

Corporate Governance in China



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Abstract

China has become the world's second largest economic entity following its economic reform process begun over 30 years ago. Corporate governance plays an important role in China economic success, but it also has many problems. These include the concentration of state ownership, management accountability and shareholder rights. Economic reform has made the problems more apparent. This thesis studies the evolution of corporate governance with the China's economic reform process, and explores its strengths and weakness by comparing current Chinese practices with western corporate governance models, primarily that of the USA.

By investigation and the comparison, this thesis proposes four ways to improve China's corporate governance. These concern the following: (1) implementation guidelines, (2) independence of board of directors, (3) functionalities of internal audit, and (4) external structures of corporate governance.

Contents

Contents	iv
1 Introduction	1
1.1 Corporate Governance Definition	1
1.2 Research Background	2
1.3 Research Objectives	2
2 Economic and Enterprise Reform	4
2.1 The Process of Economic Reform	5
2.2 Enterprise Reform	6
2.3 The Achievement of Economic Reform	8
3 Corporate Governance in China	10
3.1 The Development Stages	10
3.2 The Evolution of Governance Infrastructure	12
3.2.1 Financial and Bank Infrastructure	13
3.2.1.1 Financial Market	13
3.2.1.2 Bank Market	14
3.2.2 Legal and Regulatory Infrastructure	14
3.2.2.1 Legal System Infrastructure	14
3.2.2.2 Company Laws Infrastructure	15
3.2.2.3 Regulatory Infrastructure	15
3.2.3 Informational Infrastructure	17
3.2.3.1 Accounting Standards and Implementation	17
3.2.3.2 Information and Transparency Disclosure	17

4	The Comparison of Corporate Governance Models	19
4.1	Western Models	19
4.2	The Comparison between China and U.S	21
5	Corporate Governance Problems in China	23
5.1	Structure Problems of State-owned Enterprises	24
5.2	Problems of External Environment	24
5.2.1	Capital Market Problems	25
5.2.2	Problems of Stock Market	25
5.3	Problems of External Monitoring Mechanism	26
5.4	Problems of Internal Governance	26
5.4.1	Ownership Structure Problems	26
5.4.2	Lack of Independence on Board of Directors	27
5.4.3	Limited Function of the Board of Supervisors	28
5.5	Transparency Problems	28
5.5.1	Transparency on Corporate Governance	28
5.5.2	False Accounting Information	29
5.5.3	Insufficient Information Disclosure	29
5.5.4	Untimely Information Disclosure	30
6	The Improvement of Corporate Governance	31
6.1	Shares Reduction and Structure Improvement	31
6.1.1	State-owned Shares Reduction	31
6.1.2	Increasing Company Managers Shares	32
6.2	Developing Bond Markets	32
6.2.1	Market Reform on Issuing System	32
6.2.2	Reducing Administrative Interference	32
6.2.3	Increasing Bond Products	33
6.2.4	Establishing Credit Rating System	33
6.3	Monitoring Mechanism and Incentive Managers	34
6.3.1	Establishment of Effective Selection System	34
6.3.2	Equity for Managers	34
6.3.3	Strengthen Board of Supervisory Functions	35

CONTENTS

6.4	Audit Financing Standard	35
7	Conclusions and Future Work	36
	References	37

Nomenclature

CBRC	China Banking Regulatory Commission
CPA	Certied Public Accountant
CSRC	China Securities Regulatory Commission
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
MOF	Ministry of Finance (Chinese)
NDRC	National Development and Reform Commission
PBOC	People’s Bank of China
PRC	People’s Republic of China
RMB	RenMinBi (Chinese yuan)
SCSC	State Councils Securities Commission (Chinese)
SEC	U.S. Securities and Exchange Commission
SOE	State-OwnedEnterprise
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange
WTO	World Trade Organization

1

Introduction

1.1 Corporate Governance Definition

Corporate governance is commonly viewed as a system that delineates the rights and responsibilities of each major group of shareholders in a company, and sets rules and procedures for making decisions about company affairs [1]. It is “the mechanism of pushing firms to operate efficiently and create value”, designed to prevent potential exploitation of outside investors, particularly shareholders, by corporate insiders, such as the management” [2]. It can also viewed as the design of institutions and mechanisms that induce or control board directors and management to best serve the interests of shareholders and other stakeholder in a company, and to resolve conflicts among them, subject to the constraints of economic, legal and ethical norms [3].

From various definitions of corporate governance, corporate governance structure is the core of modern enterprise system. Corporate governance is a broad term to do with the manner, in which the rights and responsibilities are shared among owners, managers and shareholders of a given company. The purpose of corporate governance regime is the system by which business corporations are directed and controlled. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

1.2 Research Background

In recent history, China's economic reforms and corporate governance have been changing significantly. China's economy over the last three decades, has staged the strongest growth over any given period in history, for example, as the country moved away from a purely state-owned, and a centrally planned economic system to one where foreign capital and private enterprises are allowed. Nevertheless the corporate governance still remains a large government-led, relationship-based structure. Especially, the ownership of listed SOEs often remains under the state, which determines that chairpersons, board of directors, CEOs and general managers are also likely to be party members and government officials.

With the wide spread of globalization, Chinese firms, especially SOEs, are facing challenges on the globalization. They have to play in accordance to international rules if they want to increase their trade and connectivity with other countries. Therefore, they adopt the international practices, including accounting standards. However, only employing the western rules and standards will not improve corporate governance and accounting qualities in China as only these standards do not help much.

Therefore, China has aligned itself more closely with the international economy, and it has also sought to adopt more western-style oversight mechanisms and legal standards concerning the operation governance. With the rapid economic growth, corporate governance is critically important for it provides the credibility and confidence in the management that is fundamental to capital markets. In turn, China's economy reform accelerates the evolution of corporate governance.

1.3 Research Objectives

The objectives of this essay are: 1) to research the development of China's corporate governance. In practice, the company ownership of a country is the national companies ownership structure in accordance with the state characteristics, history, and cultural traditions as well as the factors, such as market structure and the corporate governance structure with a characteristic pattern. 2) The development of corporate governance evolves with the economic growth and en-

terprise reform. The research also investigates the economic growth process, the achievement, and the enterprise reform which is the key element to the reform of corporate governance. 3) The research also compares western models, in particular the US model. Through the comparison of different models, we can better identify the problems of the corporate governance of China. 4) To explore the key corporate governance problems in China, this thesis concentrate on the government-led relational system, problems of Ownership and Control, and the transparency problems of Corporate Governance. 5) The thesis offers solutions for these challenges.

2

Economic and Enterprise Reform

This chapter discusses China's economic and enterprise reform. Corporate Governance is one of the important factors to the success of economic reform. The changes brought to China resulting from economic reform, especially the enterprise reforms, make a fundamental revolution for modern corporate governance in China.

The economic system in China is called socialism market economic with Chinese characteristics. It was started from December 1978 when the third Communist Party of China Congress was held. Since then, it has proceeded more than 30 years and it continues today. The policy has released China from the constraints of planed economic, turning China into a modernization country, and it has helped hundreds and millions of people out of poverty.

In the late 1970s and early 1980s, China began to open to the world, international business trade was started, and the Contract Responsibilities System was implemented in agriculture sector. During 1990s, six special economic zones were established, including the zone of Shanghai Pudong, the pioneer of attracting foreign investment. The reforms in the late 1980s and early 1990s were focused on the creation of pricing system - a dual track pricing system, and on decreasing the role of the state in resource allocations. Some sectors such as distribution were opened to both private enterprises and foreign capitals. In the past several decades, China economic reform has made a spectacular success in all areas, as its GDP has been growing with two-digit speed, especially after China became a member of the WTO in 2001 [4]. Now China has established a market econ-

omy system and a complete industry system. It is no longer self-sufficient in agriculture, while it has undergone significant urbanization.

In the planed economic era, all companies were owned by the government with no private enterprises allowed. However, during the past 30 years, the ownership of companies has experienced unprecedented changes. The state-owned sectors are mostly those critical departments like post, bank, railway, power, and so on. However, some private and foreign capitals are increasingly allowed to invest in these. Currently, there are four kinds of companies dominating the China economic: state-owned companies, stock companies, private companies, and joint-investment companies. It is possible there will be some other types of company emerging in the future but it hard to predict at this moment.

2.1 The Process of Economic Reform

At the beginning of the reform, the goal was to generate sufficient surplus value to finance the modernization of the Chinese economy. The first reform in the late 1970s and early 1980s consisted of opening trade to the outside world, instituting the contract responsibilities system in agriculture, so that farmers could sell their surplus crops and place them on the market. The government established the Township-Village Enterprises.

Second step was to establish Special Economic Zones: By the end of the 1980s China had almost solved its food shortage problems. At the same time, China established special economic zones which are Shenzhen, Pudong, Zhuhai, Shantou ,Hainan and Xiamen. The most successful Special Economic Zone in China is Shenzhen, which has developed from a small village into a city with a population over 10 million within 20 years. The government provided a lot of policies and economic advantages for these special Economic Zones, which made the rapidly growth of these special economic zones. The main purpose is that the special economic zones can lead the whole nations economic growth. The general designer of China economic reform, Mr. Den Xiaoping, has a famous saying, a cat is a good cat as long as it can catch mice no matter its colour is black or white. The goal is success.

The third steps was to attract foreign investment inflows. In 2002, China

became the world's largest recipient of total foreign direct investment (FDI). That performance comes thanks to China's progress on structural reforms, including replacing the complicated system of authorized foreign investment categories with a simple and shorter list of sectors; accelerating the cumbersome approval process for foreign investment projects, opening stock and bond markets to enterprises that are foreign-owned and increasing transparency, particularly in the process of formulating laws and regulations.

2.2 Enterprise Reform

Different to the planned economic which only state-owned enterprise existed, the modern Chinese economic has the four kinds of enterprises as mentioned above acting in each industry. During the reform of enterprise, many state-owned enterprises were purchased by the private, foreign, or joint capital. The reform has experienced a very hard time for the reason of efficiency many enterprises had to cut their redundant employees. Therefore, many people lost their jobs, or had to change to their jobs. On the other hand, the factories did not follow central planning any more. Instead, their production is totally decided by the need of market. In order to adapt to the fast-changing market environment, the four main kinds of enterprises are playing their roles in China society.

State-owned Enterprise:

Early in the period of economic reform, there were about 65% state-owned enterprises (SOEs) in total industrial output (Figure 2.2). Sources from: National Bureau of Statistics of People of Republic of China 2008. Most of them have been reformed successfully but some enterprise, especially large ones, are proceeding very slowly. One common characteristic is that they employ many people but low efficiency, but might provide essential goods and services to the society. Many of them have to rely on the government's subsidies to survive. However, it is not economically or politically feasible to simply shut them down for many people will lose their jobs, in addition to essential services. For example, Sinopec (China Petrol chemical Corporation) has a workforce estimated by Fortune magazine to be over one million. Another Chinese petroleum-based SOE, China National Petroleum Corporation, has a workforce estimated by Gordon Chang to be about

one and a half million. There is already a serious unemployment problem particularly in rural areas and this is destined to become worse with the impact of China's entry into the World Trade Organization (WTO). The dilemma is that the government cannot stop propping up the SOE's because of the role of the SOE's as employers and providers of essential goods and services. But as long as the government keeps propping them up, the SOE's have little incentive to change. Even when a SOE is nominally privatized, the subsequent treatment of that enterprise by the government indicates that it is still a state-controlled enterprise [6].

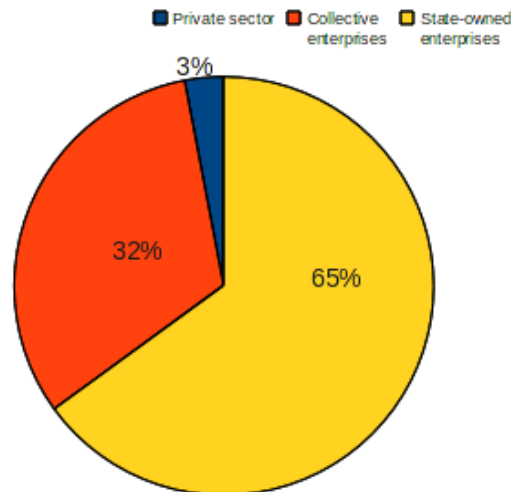


Figure 2.1: China's Industrial Output by ownership(1985)
Sources from National Bureau of Statistics of People of Republic of China 2008

Stock Enterprises: These are former state-owned companies. These enterprises with some percentage of shares retained by the government offer a better incentive system. The leaders who manage these enterprises usually possess some shares through legal approach, including management buyout. For example, TCL and Lenove which are two famous stock company in China. The entrepreneurs and employees own stock shares as well as the state. Mostly, the state own bigger percentages of the stock.

Private Enterprises: China's private sector has developed from a minor player into a significant components of the socialist market economy, and it is

steadily growing. Its average rate of increase has kept abreast with the overall development of China's industry. The non-state sector of the economy is facing more opportunities for growth as the government has promised to open up important markets to foreign and private investment. They include the telecommunications, retail and banking sectors. However, private enterprises are often troubled by a lack of funds and technologies of weak management [7].

Foreign or Joint Venture Enterprises: Foreign enterprises in China also refer to wholly foreign-owned enterprises, they are the enterprises established in China by foreign companies, enterprises, other economic organizations or individuals in accordance with Chinese law and all the investment solely ordered by foreign investors. According to China's law on foreign enterprises, the establishment of foreign enterprises in China must be conducive to the development of China's national economy, and must meet at least one of the following requirements that they will apply internationally advanced technology and equipment, and that all or most of their products will be export-oriented. The corporate form of foreign enterprises in China is generally the limited liability Company. Along with the development of China's experiment to introduce the system of Joint stock partnership, a small number of foreign enterprises in China have adopted the corporate form of joint stock limited company. Although China was relatively late in introducing the system of establishing foreign enterprises, the establishment of wholly foreign-owned enterprises in the country has developed relatively rapidly over recent years. From the State Administration For Industry and Commerce (SAFIC), in 2008 foreign-funded enterprises have invested a total of US \$2.11 trillion in China as of the end of last year, up 23.5 percent year-on-year [8].

2.3 The Achievement of Economic Reform

In general the Chinese economic reform has been an economic success which has generated rapid economic growth over two decades. Open organization and internationalization have helped the transition to a market economy.

In 2009 GDP increased by 9.1% up to almost RMB 35,000 billions, which makes China the second biggest economic body in the world(Figure 2.2). Opening to the outside remains essential to China's development. China emerged as the

second biggest trade body, after the US. So, over the past two decades of reform, the Chinese economy has achieved world-shaking changes. Since China's entry into WTO in 2001, the role of the Chinese central government derived from spontaneous economic forces and the conscious decision by reformers to replace direct central government involvement with indirect labour in the market, plus increased local decision-making. In the past, before the China's economic reform, only the government played an important role in activities. Now it is enterprises that do so. An estimated 400 million people have been lifted out of poverty; perhaps 100 million people have been booted up the middle class; and China rose from an economic backwater into the world's second largest economy [5].

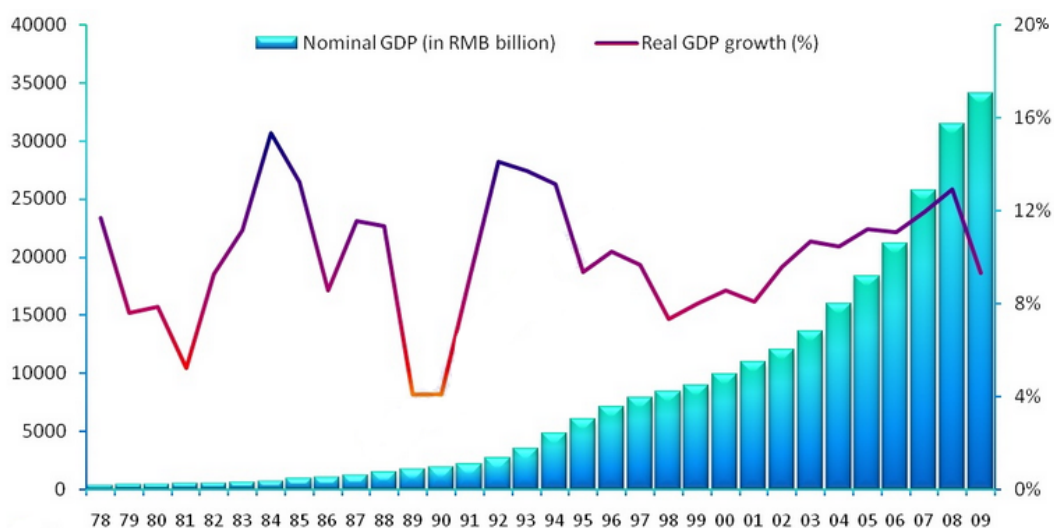


Figure 2.2: China GDP and real GDP growth rate from year 1978 - 2009 (Source From world bank website)

3

Corporate Governance in China

3.1 The Development Stages

The historical corporate governance in China can be partitioned into four stages with the time period of economic reform. To summarize: China launched a major economic reform and liberalization program in 1980's, which transformed the planned economy to a market economy. Since then, the reform of state-owned enterprises (SOEs) has been considered the key to the success of China's economic growth. In 1990's, the Chinese government reformed its SOEs through incorporation, and the concept of *modern enterprises* was introduced accordingly [17]. During this process, the separation of state ownership and control was adopted, and company managers were granted control rights.

The pre-reform era from 1949 to 1983, it was total state-owned enterprises dominated in Chinese economy, during that time, the state controlled almost every aspect of the economy, such as from manufacturing to distribution and consumption. The entire workforce was paid through a national wage hierarchy, which was modelled after the payment structure of government employees. There was no western-style corporate governance.

The second stage from 1984 to 1993, marked the beginning of the separation of government and enterprise. The Communist Party announced the decisions of the Central Committee on Economic Structural Reform in 1983, indicating the beginning of enterprise reform. The reform was not intended to change the state's

ownership, but to remedy the inefficiency of SOEs. The goal of committee was to transform firms into economic entities that could make their own decisions and be held responsible for their own profits or losses, in which to create a more effective incentive scheme among Chinese companies. Therefore, the implementation of the reform started with the policy of granting autonomy to companies and allowing them to retain a certain portion of profit, which was soon followed by the management contract system in the mid-1980s. The model of management contract delineates profit-sharing rules through negotiations between management team and related governmental agencies, and led to a steady increase in marginal profit retention rates over the 1980s. In August 1984, the Shanghai Municipal Government approved the first provincial-level regulation on securities, and more SOEs followed the path of secularization. As a result, China formally established the SSE and SZSE in 1990. The next year, the China Securities Regulatory Commission (CSRC), was a government body for serving the country's main regulator of the newborn stock market. Those were remarkable steps for corporate governance of China [9].

The third stage marked the beginning of experimentation in the modern enterprise structure from 1994 to 2005. The People's Congress issued China's first Company Law in December 1993. It was not only the first comprehensive law that fully delineated the rights and responsibilities of modern companies, but also the first major business law that did not differentiate legislation for companies based on their ownership structures. Although, the company law has significant impact on corporate governance and the economy as a whole in China, the Chinese economic system still suffered from overwhelming favouritism toward the SOEs. The SOEs continued to enjoy favourable treatment from the initial process of company establishment all the way through to public offerings of securities, and they therefore continued to survive even after the enactment of the 1993 Company Law. The state was misplaced its role as a regulator and social planner aimed at maximizing the aggregate social welfare, or its role as a regulator and social planner aimed at maximizing shareholder profit. However, after the passage of the 1998 Securities Law, the power of the CSRC was significantly strengthened and it took a more active role in monitoring and regulating corporate governance of public companies.

The final stage from 2006 onward involved legislations to balance the power between state shareholders and individual shareholders in Chinese company. It was the period of continuing growth of corporate governance in China. The stocks of two-thirds of China's security markets were non-tradable until 2005, which included both the state-owned shares and legal-person shares that are owned by employees and parent companies. Those non-tradable shares constituted a significant and persistent risk for minority investors in tradable shares; so Chinese government initiated a program to fully circulate listed companies' non-tradable shares. In October 2005, the National People's Congress passed a revision of China's Company Law, which lowered the threshold for companies' public listing. Continually, the National People's Congress amended the 1998 Securities Law in 2006 [25]. The goal is to balance the power asymmetry between the state owner and the minority shareholders. The new Securities Law lifted the ban that kept public listed companies from entering new industries. In order to protect investor interest, it required an investor protection funds be established with financing from investment banks.

Through four stages development, Chinese lawmakers still work toward closing the corporate governance gap between China and developed countries. The executive branch has also moved ahead in protecting minority shareholders.

3.2 The Evolution of Governance Infrastructure

2001 was a noticeable year in the process of corporate governance evolution. Caijing Magazine, a popular financial publication, unveiled the biggest scandal in China's economic history. It was YingGuangXia fraud matter [10]. Ying-GuangXia case reflected the weakness of China's legal, regulatory, and accounting systems. However, it drew attentions from corporate governance regulators and public investors. Since then, China's government accelerated the development of laws, rules, legislators and regulators. China made remarkable strides in all sectors within very short period, encompassing financial and bank infrastructure, legal and regulatory environment and the information disclosure infrastructure.

3.2.1 Financial and Bank Infrastructure

3.2.1.1 Financial Market

As discussed before, the economic reform transform China's economy from a totally planned to a market economy. A symbolic event was the establishment of its first stock exchange in Shanghai (1991), and Shenzhen (1992). Although there are some certain industries, like bank industry, telecommunication industry, national media and relevant publication are still highly regulated by the government in 1990s, China's accession to WTO accelerate deregulation of these industries.

As more international companies enter Chinese market, the PRC economy has to decrease its heavy reliance on administrative and policy support, and adapt itself to the competition rules of real market economy. China's government should change its role from that of approving or endorsing any business activity towards acting as a real policy-maker, implementer, enforcer and evaluator. That will also cause diversification government ownership structure, for example, state ownership changes to private businesses. The state-owned Enterprises can publish a portion of company shares in the public markets. Until now, listed companies' capital structure can consist of state-owned shares, legal person shares, A shares, B shares, H shares, and other foreign investment shares. A shares incorporated in mainland, Currently, they are mainly traded with Chinese and selected foreign institutional investors are allowed to trade A. B shares' markets are Shanghai and Shenzhen, and they are quoted in foreign currencies. In the past, only foreigners were allowed to trade B shares. But since 2001, Chinese can trade B shares as well. H shares are listed on the Hong Kong stock exchange, the origin of business should be mainland China, and the H shares are available to international investors.

It was estimated that the PRC equity market are mainly dominated by individual investors, only 0.4% of total investments are under the name of institutional investors [11]. Except equity market, there is small and underdeveloped domestic bond market. It was controlled by central government and the mainly investors are individual investors.

3.2.1.2 Bank Market

Currently in China, there are four types of national banks, the central bank, policy banks, state-owned banks and commercial banks. altogether 24 banks in China [12]. China has highest savings rate equivalent in the world. The saving rate was approximately 20% of GDP in 1981, and it increased to 43.4% of GDP in 2005 [13]. The majority of national savings are in bank deposits, with a small percentage in equity investments. Chinese corporations, especially SOEs rely largely for bank loans and policy lending for funding.

The state-owned banks and state policy banks are the mainly dominated both lending and bank deposit markets in China. China economic reform transformed a planned economy to a market economy, in spite of which most banks' lending remained policy lending. At the beginning of the reform, all these banks had very poor internal risk control systems. The huge amount of money lent to SOEs which were in serious financial difficulties, caused very serious non-performing loan problems.

China's accession to WTO bring both challenges and opportunities to China's banking industry. In short period, domestic banks have had to face pressures by opening up financial markets to international competition. But the foreign banks have influenced local banks in positive ways on management skills, product diversification, new technology, additional funding sources and customer service awareness.

3.2.2 Legal and Regulatory Infrastructure

3.2.2.1 Legal System Infrastructure

China's legal history only has a half century. The highest authorization to legislate is the National People's Congress (NPC). In China, the standing committee of the NPC has the power to interpret laws, to issue laws and draw up decrees. At the beginning of the process, many basic laws, rules, and codes were preliminarily made up during 1949 to 1956. As China's historical and political reasons, the basic laws and rules were really underdeveloped and often retracted on many aspects of society. It was not until 1978 that the National People's Congress

began to issue Criminal Law, Civil Procedures Law, Administration Law, People's Court Administration Law, and other areas earliest laws. The process of issuing laws not only involved regulations but also a large element of the Chinese culture, which in turn, grants more discretionary power of implementation and enforcement processes.

3.2.2.2 Company Laws Infrastructure

China's first Company Law was passed by the National People's Congress in December 1993, and it was effective in 1994, amended in 1999. The first company law stipulated two types of companies that are limited liability companies and joint stock companies, which intended to regular corporation structures and activities, also to protect commercial interests for the companies, shareholders, and creditors. The Law articulated the responsibilities, rights and liabilities of corporation management and shareholders. For instance, under the PRC Company Law, directors and managers are insiders. The Company Law articulated the board of supervisors should be the independent "outsider". The Law gave shareholders the right to appoint and to remove directors and supervisors. After the first company law published, there are many other securities and commercial laws were passed as follows :Securities Law, passed and effective in 1998; Contract Law, in 1999, Bankrupt Law in 1998, PRC Trust Law in 2001 and the law of Commercial Instruments.

3.2.2.3 Regulatory Infrastructure

In order to enact and supplement the Company Law, there are a series of listing rules and regulations published to regulate capital market and listed company activities.

First, the people's Bank of China (PBOC) not only regulate financial markets, but also acts as an administrator in formulating and implementing monetary policy. In March, 2003, the State Council set up a new China Banking Regulatory Commission (CBRC) that is taking over the regulatory responsibilities from the PBOC. CBRC is responsible for drafting and enforcing banking-related laws, rules, and regulations. The PRC's national currency RMB is not fully opened to

international markets, and it is under the supervision of PBOC. Also, the State Administration of Foreign Exchange (SAFE) looks after foreign currency trading activities.

Second, PRC's capital market is centrally regulated. The highest authority for the capital markets is the state Council Securities Commission (SCSC). China Securities Regulatory Commission (CSRC) is the executive institution of SCSC responsible for conducting supervision and regulation duties. The CSRC establishes supervisory authority over all securities and futures business, such as listed company stocks, funds, investment funds. The CSRC released the first Code of Corporate Governance in January 2002, it requires all listings must comply with PRC Company Law. It also supervises the key listing rules of securities codes and regulations, the structure of board, the rights of Shareholders and the requirements.

Third, the Company Law requires listed companies to adopt a two-tier board structure and it should consist of two-thirds top executives and one-third independent directors. This system is similar to Germany's mechanism. In Germany, the two-tier board structure and extensive labour representation are defining features of Germany's internal control mechanisms. The internal control functions contain supervisory board, management, insiders, outsiders, which are most like China's system[14]. Actually, under this two-tier structure, the board of directors, as the core board should work closely with the management. However, in China's , board members and top management are both from same group of person. That means that ownership and control are not separated, which causes a lot of problems. The Company Law also regulate all shareholders should have equal rights in profit sharing and participation in shareholder meetings, but it is difficult for the minority shareholders to form a large meeting for their rights.

Fourth, Over-regulation and structural imbalances, in combination with its poorly manage transition toward full economic integration are common themes that characterizes most Asian governance systems. China is no exception in this situation [15]. In China, selective force and interest group enforcement are commonly seen in all aspects of corporate governance. So, corporate risk-taker frequently challenge the system. Therefore, the code of Corporate Governance requires listed companies to establish intensive and control systems. But the

practice of establishing incentive systems seem not work well in China's corporate governance.

3.2.3 Informational Infrastructure

3.2.3.1 Accounting Standards and Implementation

China Accounting Standards Committee (CASC) started developing a range of accounting standards since 1993, which is under the supervision of the Chinese Ministry of Finance(MOF). The initiative project was "Accounting Reform and Development Project" from international Development Association in 1999 [16]. This project completed the local standards by introducing new International Accounting Standards (IAS) or amending the old standards. In 2002, there were 16 accounting standards issued. CASC work for narrowing the differences between the existing PRC standards and IAS, but it still have some major differences in key areas. For example, Chinese accounting may differ from that required by IAS due to the absence of specific Chinese rules on recognition and measurement in some areas. And there might no specific rules requiring disclosures on some certain areas such as the fair value of investment properties, the discontinuing operations and ect. There are also inconsistencies between the PRC standards and IAS on certain subsidiaries. Or in certain enterprises, like finance leases could lead to difference from IAS [11].

The implementation of accounting standards and system is the key challenge on corporate governance. China's National Audit Office randomly checked the auditing work of 16 Certified Public Accountant (CPA) firms. And it was found huge fabrication financial statement with 72% of financial report, 86% of CAP firms' audit engagements, and 41 accountants were involved in those seriously inconsistent facts [11]. This clearly show the serious problems in corporate governance, alerting the regulators to apply more strict compliance requirement.

3.2.3.2 Information and Transparency Disclosure

Except the Company Law, the Code of Corporate Governance requires listed companies to disclose related information of Corporate Governance, publish the

discrepancy between the actual situation and the requirements in the Code, and the improvement plan for corporate governance.

In 2001 and 2002, the CSRC released a series of disclosure standards and requirements to ensure quality of disclosure. The new standards requires the heads of the company, the accounting department, and external accounting firm to make a public announcement ensuring true an complete disclosure of the reports. The standards also require the public listed companies to disclose financial results by quarterly basis and publicise significant events that may impact stock prices immediately.

4

The Comparison of Corporate Governance Models

4.1 Western Models

Corporate governance refers to the relationship between the owners and management of a corporation in organization. The type of regime can be quite different in terms of the countries' structure differences. It also reflects the different economic circumstances and national traditions. Therefore, to discuss the corporate governance systems, the context of the societies in which the country function should be considered.

Normally, the wider the distribution of shareholding, the greater is the role of the market in the exercise of corporate control. Shareholding in several continental European countries is rather concentrated, so that their corporate governance problems are less frequent or at least apparently so [19].

In the world's major developed countries, due to the differences in social history and cultural traditions, in political and economic systems, and due to the differences in the property rights model, financing methods, and capital market structure, there arise different ownership structures and, as a result, different corporate governance models. Generally, corporate governance can be classified as "Anglo-American model" or "Germany and Japanese models."

The major feature of the Anglo-American model is the securities market, and

it is characterized by dispersed ownership. The concept of Anglo-American is implementing contract doctrine. It pursues value maximization on behalf of the shareholder. In the Anglo-American model, the securities market is highly developed and the company ownership is dispersed. However, banks only play limited role in corporate governance, but the securities market and associated market for corporate control in corporate governance is very prominent.

Germany and Japanese models are as bank-centered, and characterized by ownership concentration. The securities market is not as developed as in the Anglo-American system, and the information disclosure and market transparency standards are rather low. The market for corporate control is not active, as stock ownership is concentrated and controlled by large corporate ownership. Banks dominate capital markets and play an important role in corporate governance.

As a result, these two models have different features. Anglo-American model is market-oriented, and dispersed ownership structure characterises the capital market. Shareholders actively monitor management constraints by using voting rights. The Anglo-American model focus on market mechanisms, competition and bankruptcy or other external governance mechanisms. It pays a lot of attention to the interests of shareholders, which is in line with recent global corporate governance trends.

The Anglo-American model seeks to combine directors interests and shareholders interests through reasonable compensation and incentive mechanisms. A significant and controversial example is the use of stock options to stimulate the operators and shareholder to work hard in the shareholders' best interests.

German-Japanese model is organization-oriented. It restrains company managers through strict organizational structure. Germany-Japanese model emphasizes the investors, corporate staffs and equal participation of trade unions. German-Japanese model pays attention to shareholders in corporate governance role, which represents another trend in the development of corporate governance structure in the world today.

In the practice of building and improving corporate governance structure in China, focusing more Germany and Japanese for reference model. China's corporate governance model is different to U.S model.

4.2 The Comparison between China and U.S

The detailed of corporate governance systems in China and America is as shown in Table [4.1](#).

Table 4.1: Governance Structure in the China and America

Criteria	China	America
Regulation	Corporate Law 1993, Securities Law 1998, CSRC	Sarbanes Oxley Act (SOA), SEC. and NYSE listing requirements
Applicability of corporate governance	Publicly held corporations that can be listed or non-listed	Public companies
Shareholders and institutional investors	State investor in SOEs; some outside shareholder ownership; institutional investors lacking	Individuals and companies; important role for institutional investors
Board of Directors and Supervisor	At least 33% independent directors. No requirement for non-management directors to meet without management. Supervisory board can overturn director decisions.	Majority of independent directors. Non-management directors meet without management
Audit Committee	Majority of independent directors including the chair. Committee reviews internal audit and controls and oversees financial disclosures. Not required to meet separately with management or auditors.	At least 3 independent directors. Meet separately with management and independent auditors. resolve disagreements between management and auditors on accounting issues. Review internal controls
Certification of financial statements by management	Does not address this issue	Certification required by CEOs and CFOs
Internal control report	Not addressed by regulations	Prepared by management; auditors independently assess report
Corporate governance report	Comply or explain gaps between existing practices and recommendations in the Code; no penalty for failing to do so	Disclosure of corporate governance guidelines; CEO certification. Listed foreign companies must disclose practices that do not comply with America requirements

5

Corporate Governance Problems in China

After more than 20 years reform of corporate governance, a large number of state-owned enterprises were transferred into public companies through restructuring, mergers and acquisitions. Those state-owned enterprises have helped to take total market capitalization forward.

At the end of December 2010, there were total in number of 2042 listed companies in Shanghai and Shenzhen stock markets. The market value reached 27.5 trillion, with third quarter operating income of 12.3 trillion yuan. But the total listed state-owned enterprises account for more than 80% in total stock market [22]. State holding listed companies cover aerospace, telecommunications, energy, transportation, equipment, manufacturing and finance industries.

Therefore, the state holding listed companies comprise the main ownership structure of China's listed companies. The failure or success of corporate governance reform is an important factor of state-owned enterprise reform, which is not only to achieve the objective of an important value-added identity, but also is related to the health development of capital markets.

But precisely because the state-owned enterprises account for the weight ratio of listed companies, it leads to significant problems of corporate governance.

5.1 Structure Problems of State-owned Enterprises

The Institution framework of listed companies is complicated in China, as there are many government entities playing an important role in corporation activities. The institution of listed corporation can be described into an inner structure and an outer structure.

First, the inner structure contains shareholders general meeting, the management of corporate and the auditing system. The inner entities effectively direct companies. However, due to the short period of development of corporate governance, Chinese corporation are always lacking experienced personnel. The shortages of the professional knowledge make their corporate governance inefficiency. Additionally, since the most management teams compise government officials, it brings a lot of conflict-of-interest problems in a government-controlled economy.

Second, the outer structure contains the regulators, the legal system, the institutional investor, auditing system and stock exchange activities. The outer entities have a significant impact on corporation governance, as they can control companies through publishing regulations, codes of conducts, certification of financial reports, or legal enforcement, and so on.

Through 20 years development, China's state-owned enterprise reform and corporate governance reform gain huge process. A large number of joint-stock corporations and state-owned enterprises have already achieved a lot of process, especially on the organizational form, enterprises restructuring, and governance structure areas. However, the operating mechanism still remains a product of the original system. Since more than 80% of listed companies are state-owned corporation. That rises a lot of problems, contradictions and shortcomings in the new forms of corporate governance. The chapter analyses these problems.

5.2 Problems of External Environment

Governance mechanisms could play an important role outside the company only if the economic market is under the capital market competition. Government

should through the implementation of their economic functions, create an effective macro-control system and perfect the social security system to bring a healthy, mature market system. However, the structure of external environment towards state-owned companies and corporate governance reform process suffers from following problems:

5.2.1 Capital Market Problems

Although China's stock market have achieved great development in recent years, but the number of listed companies is limited, so the stock market capacity is small, and it is not standardised. First, in Chinese stock market, more than two-thirds of listed companies are state-owned companies. So, the proportion of state shares and legal person shares are too large. The state shares are mostly no-tradeable shares, and tradeable shares account for a very small proportion of total share capital. That means a considerable portion of shares are not in circulation, which loss the vitality of the stock, the stock market could not play its full function to allocate resources.

5.2.2 Problems of Stock Market

Firstly, there are serious stock market segmentation problems. In China, the shares of one stock company can be circulated in different market flow, such as A-share market, B-share market and H-share market, and each share in different stock markets has different circulation conditions. That results in the same share having different interests and different price in different share market.

Secondly, there are no institutional investors on the stock market. If stock markets do not have institutional investors, the stock market is an immature market. Securities market include a wide range of content, including the stock market. If the stock market can be developed, the securities market can really play its function of resource allocation. That benefits the whole stock market.

5.3 Problems of External Monitoring Mechanism

Banks and other creditors have limited monitoring implementation on listed companies. Although China has established a relatively good relationship between banks and enterprises, but the current law prohibit equity investments of commercial banks to the securities industry and non-financial sectors. In these sectors there is no board representatives from commercial banks. The external market for corporate controlling is also very limited. After the split share structure reform launched, state-owned shares and legal person shares can be gradually traded, at least theoretically. The performance evaluations of state-owned enterprises have gradually become dominated by the company's stock price, which in future will provide the conditions for the strengthening of external control.

Improving the managerial labour market is another important external mechanisms of oversight companies. China's Capital Market and the current ownership structure greatly limit the behaviour of manager market that are binding on the role of the operators. In the absence of evaluation mechanisms, managers market cultivation does not have the practical operability in China. Therefore, the monitoring role of the market is also very limited.

5.4 Problems of Internal Governance

5.4.1 Ownership Structure Problems

China institution frameworks determine the concentration of state ownership. For example, the company law empowers shareholders general meeting to be the ultimate decision making entity for a corporation. However, the attendance at general meeting has been very low in China, and the controlling shareholders have dominated it. China's corporate governance is the weak protection of individual shareholders rights. This is because the majority shareholders are typically very strong, while the individual shareholders are extremely weak, and most individual shareholders do not attend the general meetings because they have limited voting rights, and they could not influence the corporation decisions.

The important management structures on corporate governance are the ownership structure, board of supervisors and senior management incentive. First, the ownership structure is the foundation of corporate governance and it plays a decisive role. This is because it determines the board of directors, the composition of the board of supervisors and managers. The Board is the executive agency for the company. Therefore, it has important impact on corporate governance. Second, establishing effective incentive and restraint function for senior management is the key factor to improve the corporate governance structure.

5.4.2 Lack of Independence on Board of Directors

The direct result of ownership concentration is the lack of independence among board directors. In China, the supervisory board has not played an efficient role in corporate governance. There is no laws giving rights to supervisors for taking civil litigation against board directors or senior managers, when they detect company misconduct. Moreover, the supervisors are usually selected from the companies employees or from former communist cadres in the state owned enterprise who could not fit in other positions in a corporative organization. In this way, people who are supposed to supervise, directly determine the financial interests of corporation. The supervisory board usually has labour union, party and major shareholder representation. Therefore, they do not play effective governance role.

But with development of corporate governance, the situation has improved, but there remain problems. Currently, Chinas Company Law stipulates that the board of directors determines all major business decisions, and the shareholders meeting elect the board of directors. In practice, directors appointment or dismissal does not require a shareholders meeting, and the election of chairman are actually appointments by the higher authorities. As the board establishments are not standardized, there is no legislation and reasonable remuneration. Therefore, the board of directors often does not act independently and the board executive order becomes higher intermediary transferee.

5.4.3 Limited Function of the Board of Supervisors

Board of directors is parallel to the supervisory board in corporate enterprises. The supervisory board is only part of the supervision, and they do not have control and strategic decision-making power, neither no rights to appoint or remove board members or senior manager. The Company Law and other regulations of corporate governance specific the shareholder value-oriented, which only attach the importance to the role of the boards position and ignore the supervisory board. So the board of supervisors is really just a board controlled by deliberative bodies. First, exposure to a specific company running under the governance structure of financial accounting information system, its information disclosure and corporate governance structure is subject to a crucial impact, corporate governance not only helps to regulate the implementation of accounting information disclosure standards and specific content but also help to improve the quality of accounting information disclosure.

5.5 Transparency Problems

5.5.1 Transparency on Corporate Governance

From the perspective of modern capital markets, corporate governance and information disclosure constitutes an integral part of efficient operation on capital market. First, accounting disclosure is running under the governance structure of financial information system and it is crucial to corporate governance. Corporate governance not only helps to regulate the implementation of information, but also to improve the quality of accounting information disclosure. On the other hand, the disclosure of accounting information is an important factor on corporate governance, and its system of quality improvement directly affect the operating results which is related to the success of corporate governance. There remain some transparency problems, however.

5.5.2 False Accounting Information

Some listed companies need to publish financial information. However, some over-value the companies assets, and make false packaging. For example, some listed companies incorporated into the price of unrelated assets to the stock market, which is together with other related assets. It increases tens of millions of inflated capital. If the company do not make any profits or even have seriously losses, then it make false accounts and turn it into blue-chip companies. A umber of listed companies disclose false information intentionally, in order to mislead small investors with the promulgation false information. There is real case about false accounting information of YinGuangXia fraud.

GuangXia(Yinchuan) limited Industry Company is listed on stock market in June, 1994. It was Known as Chinas first blue chip as its remarkable performance and attractive prospects. According to YinGuangXia annual report, its year earnings for per share reached 0.51Yuan. The initial share price from 13.97 raised to 35.88 Yuan with the date from December 30, 1999 to April 19, 2000. And it reached 37.99Yuan on 29 of December 2000. It increased 440% within one year, which was eight times increasing compared former year. It was until August 2001, one Chinese finance magazine of CaiJing disclosed that it was totally because of false finance information. From 1997 to 2001, YinGuangXia made fictitious sales ravenous as 1 billion Yuan, the benefits of it was more than 700 million Yuan [10].

5.5.3 Insufficient Information Disclosure

In China, many listed companies only disclosed by industry segment for the year's main business revenue, operating profits, the main business products, and the proportion of income and operating profit increases or decrease. But they do not disclose the required number which is comparing with the previous year. So, the disclosures are covering limited accounting information, and it is difficult for investment decision-makers to understand the complete information.

5.5.4 Untimely Information Disclosure

The Disclosure of accounting information is not timely, so that it reduces the value of information usages. In the stock market, that whether listed companies timely disclose accounting information is directly related to many investors of their vital interests. Currently, in China, the vast majority of listed companies basically be able to do performance report disclosed within the prescribed time, but not timely disclose of the major events. For the majority of stock investors, the misleading distortion of accounting information will affect their investment decisions, and even cause losses due to investment mistakes. It will reduce investor confidence. Therefore, the stock market is not conducive to normal development.

6

The Improvement of Corporate Governance

As summarized in previous chapter, the five main problems of corporate governance in China are structure problems, external environment and capital market problems, external monitoring mechanism problems and internal governance and transparency problems. In this chapter, the suggest improvement towards each problems as follows:

6.1 Shares Reduction and Structure Improvement

6.1.1 State-owned Shares Reduction

State-owned equity can be phased out, where those listed companies are operating on a non-economic basis and therefore not competitive, strong companies. Government should reduce the concentration of state-owned shares, and accelerate the free flow of state. In this ways, the state can achieve diversified equity owners, and can accept new investors such as banks, investment funds, and individual funds. Particularly, it can attract and encourage enterprise investors who represent the interests of individual investors. Additionally, the enterprise investors, coupled with its expert management, so it will effectively inspire and

supervise over listed companies.

6.1.2 Increasing Company Managers Shares

Listed companies should increase managers shareholdings, and expand their stakes timely. Also, listed companies should make managers individual benefits associated with companies achievements. In this ways, company managers can increase the consideration of long-term development and growth for listed companies. If company managers could achieve enterprise business goals, listed companies should promise its higher income.

6.2 Developing Bond Markets

A developed capital market is the regulator and controller of listed companies optimization. In China, the lag in the development of bond market results in a single means of financing of listed companies. Those impacts stock market optimizing resources and financing methods. On developed international capital market, the size of bond market is much larger than the size of stock market, which reminds that the bond market should be vigorously developed. To promote healthy development of the bond market that coordinated with stock market, the existing system should be improved as follows:

6.2.1 Market Reform on Issuing System

Bond issuing qualification should be changed from examination and approval system to registration system. The bond market should continue to meet the issuing needs of large high quality enterprise, while the market should allow eligible private enterprises issuing bonds, and eliminate the discrimination against non-state owned enterprises bonds.

6.2.2 Reducing Administrative Interference

Board of supervisors main task is to monitor insiders and management. However, most Chinese companies have a strong management but weak and non-

independent supervisory boards. It should be clearly defined the functions of supervisory board. There is a CSRC rule starting in June 2003, it requires all listed companies have at least one-third of board of directors are independent directors.

On the other hand, government should reduce its administrative interference on bond market, and let market condition determine the bond interest rate. Interest rates are the prices of capital, and it reflects the degree of scarce funds. Also, it represents the benefits and risks of investors on bond market. Only after interest rate liberalization, the different credit rating and liquidity on bonds market could form different interest rates, which reflect its intrinsic value, and “high risk with high return, low risk with low income”. In this way, there are different interest rate bond to meet varieties investors on market, and thus attract more funds into market.

6.2.3 Increasing Bond Products

Due to the differences of company interests, assets, financing, investments and other purposes, bonds have different requirements on issuing. Chinas bond products are limited, and investors do not have so many choices, which is difficult to evade risks. Therefore, bond products innovation can provide both issuers and investors with a wide choice of products.

6.2.4 Establishing Credit Rating System

Credit Rating System is the assessment to investment value, solvency and risk rates on bond market. Company credit is the vital factor for one company issued its bonds. If credit rating and evaluation system is not health, it would seriously hinders the healthy development of the bond market. Therefore, it is important to cultivate credit rating agencies, in order to provide objective, fair, scientific assessments to investors who can make investment decisions based on the companys credit rating.

6.3 Monitoring Mechanism and Incentive Managers

Currently, there are more than 80% state-owned stocks in China. Government officials represent state-owned capital, but they do not have rights to gain more enterprise asset. They have fixed salary and benefits, which cause less enthusiasm of supervision and motivation. Additionally, the minority shareholder have limited supervisory role to managers. So, company managers are lack of supervision and control.

Therefore, listed companies should develop manager market on the external environment, so that make listed-companys managers have potential competitors. If listed companies lost their interests due to managers inefficient operations, which managers would keep their reputation declined and their own human capital would get reduction. That is not conducive to their future career development. On the other hand, listed companies should design optimal selection, encouragement and supervision mechanism on the internal governance structure.

The listed company also should strengthen the mechanism for shareholders to enforce their rights, such as enhancing shareholders voting mechanism, entitling shareholders to seek answers from the board of directors, and increasing legal obligation of controlling shareholders.

6.3.1 Establishment of Effective Selection System

Listed-company should introduce a competition mechanism, job and payments incentive for managers. For example, shareholders and managers can arrange a previous payment system of reward performance. In this way, it not only can determine managers income according their performances, but also reduce the moral hazard of managers.

6.3.2 Equity for Managers

Listed companies should give equity to managers, and linked their own interests with shareholders interests. If managers can make more benefits to companies

as well themselves, they would make best efforts on investment selections and carefully carrying large project.

6.3.3 Strengthen Board of Supervisory Functions

Listed companies should give substantial powers to board of supervisors, such as the major resolutions should passed by board of supervisors. Board of supervisors should participate in recruitment, assessment of managers. Therefore, the personnel of board should understand business growth, with professional skills and well checking abilities.

6.4 Audit Financing Standard

Government should strictly examine the qualifications of listed companies and select really qualified companies to stock market. Stock issuing should implement real approval system so that companies can determine if they offer shares or issue rights according to their actual operating conditions and capital market conditions. Then, enterprises take all risks of stock market. Board of supervisors also should strictly audit dividends and dividend in proportion to listed companies.

Government should track the whole process supervision of listed companies, and investigate if its rights of issue funding is consistent with the originally plan. Board of supervisors all should investigate if the project earnings is as expected. If they do not in accordance with the provisions, board of directors should set more restrictions in terms of rights issue, or issue new shares, and punish listed companies. Therefore, companies strengthen the using rights of issue funding constraints, which can limit the listed companies to some extent.

7

Conclusions and Future Work

The economic reform in China started in 1978. Now, China has become the second largest economic entity in the world, ranked after the United States. The securities market, the corporate governance structure and company law have played an important role in the economic reforms, and will continue to do so. Since 1992, China has been making substantial progress in (1) specifying the rights of shareholders, (2) clarifying the duties and responsibilities of directors, (3) increasing independence of board of directors, (4) emphasizing the importance of information disclosure and transparency (5) specializing the auditor process, and (6) providing guidelines guarding against misuse of insider information and related party transactions.

This thesis has investigated the challenges and problems of corporate governance in China, and has proposed the solutions for these problems. This thesis also discussed China's economic reform and subsequent economic growth, as these are highly relevant to the subject of corporate governance. The interaction between the system of corporate governance and economic performance is complex and drives the pressure for further changes in governance laws and practices.

Since 2008, the world's economic has been in rescission. Though it brought significant impact to China, it was not enough to divert China's economy from the path of sustained growth. It would be interesting to investigate the reasons behind China's economic success during this recent period, and more specifically the role that its corporate governance arrangements played in sustaining economic growth during the financial crisis of 2008 onwards.

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