performance expectations, signifying governance legitimacy to external constituents and attracting potential investors. For such reasons, I hypothesize:

Hypothesis 4.2:Firms selecting auditor firms affiliated with large North American auditing firms will be more likely to apply for Corporate Governance Index membership.

CHAPTER 4 DATA AND MEASUREMENT

Data Sample

This study chose publicly listed firms on the Shanghai Stock Exchange in China as the empirical context. The sample used in this study consists of three sub-groups of publicly listed firms on the Shanghai Stock Exchange. The first sample of firms included 197 constituents (out of 199) of the "Corporate Governance Sector Index" in 2008. These firms were successful applicants, and they represented firms that were willing to adopt North American model of corporate governance. The second sample of firms was selected from those firms that have not voluntarily applied for the Corporate Governance Index in 2008. Firms chosen in this group were matched those in the first group based on industry representativeness and numbers to have a meaningful comparison. The third group included 53 (out of 56) firms that have applied for CGI membership but were declined membership in 2008. This subsample was used to compare with both the first group (successful applicants) and the second groups (non-applicants) to further detect and validate findings. In sum, the total number of sample firms used in this study is 447 listed firms.

Sources of data in this study included Shanghai Stock Exchange official website, OSIRIS database, which is a comprehensive multinational data base that has been used in previous studies (Martin, Karl & Jens, 2004); ADR database, annual reports, and China Finance Online, which is one of the leading companies that provide online financial data of Chinese listed companies, and Chinese website http://finance.sina.com.cn/, which provided listed firms' prior sanction records.

Measures

Dependent Variable

CGI List. The dependent variable in this study is firms' Corporate Governance Index membership, which measures firms' corporate governance orientation by checking whether the firms apply for and belong to the constituents of the Corporate Governance Index. A firm's application and membership indicates its willingness to adopt North American corporate governance standards. 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. The CEO tenure was coded based on the number of years since the CEO has been in office. For those firms that have CEO tenure less than one year, CEO tenure is coded as 1 year. Data were collected from China Finance Online and firms' annual reports.

CEO education and experience. Due to the existence of different corporate governance model in the world, CEO education and experience were coded based on country difference initially. For example, it was coded differently when a CEO received education or had managerial experience in USA, Britain or in other countries such as Japan, Australia, and Germany. As this study stresses the different impact of local verses global pressures on firms' responses, the coding was combined so that all foreign education and experience tap dimension of global pressure, and local education and experience tap local institutional pressure. Thus, so long as the CEO has foreign education or managerial experience, it is coded as "1", and otherwise as "0". Data were collected from both China Finance Online and firms' annual reports.

CEO duality. It is coded as 1 when a CEO is also the chairman of the board. If not, it is coded as '0'. Data were collected from China Finance Online database.

Board size: It is calculated based on the total number of board members, including independent boards. Supervisory board members are not included in this study. Data were collected from China Finance Online database.

Board from government. It is calculated from the total number of board members that have government experience, including both past government experience and current government experience. Data were collected from China Finance Online and firms' annual reports.

Proportion of independent board. It is calculated by the number of independent members divided by board size. Data were collected from China Finance Online database.

Board education and experience. Similar to CEO education and experience, board education and experience were coded as "1" when the board members have foreign education or managerial experience, and "0" if none. Data were collected from China Finance Online as well as firms' annual reports.

Prior firm performance. It is measured by ROA in 2006. Data were collected from Osiris database.

Auditing firms. When a publicly listed firm uses a domestic CPA firm, the Auditor-dummy is coded as 0, and it is coded as 1 when a firm selected was affiliated with the North American (particularly Big-4) auditing firms. Data were collected from Osiris database.

Ownership concentration. This study measures ownership concentration by looking at both top 1 and top 2 shareholder's holding of shares. Data were collected from China Finance Online database.

Tradable shares. It is calculated as the total percent of shares that is tradable. Data were collected from China Finance Online database.

Foreign ownership. It is coded as “1” when a firm has foreign ownership and “0 for none. Data were collected from Osiris database.

Control variables

The following control variables are introduced to isolate the effect of other independent variables on firms’ applying for CGI membership.

Firm size. As indicated by Nee et al. (2007)**,** large firms may have more resources and enjoy the benefits of economy of scale. To capture this possible confounding effect, this study controls the natural logarithm of a firm’s total assets. Data were collected from Osiris database.

Industry. To capture possible industry differences in firm’s convergence behavior, this study includes industry dummies for energy, transportation, retail, real estate, manufacturing, and conglomerate firms are chosen as the reference industry. Data were collected from SSE website.

IPO. Young organizations tend to suffer from liability of newness (Singh, Tucker, & House, 1986) as they have to adjust their new roles in business society. The level of legitimacy is lower for these young firms. Younger firms also tend to have lower level of structural inertia in dealing with change. Thus, the history of IPO for listed firms may impact firms’ responses to governance change. IPO history is introduced as a control variable in this study. It is calculated as the total number of years since the first IPO date. Data were collected from SSE website.

Cross-listing at Hongkong Stock Exchange. Listed firms cross-listed at Hongkong Stock Exchange are facing more stringent governance codes, such as information and disclosure, requirement of independent directors, and requirement of auditor standards. Thus, these firms may respond to governance convergence differently from those firms listed only at Shanghai Stock Exchange. To capture this possible confounding effect, this study codes those firms cross-

listed at Hongkong Stock Exchange as ‘1”, and “0” otherwise. Data were collected from SSE website.

Prior sanction. Listed firms’ prior sanctions records can also shape a firm’s governance behavior. Firms with good records may be more likely to apply for CGI membership. The sanctions records used in this study include public condemnation carried out by SSE and CSRC. It is coded as “1” if the firm has such a record, and “0” indicating none. Data were collected from Chinese website: Http://sina.com.cn.

Table 4.1 Summary of Variables and Measurement

	Variables	Measurement	Source of Data
1	CGI List	0= non-membership , 1= membership	SSE website
2	IPO	number of years since first IPO date	SSE website
3	Firm size	Total assets 2006 (logged)	Osiris database
4	Firm performance	ROA 2006	Osiris database
5	Auditing firms	0= non-affiliated firms, 1=affiliated with Big-4	Osiris database
6	H-shares	cross-listed in Hong Kong stock exchange	SSE website
7	ADRs	cross-listed in ADRs	ADR database
8	Prior sanction	1=record of prior sanction, 0=none	Http://finance.sina.com.cn
9	Accounting Standards	1= GAAP or IAS, 0= Local accounting standards	Osiris database
10	CEO Duality	1=duality, 0=no duality	China Finance Online
11	CEO tenure	number of years in position	China Finance Online
12	CEO Background	1= foreign education and foreign industry experience, 0= none	China Finance Online, annual reports
13	Board from Government	number of board members with government experience	China Finance Online, annual reports
14	Board with foreign Education/experience	number of board members with foreign education or experience	China Finance Online, annual reports
15	Board size	number of board members	China Finance Online
16	Tradable shares	proportion of tradable shares	China Finance Online
17	Ownership concentration	top 1 and 2 shareholder ownership	China Finance Online
18	Foreign Ownership	1= with foreign ownership, 0=none	Osiris database

CHAPTER 5 ANALYTICAL TECHNIQUES AND RESULTS

Logistic Regression Models

As the dependent variable is binary (Hair et al., 2006; Wang & Deng, 2006), this study used logistic regression to analyze the models. In the first two groups of 394 sample firms, about 58 percent of these firms are manufacturing firms, 9 percent in energy, 12 percent in transportation, 3 percent in retail, 5 percent in real estate, and 14 percent are conglomerates. On average, these firms have 8.28 years of IPO history. Around 90 percent of these firms adopted local accounting standards, and about 16 percent of auditing firms are affiliated with "the Big Four" accounting firms. As for board structure, about one third of board members are independent directors, and the average board size is 10.68. The average CEO tenure of these firms is about 4.79 years. Only 6 percent of CEOs have foreign education or foreign managerial experience. For ownership, 60.99% of firms' stocks are tradable shares, and 31% firms have presence of foreign ownership. Interestingly, this information about ownership is not consistent with previous report that about two-thirds of ownership is non-tradable shares (Qiang, 2003). This may be because the sample firms do not represent listed firms in China or it could be a result of change in ownership structure due to government's recent effort to transfer more non-tradable shares to tradable shares.

Compared with non-applicants, successful applicants are in general larger in size, better in performance, with fewer firms having prior sanction records. In terms of CEO and board characteristics, the differences were not pronounced in dimensions such as CEO duality, CEO tenure, size of board, number of independent directors, CEO and board foreign education and experience. The successful applicants are not very different from the non-applicants in accounting standards used, but more successful applicants were using auditor firms affiliated the Big-4 accounting firms, while the majority of non-applicants used local auditor firms. In terms of

ownership structure, more CGI member firms have presence of foreign ownership than those non-applicants, but they differ little in terms of tradable shares and concentration of ownership.

Table 5.1 Comparison of Key Attributes between Subsamples

Variables	**197 Successful Applicants**	**197 Non-Applicants**	**56 Unsuccessful Applicants**
IPO History (years)	7.9	8.6	9.1
Market capitalization (in Chinese RMB)	15, 239,417	3, 412, 814	4, 146,655
Total assets (in Chinese RMB)	124, 212,848	15, 660, 721	6,009,254
Average profit margin	15.38%	5.90%	7.72%
Average ROA	5.09%	1.82%	3.4 %
Number of audit firms that are affiliated with Big-4	44	18	6
Number of firms that using local accounting standards	171	189	54
Number of firms with CEO duality	13	16	5
Average CEO tenure	4.9	4.67	5.7
Number of CEO with foreign education/experience	15	5	2
Average number of directors with foreign education/experience	0.67	0.49	0.37
Average of board size	10.63	11	9.64
Average number of independent directors	3.6	3.4	3.56
Average number of directors from government	2	1.26	1.32
Average tradable shares	60.62%	61.37%	61.02%
Number of firms with presence of foreign ownership	85	37	9
Average top 1 shareholder ownership	41.32%	36.41%	37.9
Average top 2 shareholder ownership	13.37%	8.78%	7.69
Number of firms with prior sanction	1	8	1

Descriptive statistics and correlations are displayed in Table 5.2. The correlation table 5.2 indicates that correlations among independent variables were generally low; therefore the problem of unstable coefficients was minimized due to multi-collinearity. From the table, we can see that firm's CGI membership is positively correlated with firm size, firm performance, use of international accounting standard, use of foreign affiliated auditing firms, directors from government, and presence of foreign ownership. Firm size has been shown to be positively associated with government's selection of restructuring. This is partly consistent with government's policy of "taking a firm grip on the large, and letting go of the small" (Aivazian et al., 2005:798). As is expected, it is negatively correlated with record of prior sanctions. It is not significantly correlated with other variables.

Table 5.3 reports the results of the logistic regression analysis on CGI Index using a sample of successful applicants and the matched number of non-applicant firms. Model 1 tested the effect of the control variables on CGI index membership. Groups of independent variables were added to model 2, 3, and 4 respectively.

Results from Comparison of Successful Applicants and Non-applicants

Table 5.3 shows that among the control variables including firm size, industry, the number of years listed after the Initial Public Offering (IPO), cross-listing at Hong Kong Stock Exchange, and whether firms receive prior sanctions are not significant factors affecting firm' success of applying for the CGI membership.

Hypothesis 1.1 predicted that CEO tenure is negatively associated with the likelihood of firms' applying for CGI membership. From the test, though the coefficient for CEO tenure was significant only at 10 percent level, the direction of this marginal effect of CEO tenure is contrary to what is predicted. Thus, this hypothesis is not supported.

Hypothesis 1.2 postulated that CEO and board foreign education or managerial experience increase the likelihood of firm's applying for CGI membership. Test results in Table 5.3 show that the coefficients for CEO education and experience are not significant, thus providing no support for Hypothesis 1.2.

Hypothesis 1.3 hypothesized that CEO duality decreases a firm's likelihood of applying for CGI membership. The coefficients for CEO duality in Table 5.3 are not significant. Hence, Hypothesis 1.3 is not supported either.

Hypothesis 1.4 hypothesized that firms with a large board will be less likely to apply for the CGI membership. Table 5.3 shows that coefficient of boards size is not significant, providing no support for this hypothesis.

Hypothesis 1.5 postulated that firms with more independent board members will be more likely to apply for CGI membership. Both Table 5.3 and Table 5.4 show that coefficient for independent board is not significant, which indicate that the number of independent boards did not statistically make a difference in determining CGI membership.

Hypothesis 1.6 posited that firms with more board members that who are/were government officials are less likely to apply for CGI membership. The coefficient in Table 5.3 is positive and significant. This shows that more number of directors from government officials impacts the result of firms' applying for CGI membership, even though the direction of the relationship is contrary to what is predicted.

Hypothesis 2.1 hypothesized that ownership concentration will be negatively related with firms' applying for CGI membership. Table 5.3 shows both coefficients for top 1 and top 2 shareholder ownership are not significant, providing no support for this hypothesis.

Table 5.2 Descriptive Statistics and Correlation Matrix

	Variable	Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1	CGI list	0.5	0.5	1.000														
2	Manufacturing	0.58	0.49	.000														
3	IPO	8.28	3.87	-.105*	-.059													
4	Total assets 2006 (logged)	6.56	0.68	.237**	-.205**	-.038												
5	H-listed	0.08	0.27	.160**	-.152**	-.185**	.292**											
6	Prior sanction	0.02	0.15	-.119*	-.076	.158**	-.139**	-.045										
7	Auditor	0.16	0.37	.181**	-.069	-.153**	.415**	.573**	.027									
8	ROA 2006	3.45	8.65	.309**	.043	-.150**	.098	.025	-.086	.083								
9	Accounting Standards	0.09	0.28	.163**	-.140**	-.211**	.363**	.749**	-.047	.711**	.013							
10	CEO duality	0.07	0.26	-.029	-.015	.046	-.069	-.046	.022	-.015	.004	-.052						
11	Board size	10.7	2.91	.002	-.110*	-.053	.241**	.150**	.010	.139**	-.146**	.173**	-.066					
12	Independent board	0.33	0.82	.080	.024	-.024	.029	-.036	-.069	.003	.120*	-.019	.040	-.260**				
13	CEO tenure	4.79	2.57	.001	.107*	-.119*	-.156**	-.080	.023	-.119*	.010	-.113*	.121*	-.111*	.086			
14	CEO education & experience	0.06	0.28	.087	-.105*	-.018	.065	.011	.036	.229**	-.003	.082	.016	.075	-.084	-.076		
15	Board from government	1.65	1.39	.267**	-.190**	-.042	.279**	.167**	-.054	.153**	.058	.169**	-.007	.330**	-.024	-.119*	.006	
16	Board education & experience	0.58	1.17	.030	-.128*	-.090	.203**	.216**	.001	.277**	-.083	.240**	-.053	.215**	.006	-.085	.103*	.231**
17	Tradable shares	61	18.5	-.044	.017	.128*	-.235**	-.195**	.074	-.153**	-.129*	-.164**	.132**	-.029	-.043	.096	.021	-.092
18	Foreign ownership	0.31	0.46	.263**	-.062	-.159**	.355**	.334**	-.102*	.419**	.207**	.439**	-.042	.061	-.003	-.033	.100*	.204**
19	Top1 shareholder ownership	38.9	16.6	.170**	.020	-.031	.325**	.146**	-.091	.170**	.206**	.116*	-.111*	-.027	.047	-.102*	.029	.059
20	Top2 shareholder ownership	8.81	8.54	-.034	-.058	-.221**	.055	.345**	-.034	.280**	.021	.380**	.012	.057	-.040	-.054	-.063	.051

Table 5.2 Descriptive Statistics and Correlation Matrix (continued)

	Variable	16	17	18	19
17	Tradable shares	$-.112^{*}$			
18	Foreign ownership	$.216^{**}$	-.080		
19	Top1 sharedholder ownership	.013	$-.683^{**}$	.043	
20	Top2 shareholder ownership	$.134^{**}$	-.031	$.246^{**}$	$-.349^{**}$

N =394

*. Correlation is significant at the 0.05 level (2-tailed).

**. Correlation is significant at the 0.01 level (2-tailed).

Table 5.3 Logistic Regression Analysis : Successful vs. Non-applicants

	Model 1			Model 2			Model 3			Model 4		
	B	Sig.	Exp (B)	B	Sig.	Exp (B)	B	Sig.	Exp (B)	B	Sig.	Exp (B)
Constant	-3.754	0.006	0.023	-4.098	0.004	0.017	-4.561	0.021	0.010	-5.468	0.014	0.004
Industry		Industry			Industry			Industry			Industry	
IPO	-0.016	0.563	0.984	0.000	0.993	1.000	0.003	0.924	1.003	-0.010	0.752	0.990
Total assets 2006	0.567	0.005	1.763	0.534	0.009	1.706	0.510	0.025	1.666	0.348	0.153	1.416
H-Listed	0.525	0.328	1.690	0.650	0.322	1.916	0.579	0.412	1.785	0.850	0.230	2.339
Prior sanction	-1.749	0.107	0.174	-1.418	0.198	0.242	-1.563	0.175	0.210	-1.515	0.194	0.220
Auditors				0.316	0.498	1.371	0.296	0.555	1.345	0.213	0.684	1.237
Accounting Standards				0.009	0.990	1.010	0.099	0.903	1.104	0.001	0.999	1.001
ROA 2006				0.109	0.000	1.116	0.095	0.001	1.099	0.085	0.003	1.089
CEO duality							-0.388	0.390	0.679	-0.365	0.428	0.695
CEO tenure							0.083	0.071	1.087	0.072	0.132	1.074
CEO education and experience							0.467	0.270	1.596	0.270	0.548	1.310
Board size							-0.097	0.612	0.908	-0.021	0.916	0.979
Independent Board							1.342	0.348	3.828	1.557	0.289	4.746
Board education and experience							-0.051	0.697	0.950	-0.034	0.799	0.966
Board from government							0.523	0.000	1.687	0.511	0.000	1.668
Tradable Shares										0.018	0.056	1.018
Foreign ownership										0.685	0.021	1.983
Top 1 shareholder ownership										0.015	0.190	1.015
Top 2 shareholder ownership										-0.022	0.250	0.978
Chi-Square		31.018 (0.000)			52.291(0.000)			85.120(0.000)			97.869(0.000)	
Hit Ratio			61.4			66			71.6			77.2
Nagelkerke R^2			0.101			0.166			0.259			0.293
Number of observations			394			394			394			394

Table 5.4 Logistic Regression Analysis : Successful vs. Unsuccessful Applicants

	Model 1			**Model 2**			**Model 3**			**Model 4**		
	B	Sig.	Exp (B)	B	Sig.	Exp (B)	B	Sig.	Exp (B)	B	Sig.	Exp (B)
Constant	-2.326	0.373	0.098	-2.520	0.322	0.080	0.096	0.974	1.101	-2.451	0.489	0.086
Industry		Industry			Industry			Industry			Industry	
IPO	-0.089	0.054	0.915	-0.066	0.162	0.936	-0.066	0.189	0.936	-0.049	0.367	0.953
Total assets 2006	0.734	0.064	2.083	0.668	0.082	1.950	0.366	0.401	1.441	0.078	0.871	1.081
Prior sanction	-1.774	0.167	0.170	-1.911	0.137	0.148	-2.147	0.136	0.117	-2.590	0.081	0.075
Auditors				0.459	0.418	1.583	0.418	0.490	1.520	-0.220	0.742	0.802
ROA 2006				0.103	0.042	1.108	0.092	0.072	1.096	0.092	0.083	1.096
CEO duality							0.155	0.814	1.167	0.107	0.874	1.113
CEO tenure							-0.072	0.215	0.930	-0.077	0.203	0.926
CEO education and experience							0.156	0.824	1.169	0.391	0.597	1.479
Board size							0.048	0.540	1.049	0.064	0.435	1.066
Independent Board							-3.503	0.072	0.030	-3.289	0.099	0.037
Board education and experience							0.147	0.567	1.159	0.203	0.435	1.225
Board from government							0.246	0.125	1.279	0.231	0.168	1.260
Tradable Shares										0.031	0.071	1.032
Foreign ownership										0.479	0.262	1.614
Top 1 shareholder ownership										0.043	0.039	1.044
Top 2 shareholder ownership										0.059	0.075	1.061
Chi-Square		18.742 (0.002)			23.470 (0.001)			34.100(0.001)			41.314(0.001)	
Hit Ratio			79.6			79.6			78.8			80
Nagelkerke R^2			0.113			0.141			0.2			0.239
Number of observations			250			250			250			250

Table 5.5 Logistic Regression Analysis : Unsuccessful vs. Non-applicants

	Model 1			Model 2			Model 3			Model 4		
	B	Sig.	Exp (B)	B	Sig.	Exp (B)	B	Sig.	Exp (B)	B	Sig.	Exp (B)
Constant	-3.729	0.090	0.024	-3.389	0.133	0.034	-5.270	0.046	0.005	-4.560	0.132	0.010
Industry		Industry			Industry			Industry			Industry	
IPO	0.043	0.288	1.044	0.046	0.260	1.047	0.058	0.188	1.060	0.056	0.222	1.057
Total assets 2006	0.239	0.462	1.270	0.159	0.635	1.173	0.201	0.601	1.223	0.199	0.620	1.220
Prior sanction	-0.015	0.986	0.986	0.141	0.869	1.151	0.179	0.845	1.196	0.168	0.855	1.183
Auditors				0.341	0.539	1.406	0.277	0.649	1.319	0.336	0.607	1.399
ROA 2006				0.040	0.191	1.041	0.031	0.361	1.031	0.028	0.409	1.029
CEO duality							-0.151	0.800	0.860	-0.085	0.889	0.919
CEO tenure							0.166	0.016	1.181	0.159	0.025	1.172
CEO education and experience							0.215	0.661	1.240	0.190	0.706	1.209
Board size							-0.107	0.129	0.899	-0.111	0.118	0.895
Independent Board							4.824	0.020	124.489	4.821	0.021	124.027
Board education and experience							-0.240	0.339	0.787	-0.238	0.348	0.788
Board from government							0.165	0.336	1.179	0.160	0.358	1.173
Tradable Shares										-0.005	0.768	0.995
Foreign ownership										0.081	0.868	1.084
Top 1 shareholder ownership										-0.005	0.778	0.995
Top 2 shareholder ownership										-0.016	0.543	0.984
Chi-Square		5.806(0.326)			7.896(0.246)			27.519(0.011)			27.921(0.046)	
Hit Ratio			78			78.8			78.800			78.4
Nagelkerke R^2			0.036			0.048			0.162			0.164
Number of observations			250			250			250			250

Hypothesis 2.2 posited that proportion of tradable shares is positively related to firms' CGI membership. Table 5.3 shows that coefficient for tradable shares is positive and very close to significance ($p< 0.10$), indicating a marginal effect of this predictor.

Hypothesis 2.3 postulated that foreign ownership of the firms will be positively related to firms' CGI membership. The coefficient of foreign ownership in Table 5.3 is positive and significant ($P < 0.05$). Thus, this hypothesis is supported.

Hypothesis 3 posited that firms' prior performance is negatively related to the likelihood of firms' applying for membership. The coefficients for ROA 2006 in model 3 are positive and significant ($P < 0.01$). Interestingly, though it is significant, the direction of the relationship is unexpected, and contrary to what is expected.

Hypothesis 4.1 hypothesized that firms adopting international accounting standards are more likely to apply for CGI membership. The coefficient for accounting standards is not significant, thereby providing no support for this hypothesis.

Hypothesis 4.2 predicted that firms' selection of auditing firms affiliated with Big-4 North American auditing firms are more likely to apply for CGI membership. The coefficient for auditing firms is not significant. Therefore, this hypothesis is not supported.

Results from Comparison of Successful and Unsuccessful Applicants

Given that firms that do not meet the CGI standards were not obligated to apply, it is interesting to examine and compare the characteristics of these unsuccessful applicants with both successful applicants and non-applicants. Using the two different group of sub-sample of firms, I conducted similar logistic regression analysis. The results are summarized in Table 5.4 and Table 5.5 respectively. Table 5.4 reported the logistic regression on CGI membership using a sub-sample of 53 unsuccessful applicants and 197 successful applicants. Tests in table 5.4 were

conducted in a similar order as in table 5.3. First, control variables were entered in model 1, and independent variables were added to model 2, 3, and 4 respectively.

The coefficients of firms' prior performance in Table 5.4 are to some extent significant ($0.05 < P < 0.10$). This indicates that firms' prior performance is an important determinant of the CIG membership.

In comparing the impact of top management characteristics between these two groups, only the proportion of independent board is significant at 10 percent level, other variables are not statistically significant.

Finally, ownership features are important determinants in results of CGI membership in these two groups. The coefficient of tradable shares is marginally significant ($P < 0.10$), indicating that higher proportion of tradable shares increases the likelihood of the CGI membership for such a firm. The coefficient for top 1 shareholder ownership is statistically significant ($P < 0.05$), showing that firms with higher concentration of ownership (higher top 1 shareholder ownership) is positively related to firms' CGI membership. Similar support can be found with top 2 shareholder ownership. However, the presence of foreign ownership is not significant in determining a firm's CGI membership.

Results from Comparison of Unsuccessful Applicants and Non-applicants

Table 5.5 displayed results of tests using the sample of 53 unsuccessful applicants and those 197 non-applicants. In this analysis, the 53 unsuccessful applicants for CGI were chosen as the dependent variable and coded as "1", representing firms that were willing to apply for CGI and those 197 non- applicants were coded as "0". The purpose of this analysis is to understand why some firms chose to apply for the CGI, while others did not. Table 5.4 showed that CEO tenure and independent board were significant in determining why firms applied for the CGI. Other variables were found non-significant.

Table 5.6 summarizes the comparison of the effect of antecedents among three groups of firms. While firm size and prior firm performance are statistically significant between successful applicants and non-applicants, the coefficients of firm size and prior performance are not significant when we compare unsuccessful applicants with non-applicants. Similarly, the same results are found with antecedents of board educations and experience, and foreign ownership. However, the coefficients of CEO tenure and Independent board are not significant in the comparison of successful applicants and non-applicants; they are significant in the comparison of unsuccessful applicants and non-applicants. Implications of these results will be analyzed in the later chapter.

Table 5.6 Summary of Between-Group Comparisons of the Effect of Antecedents

Antecedents	**Successful applicants vs. non-applicants**	**Successful applicants vs. unsuccessful applicants**	**Unsuccessful applicants vs. non-applicants**
CEO tenure	--	--	**
CEO education and experience	--	--	--
Board education and experience	--	--	--
CEO duality	--	--	--
Independent directors	--	*	**
Directors from government	***	--	--
Ownership concentration	--	**	--
Tradable shares	*	--	--
Foreign ownership	**	--	--
Prior firm performance	**	*	--
Auditors	--	--	--

Note: "*": significant (p<0.1)
"**": significant (P<0.05)
"***": significant (P<0.01)
"--": non-significant

CHAPTER 6 DISCUSSION AND CONCLUSION

Discussion

Coffee (1999) asked one of the central questions in understanding corporate governance, that is, “what forces explain corporate structure and shareholder behavior?” There is hardly empirical consensus with any of the major explanations: convergence hypotheses (efficiency perspective), political perspective (path dependency perspective), or liquidity hypotheses- a perspective that stands in between. Acknowledging that evolution of national corporate governance systems is “more complex than a simple convergence-divergence debate” (Yoshikawa & McGuire, 2008: 16), this study has attempted to get a fuller understanding of the forces to this ‘change and continuity’ of national corporate governance systems by integrating different theoretical frameworks. The integrated analytical framework highlights that organizational economic actions are embedded in a national institutional environment, and thereby institutional pressures play important role in firms’ governance structure and behavior. In particular, this study hypothesized that a listed firm’s adoption of North American standards (successful application for Corporate Governance Index) in China was influenced by the extent to which it was subject to global and local institutional pressures. Firm-level factors that tap into global pressures tend to push firms to apply for the Corporate Governance Index, whereas factors tapping into local institutional pressures tend to reinforce the continuity of established governance practices. Specifically, this study looks at the following four groups of antecedents that affect publicly listed firms’ choice of governance practices, (1) CEO and board characteristics, (2) firm ownership, (3) prior firm performance, and (4) firms’ selection of accounting standards and auditing firms.

The overall findings show that institutional environment is important to examine cross-border diffusion of corporate governance. Firms' governance structure and behavior are determined by not only economic decisions, but also by institutional pressures to which firms are subject. Specifically, this study found that (1) publicly listed firms with better prior performance measured by ROA in China were more likely to be early adopters of North American governance model; (2) in general, the antecedents such as CEO, board structure and characteristics are not significant predictors of firm's adoption of international corporate governance standards in China; (3) government plays indirectly important role in influencing firms' choice of governance standards and practice besides setting business policy and regulations and (4) firms' ownership structure especially proportion of tradable shares and presence of foreign ownership are significant predictors of firms' corporate governance orientation, while ownership concentration is not. Implications of these findings are discussed below.

First, prior firm performance is significant in firms' applying for the CGI membership when the sample of successful applicants was compared with non-applicants (Table 5.2). It was expected that poorly-performing firms will be more likely to apply for the CGI membership. However, the results indicate the opposite. Firms with better prior performance are more likely to apply for the CGI membership. This result is inconsistent with similar empirical study in Japan (Yoshikawa et al., 2008), in which they found a decline in financial performance was the antecedent to learning from foreign models. This shows that in China the public in general believe that 'Americanized' model of governance is perceived to be "superior" in that better-performing firms should be chosen as constituents. This finding also highlights the context of a different institutional environment from other studies.

Two scenarios might explain why poorly-performing firms were less likely to apply for the CGI membership. First, firms with poor performance are more likely to have dissonance with the CGI standards, which represents a more "Americanized" model of governance. As a result, these firms chose not to apply for such membership for fear of not meeting a stringent governance standard. The alternative explanation is that poorly-performing firms do not see a strong link of "governance model" to future firm performance, nor do these firms perceive a symbolic value of sending message to the public that they are trying to comply with a 'superior' Americanized model of governance. Indeed, empirical studies have reported mixed results regarding the relationship between corporate governance and firm performance in China (Sun & Tong, 2003; Xu, 2000; Shirley & Xu, 2001).

On the other hand, the fact that good performing firms are more likely to be successful CGI members suggests that there is a great need to strengthen the link between the governance and performance of listed firm in China. For example, Cheung et al., 2007 examined two important questions in Hong Kong context: "Are investors concerned with the good corporate governance practices of Hong Kong firms? Do better-governed firms perform better than firms that are more poorly governed?" (Cheung et al., 2007: 88). Their CGI measurement was based on both the revised OECD Principles of corporate governance practices (OECD, 2004) and the Code of the Best Practices in Hong Kong. Their findings suggest that there is a positive relationship between good governance and firm performance measured by both market-to-book ratio (MTBV) and return on equity (ROE). Since this is the first time for China to introduce the CGI, we still do not have evidence of the positive link between the CGI constituents and firm performance. As indicated earlier, the fact that more good performing firms were applying for the CGI indicate that we need evidence that these CGI constituents' firm performance have

improved after they were chosen as members to support the hypothesis that good governance matters. Such empirical validations can have two important implications to investors. First, the CGI means a more stringent governance standard and more effective governance model in China. Second, it suggests a positive relationship between 'good' corporate governance and firm performance. Accordingly, the findings have a potential implication of providing effective means to improve the poor performance of SOEs by choosing the appropriate governance models in China.

Second, the results show that most of the second set of hypotheses regarding the role of CEO and board characteristics was not supported. Corporate governance measures such as CEO and board characteristics (except directors from government officials) were not found significant factors in predicting firms' corporate governance orientation. This is consistent with previous findings that mixed results could be found in settings different from North America (Lubatkin, Lane & Schultze, 2001; Tian & Lau, 2001). For example, in identifying predictors for listed firm performance in China, Wei (2007) found that the corporate governance measures such as the proportion of independent directors, supervisory directors, and size of board, managerial incentives and audit committee have no significant effect, while state ownership has negative impact. One possible reason for these unsupported results is that the traditional agency problem between ownership (shareholders) and control (managers) is not commonly observed in a highly-concentrated and family-dominated ownership structure. This suggests that in its current transitional economy, western corporate governance models in China would not be a panacea for solving the problems in governance. Rather, related macro and micro institutional changes are equally critical to the development of corporate governance systems in China.

The finding of important role of directors from government officials has important implications. The direct role of government in impacting firms' governance structure and behavior has been traditionally documented in ownership literature. This study shows that government can play a significantly indirect role by influencing firm's resources and legitimacy. The fact that firms with more directors from government officials were more likely to apply for the CGI membership seem to suggest that closer ties between the firm and the government can help firms in terms of acquiring critical resources and legitimacy, thereby ultimately shaping firms' governance actions. This finding is congruent with Fiss & Zajac's (2004: 527) argument that "organizations are also political arenas in which different actors are engaged in contests over goals and rules of governance of the corporations."

Third, the findings also show that the proportion of tradable shares and presence of foreign ownership are significant predictors of firms' governance orientation, while the ownership concentration (top 1 and top shareholder ownership) did not predict a firm's governance orientation. This is partly consistent with Porter's (1990) arguments that ownership structure can determine company (governance) goals. It also seems to suggest that the identity of different owners shapes firms' governance, while ownership concentration does not. Indeed, scholars have argued that ownership concentration can not sufficiently "capture the constellations of diverging interests among and within ownership categories" (Fiss & Zajac, 2004:528).

Finally, some findings from the comparison of unsuccessful applicants and those non-applicants also have important implications and consequences. Table 5.4 also shows that firms with more independent board are more likely to apply for CGI membership. The CSRC rules set specific requirement about minimum number of independent directors in the board, establishing

‘norms’ deemed desirable for firms to follow. This suggests that legal mandates can be important source of institutional change (Tolbert & Zucker, 1983). The result also reflects the enormous degree of normative pressure on firms to meet social expectations on governance standards.

The fact that CEO tenure played important role in deciding a firm’s applying for the CGI membership suggests the important role of institutional differences in explaining the diversity of international governance practices (Peng et al., 2003). Longer-tenured CEOs were expected to have a less propensity to initiate change in governance practices. The role of guanxi in institutional environment of China might help explain this unexpected result. Xin & Pearce (1996) reported that executives in China are reluctant to develop business relationships with those people they do not personally trust. Gaining legitimacy (applying for the CGI in this case) in businesses can help CEOs to achieve such purpose by cultivating with ‘legitimate’ personal relationship so that they can obtain resources. China is in a transitional economy featured with weak capital market structures, poorly specified property rights, and institutional instability (Nee, 1992). Under such conditions, longer-tenured CEOs know better the importance of gaining legitimacy and resources vital to the profitability and survival of the firm.

This research carries some practical implications. From the perspective of policy-making, a potential link of good governance with firm performance can provide support for the policy of keep improving governance practices in China. It also suggests that national governance measures in shareholder’s rights, equitable treatment of shareholders, stakeholder’s role, disclosure and transparency, board responsibilities and compositions can be improved based on international governance experience and guidelines.

In addition, the findings suggest that government influence, foreign ownership, tradable shares are important factors influencing firms' choice of governance elements. How to make good use of these influences can have important practical implications for not only crafting appropriate policies but also implementing governance reforms successfully. For example, to continue transforming listed firms' non-tradable shares (especially those state shares) to tradable shares may be important solution to current loss of profitability of SOEs. This can supplement previous findings of solutions such as lowering government intervention (Shleifer & Vishny, 1994; Li, Sun & Liu, 2006), effective incentive and monitoring mechanisms (Chen, 2004).

This study also brings up relevant management issues in publicly listed firms in China. First, it raises awareness among management teams in China of the choices of governance models. Should firms keep its old governance practices or adopt new codes of governance? What are the consequences of such choice in governance? Second, as the research indicates, guanxi and government are two important institutional factors impacting firm's governance structure. This has practical managerial implications in selecting and appointing directors. Selection of directors from government officials can help listed firms enhance legitimacy and secure resource, ultimately shaping firm's strategy and structure. Lastly, even though those 56 firms were declined for CGI membership, it might bear some benefits associated with symbolic management. By signaling their conforming to normative expectation on corporate governance, such practices can enhance legitimacy imperative for organizations (Fiss & Zajac, 2006).

Limitations

Like other empirical research, this study entails several limitations. The first one is about the robustness of the argument that applying for the "The Corporate Governance Sector" represents an inclination of adopting a more shareholder-oriented governance model. The current

evidence for such argument is convergence in legal rules and regulations in governance, which was used in other empirical studies (Shleifer &Vishny, 1997; Hansmann & Kraakman, 2001). Though comfortable with this proxy measurement through validation of a phone interview with China Securities Index Co. Ltd (CSI), I feel that this crude measurement can be further refined and validated by other means of measurement. For example, future research can provide other evidence such as decreased concentration of ownership (Wojcik, 2003) and accounting standards adopted.

Second, the data in this research is limited in terms of availability. Prior performance was based on year 2006, and when the data was collected, the database didn't have 2007 financial performance for a lot of firms. Thus, this measurement of prior performance for some firms might be confounded by factors such as product life cycling or industry fluctuation. In addition, this study only used accounting-based performance (ROA) for the same reason, and this limited the scope of firm performance. Future studies can encompass other marketing-based measure of performance such as Market to Book ratio or stock returns. Finally, as the data is collected from Shanghai stock exchange only, caution is warranted in generalizing the findings to all listed firms in China.

Future Research

Publicly listed firms in China face a serious problem of loss in profitability. Scholars such as Tam (2000) have argued that corporate governance matter to firms' performance given the current conditions of Chinese state enterprises. But which model? This research has shown that constituents of CGI represent adopters of a more Americanized model of governance, but has not examined consequence of such adoption. One of the possible avenues for future research is to explore the relationship between governance models and firm performance in China. Will

the constituents of “Corporate Governance Sector” perform better than the competitors that are not constituents? More importantly, will there be significant change in performance for those firms after they were chosen to be constituents of the “Corporate Governance Sector”? The current study collected only prior performance of the constituents of CGI, future research can gather data of subsequent performance these firms in the CGI and examine such relationships questioned. With both pre and post performance of those constituents of the “Corporate Governance Index”, future research can better ascertain the possible causality between governance model choice and firm performance in China.

Given that many hypotheses of antecedents were not supported, we need to examine other antecedents appropriate in the Chinese institutional environment. Future research can look at factors that haven’t been examined in China. For example, Chizema & Buck (2006) proposed that firm level factors such as peripheral companies (less embedded organizations), value commitment from firms, power dependency, access to resource, and density of firm networks can be important predictors for firms in Germany to adopt Americanized German executive pay system. Similar research in Chinese context is warranted to emphasize how similar firm level factors can work differently under a variety of institutional contexts. At the macro level, the argument of ‘law matters’ has been validated mostly in European countries and USA (La Porta et al., 1997), the effect of laws on governance needs to be examined in weak legal system such as China. For example, how does the promulgation of governance rules and regulations (such as company law, and CSRC rules) affect adoption of governance elements? Can large organizations buffer from such impact?

A related promising avenue for future research is to examine the impact of some macro institutional environment on governance in China. We know that “guanxi” play a pivotal role in

business exchange (Xin & Pearce, 1996), and government remains influential on firms' structure and performance. For example, do executive interlocks shape a firm's governance structure and behavior? How does government affect governance structure and behavior besides its role in ownership structure, issuance of laws and regulations? What roles do creditors such as banks and other financial institutions play in governance in China? These questions can deepen the understanding of how the embeddedness in particular institutional environment shape distinct organizational structures and actions.

The current focus on CEO and board characteristic (such as tenure, education and experience) may overlook other dimensions that could have influenced firm's governance structure and behavior. What other leadership factors than these could also play an important role? Given that "guanxi" play important role in business life in China, it may be worthwhile to examine the impact of executive interlocks on firm's governance. Board interlock has been proved to be significant factors in other contexts such as Germany (Sanders & Tuschke, 2007). In terms of ownership structure, this study focuses on the proportion of tradable shares internally and the presence of foreign ownership externally. Again some other dimensions of ownership structure are not examined. For example, it does not look into the effect of financial institutional shares (banks and other creditors) or family shares, nor does it examine the impact of CEO and board shares on firm's governance choices.

Finally, comparative studies on diffusion of corporate governance across different contexts might be fruitful in understanding the determinant of diffusion of governance models in different institutional contexts. Researchers have demonstrated that institutional contexts play significant role in corporate governance relationships (Gedajlovic & Shapiro, 1998). Firms in Japan and China, for example, face distinct institutional pressures and thus respond to corporate

governance reform differently. In Japan, Yoshikawa et al., (2008) found evidence of hybrid corporate governance systems due to conflicting institutional pressures for change and continuity. This was in part due to resistance of change in governance from many well-established large firms such as Toyota, Canon, and partly due to different opinions from the government. The family-like relationship built from 'keiretsu' plays important role in warding off potential takeover bids (Miles, 2006), which enables corporations in Japan to have the capability to buffer from uncertainty and change in environment. In China, government has been predominant in organizational life at both macro and firm level. At the macroeconomic level, government influences firms through issuance of policy and regulations. At the firm level, government impacts firm strategy and structure through ownership mechanism. So firms in China face distinct sources of pressures. Like Japan, China is also a country with deep-rooted Confucian values, and personal connections are also very important in business community. But unlike Japan, relationships focus more on kinship than on corporate ties. From a corporate governance perspective, relationships play a different role in influencing firm's governance behavior between China and Japan. Across-country comparative studies can further understand the interactive forces between institutional forces and efficiency forces.

Conclusion

Djankov & Murrell (2002) pointed out that research of corporate governance in transitional economies has special significance in terms of theoretical development and empirical testing. Using a sample of publicly listed firms in China, this study found local institutional pressures in addition to global market pressures play significant role in a firm's corporate governance structure and behavior. This is consistent with previous empirical studies that both market forces and state influences listed firms in China (O'Connor, Chow & Wu, 2004).

However, the direction and magnitude of many of such forces are not congruent with predictions based on North American theories of governance. In fact, the findings suggest that some institutional factors have more bearing on listed firm's governance structure and behavior than those based on agency theory. This suggests that in its transition from traditional planned economy to market economy, China is undertaking some fundamental institutional shifts, which may produce conflicting demands on firms' behavior and structure. As Hua et al., (2006: 405) put it: "… the final results of China's transition remain unknown. As firms progress in their governance, some results are unpredictable. While others cannot even be fathomed; and some results are superficial rather than substantive."

The theoretical framework developed in this study identified and highlighted the significant institutional underpinnings among the economic relationships in which organizations are embedded. Specifically, this study contributes to research on institutional theory in that it recognizes institutional factors were shown to play important roles in firms in Asia (Peng, 2004). Hoskisson et al., (2000) proposed that institutional theory can provide special insights in exploring Asian firm strategies. This research provides empirical evidence for such proposals. Institutional theory has traditionally been used to explain homogeneity or isomorphism among firms. The findings in this study suggest normative pressures other than coercive pressures on firms can lead to firm's changing structures. Recently, institutional theory has been used to account for heterogeneity between firms (Kraatz & Zajac, 1996). This research demonstrates how publicly listed firms in China embedded in the same institutional environment 'interpret' and respond differently to external demands of technical efficiency in corporate governance.

This study offers significant insights as to the debate of convergence of national corporate governance systems. Though the development of national corporate governance

system is an on-going process, and we will probably not see '… victory of one system over the others' (Thompson & Nestor, 1999), we can draw some preliminary conclusions about the future development of Chinese governance system. While the findings provide some evidence of adoption of Americanized governance model in Chinese context, the study also suggests the existence of intermediate form of governance practices. On the one hand, corporate governance reform in China can be said to adapt in functions, but persists in forms (Gilson, 2001). Functional change in governance can be observed through convergence of laws and regulations in governance, yet many organizations (particularly so-called SOEs) are persistent in form. The high state ownership in these publicly listed firms seems not to dwindle in the near future, and the role of government intervention in public firms remains pronounced. On the other hand, there have been serious problems of implementing the governance laws and regulations. In this sense, corporate governance reform in China can be said to change in form, not in substance. Over the past two decades, Chinese corporate governance systems have undertaken tremendous changes. As China issued corporate governance laws and regulations resembling those of North American, we expect to see more listed firms to conform to North American corporate governance standards especially when property rights and other institutional structures are more developed to resemble those in developed countries (Shi & Weisert, 2002). Meanwhile, the newly transplanted governance concepts and structures from the West have to coexist with the remnants of traditional governance systems in China for years to come.

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APPENDIX A ACROSS-COUNTRY GOVERNANCE INDICATORS

Governance Indicator	Year	China Percentile Rank (0-100)	Japan Percentile Rank (0-100)	USA Percentile Rank (0-100)	Britain Percentile Rank (0-100)	Germany Percentile Rank (0-100)	France Percentile Rank (0-100)
	2006	4.8	75.5	83.7	92.8	95.7	92.3
	2005	7.7	79.8	89.9	93.8	95.7	93.3
	2004	10.6	79.8	89.4	95.2	94.7	91.3
	2003	10.1	76.9	89.4	91.3	95.2	84.1
	2002	9.1	76.4	92.8	90.4	95.7	84.1
Voice and Accountability	2000	9.6	76.4	90.4	88.9	90.9	85.1
	2006	33.2	85.1	57.7	61.1	75	61.5
	2005	36.5	82.2	48.1	58.2	72.6	61.5
	2004	39.9	84.6	52.9	59.6	67.8	63.5
	2003	33.2	88	55.3	63	68.3	62
	2002	38.5	86.5	55.3	72.6	84.6	78.8
Political Stability	2000	39.9	82.7	87	81.3	91.3	76
	2006	55.5	88.2	92.9	94.8	90.5	85.8
	2005	53.6	85.3	91.9	94.3	90.5	90
	2004	57.3	84.4	93.8	94.3	90.5	91
	2003	58.3	83.4	92.9	93.8	90.5	91.5
	2002	60.2	82.5	91.5	94.3	91.9	90
Government Effectiveness	2000	55.5	82.9	93.4	93.8	94.3	90
	2006	46.3	87.3	93.7	98	91.2	82.9
	2005	45.4	84.9	92.7	94.6	90.2	80.5
	2004	42	81.5	91.2	96.6	90.2	83.4
	2003	37.1	79	91.2	95.6	92.2	85.4
	2002	31.7	68.3	92.2	97.1	93.7	81.5
Regulatory Quality	2000	38.5	76.6	95.1	97.1	93.7	81.5

APPENDIX A: ACROSS-COUNTRY GOVERNANCE INDICATORS (CONTINUED)

Governance Indicator	Year	China Percentile Rank (0-100)	Japan Percentile Rank (0-100)	USA Percentile Rank (0-100)	Britain Percentile Rank (0-100)	Germany Percentile Rank (0-100)	France Percentile Rank (0-100)
Rule of Law	2006	45.2	90	91.9	93.3	94.3	89.5
	2005	41.9	90	91.9	92.9	94.3	89.5
	2004	42.4	89.5	91.9	93.8	93.3	91.4
	2003	39.5	90	92.4	94.8	93.8	91
	2002	43.8	88.6	92.4	94.3	93.3	87.6
	2000	39.5	90.5	92.9	94.3	93.3	88.1
Control of Corruption	2006	37.9	90.3	89.3	93.7	93.2	91.7
	2005	30.6	85.4	91.7	94.7	93.7	90.8
	2004	35.4	85	92.7	94.2	93.2	90.3
	2003	39.8	84	92.7	95.1	94.2	90.8
	2002	42.7	85	93.2	95.1	93.7	89.3
	2000	44.2	86.4	92.7	96.1	94.2	91.3

Source: Kaufmann D., A. Kraay, and M. Mastruzzi 2007: Governance Matters VI: Governance Indicators for 1996-2006

Note: The governance indicators presented here aggregate the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. Countries' relative positions on these indicators are subject to indicated margins of error that should be taken into consideration when making comparisons across countries and over time.

APPENDIX B SSE CGI ESTABLISHMENT PROCEDURES

"The Shanghai Stock Exchange (SSE) and China Securities Index Co., Ltd (CSI) announced on December 19, 2007 the construction scheme of SSE Corporate Governance Index. After soft operation for some time, the index is officially released today, with the code of 000019 and the short description of "Governance Index". Its constituents are all the stocks in the SSE Corporate Governance Sector, with 199 stocks in the current term. The base is June 29, 2007, with the base point of 1,000. Investors can learn the index's performance from the market terminals including Qianlong, Great Wisdom, Reuters and Bloomberg or visit the SSE's or CSI's website for details. The SSE Corporate Governance Index closed on December 28, 2007 at 1,454.01 points, up 45.40% from the base day.

It is learnt that the SSE Corporate Governance Sector has undergone the procedures including voluntary application of listed companies, public opinion solicitation, and comments by special appraisal organizations, primary selection and examination by the Expert Consultative Committee. On October 9, 2007, the "Appraisal Measures of SSE Corporate Governance Sector" was officially released to receive the voluntary application of listed companies. The SSE and the CSI had received valid application material from 255 companies by November 2, 2007, and had them publicized to receive public comment. After the examination by the Expert Consultative Committee of Corporate Governance Sector, the 199-constitutent list of governance sector was finally confirmed (For the list, please refer to the websites of SSE and the CSI).

With the rapid development of China's capital market and increasing number of institutional investors, market participants have higher expectation for the corporate governance. In 2007, the China Securities Regulatory Commission conducted special activities to promote the corporate governance of listed companies. Following the special activities, the introduction of the index is aimed at improving the supervision work on the corporate governance of listed companies and offering more underlying products for institutional investors.

The list of 16 special appraisal units of corporate governance (with all names in random order):

CITIC Securities co, Ltd.
China Asset Management Co., Ltd.
Guotai Junan Securities Co., Ltd.
Harvest Fund Management Co., Ltd.
Shenyin & Wanguo Securities Co., Ltd.
GTJA Allianz Fund management Limited
Haitong Securities Co., Ltd.
Ping An Insurance (Group) Company of China, Ltd.
Changjiang Securities Co., Ltd.
China Chengxin International Credit Rating Co., Ltd.
Everright Securties Co., Ltd.

Pengyuan Credit Rating Co., Ltd
GF Securities Co. Ltd
Financial Engineering Research Center of Nanjing University
China Galaxy Securities Co. Ltd.
RepuTex China Pte. Ltd.

APPEXDIX C SSE CGI APPRAISAL INDICATORS

1. Any guaranty, litigation, arbitration or other important matters that affect the company's continuing operations?
2. Does foreign companies guarantee comply with the "Company Law", "Securities Law", as wells as the relevant provisions of SEC and the Stock Exchange?
3. Any violation of procedures and involvement of unfair related-party transactions during the past three years?
4. Are the procedures for the change of ownership of the controlling shareholder or the actual controller of the assets invested in the listed company complete?
5. Any competition in the same industry between the company and those partially controlled or wholly controlled by its controlling shareholder or the actual controller?
6. Heavy reliance on the controlling shareholder or the actual controller for the company's business and profits?
7. Any rejection of the allocation plan publicly announced through board of directors by the majority shareholders?
8. Any discrimination in the corporate charter of anti-takeover regulations?
9. Adoption of cumulative voting system on the general meeting of shareholders?
10. Any active seeking of internet to facilitate voting from small and medium shareholders in addition to the required use of internet to vote on the general meeting of shareholders by regulative bodies?
11. Existence of non-procedural recommendation or appointment of chairman and general manger?
12. Any long-term incentive plan or institutional arrangements for the directors and the management?
13. Any job-related crimes and illegal actions from the company's current or retired directors, supervisors, and senior managers in the past three years?
14. Whether independent directors are nominated by the controlling shareholders or other affiliated shareholders?
15. Number of independent directors and representatives of non-controlling shareholders holding more than 50%?
16. Any independent opinion voiced by independent directors in the past three years?
17. Over one third of voting on the general meeting of shareholders by communication in the past one year?
18. Existence of issued reservations, negative comments, or incapability of making comments on the company's financial and accounting reports from CPA?
19. Any regular report of internal self-assessment and internal auditing to the public in the annual report?
20. Any disclosure of corporate social responsibility taken by the company in the annual report or in a separate report?

VITA

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