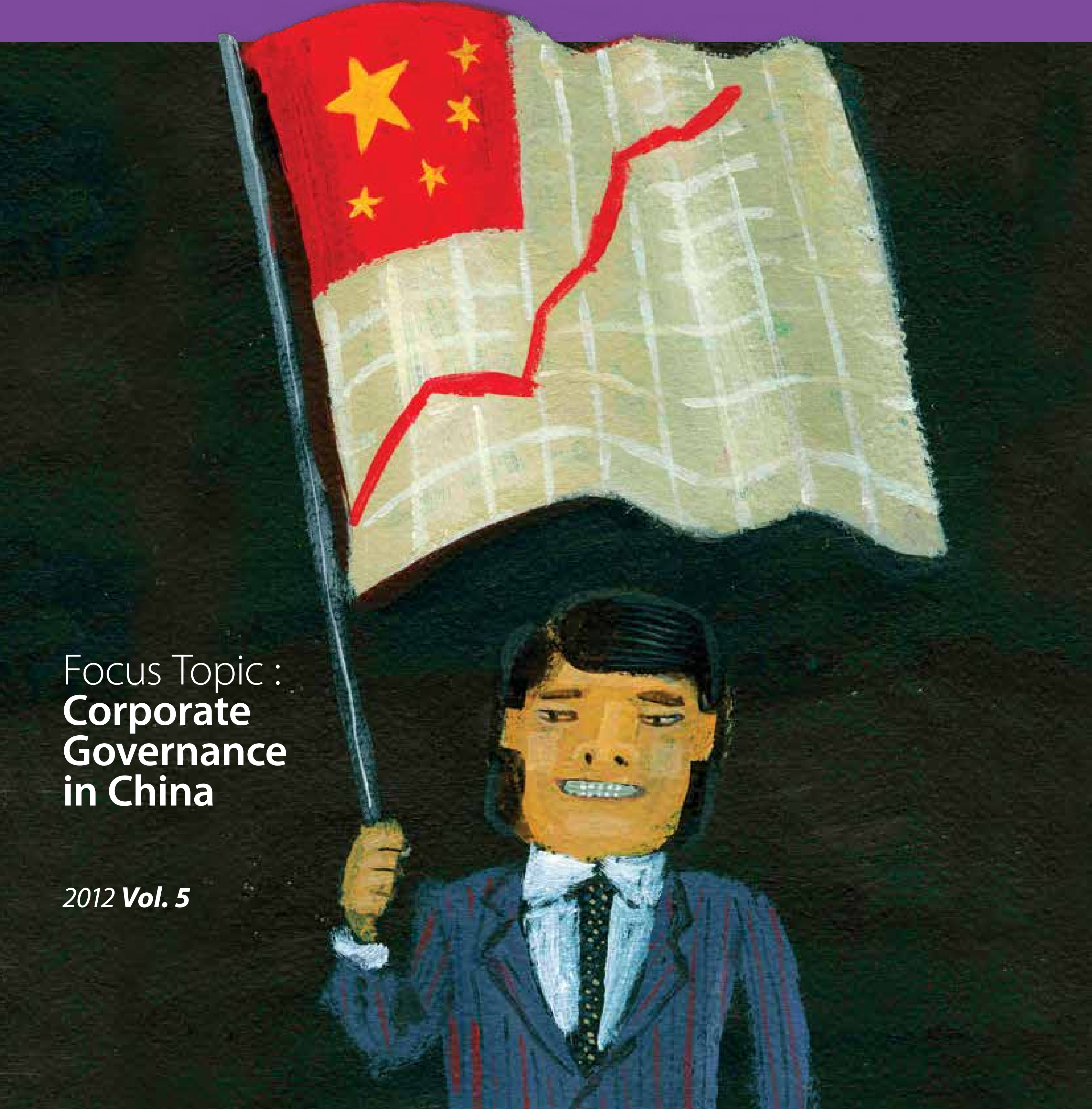
CONNECT



Focus Topic :
Corporate Governance in China

2012 ***Vol. 5***

CUHK BUSINESS SCHOOL

CUHK Business School
The Chinese University of Hong Kong

Dean's Message

I would like to welcome our readers to this edition of the CUHK Business School's magazine CONNECT. Situated at the world's doorway to China, with a well-developed foundation in business education and research, CUHK Business School at The Chinese University of Hong Kong has a unique role in nurturing business leaders for tomorrow. CONNECT magazine provides a platform through short articles in which to educate and inform on selected business topics by staff at CUHK Business School and guest writers. This edition of CONNECT magazine focuses on Corporate Governance in China and we hope that you will find the articles both interesting and stimulating.

Prof. T.J. Wong

Profile: The Chinese University of Hong Kong

- The Chinese University of Hong Kong (CUHK) was established in 1963 after the amalgamation of existing colleges which date back to 1949
- The Vice Chancellor & President is Prof. Joseph J.Y. Sung
- CUHK has eight faculties (Arts, Business Administration, Education, Engineering, Law, Medicine, Science, Social Science) and 62 academic departments
- CUHK is ranked #37 in the QS World University Rankings 2011 and four of its academic staff have been awarded Nobel Laureates
- CUHK is based on a collegiate system of nine colleges
- CUHK has 23,000 students; 3,000 of whom are from outside Hong Kong

Profile: CUHK Business School (The Faculty of Business Administration)

- The Dean is Prof. T.J. Wong
- The Business School is comprised of two schools (Accountancy, Hotel & Tourism Management) and four departments (Finance, Decision Sciences & Managerial Economics, Management, Marketing)
- It has over 3,800 students (full-time/part-time)
- The School offers the most prestigious business undergraduate programs in Hong Kong and each year, it receives the largest proportion of top-ranking high school students in Hong Kong (based on public examination results)
- Over 400 undergraduate and postgraduate business students embark on an international exchange during regular term time annually
- CUHK Business School is the first business school in Hong Kong to offer MBA and Executive MBA programs
- The MBA programs was ranked 28th in the world in 2012, and the EMBA programs was ranked 14th in the world in 2011, by the Financial Times
- The OneMBA program partners with four top business schools from Asia, Europe and North and South America and was ranked 26th in the world by Financial Times in 2011
- The School runs dual MBA degree programs with HEC in France, Rotterdam School of Management in the Netherlands, University of Texas at Austin, a joint program with MIT Sloan School of Management in the U.S. and masters teaching partnerships with Tsinghua University and Shanghai National Accounting Institute in China

Good relations with the state a double-edged sword, research shows

Prof. T. J. Wong
Dean

Why are some Chinese firms nearly crippled by scandals, while others seem to shrug them off? Are business and government links beneficial – or a poisoned chalice? Pioneering research by leading academics in Hong Kong reveals that an understanding of how the fortunes of Chinese companies are entwined with the state will be critical for the flow of future investment. With three decades of unprecedented economic growth, China exerts a powerful appeal to foreign investors. But as the economy makes its transition from a purely state-administered system to one which admits foreign capital and responds to market forces, appreciating how Chinese business operates becomes crucial.

Research undertaken by Prof. T. J. Wong of CUHK Business School and fellow academics[1] aims to investigate and explain the sometimes unpredictable results of corporate misconduct – including bribery, financial misappropriation, manipulation of accounts and patronage – for the benefits of the outside world. The researchers examined the far-reaching effects of some 212 Chinese corporate scandals dating from 1997 to 2005, shedding light on the arcane links between business and government. "This type of work is a way of opening up the black box that is China for the rest of the world to see," says Prof. T. J. Wong.

To date, research on corporate corruption has largely focused on the United States. But prior to this investigation, the longer term effects of business scandals in an emerging economy such as China's have not been examined in depth. When US firms are hit by scandal, notably manipulating financial information, their share price drops by 38 percent, reflecting the subsequent loss in opportunities for business and growth. US markets rely on laws, regulation and open competition to keep businesses in check. Not so in China, where business operates within a government-led structure and commerce depends upon relationships. When Chinese companies are found guilty of false accounting and manipulating the books – something researchers call a "market-based" scandal - their stock return drops an average of just 8.8 percent six months later. In China, it appears, professional reputation is simply less important than in the United States.

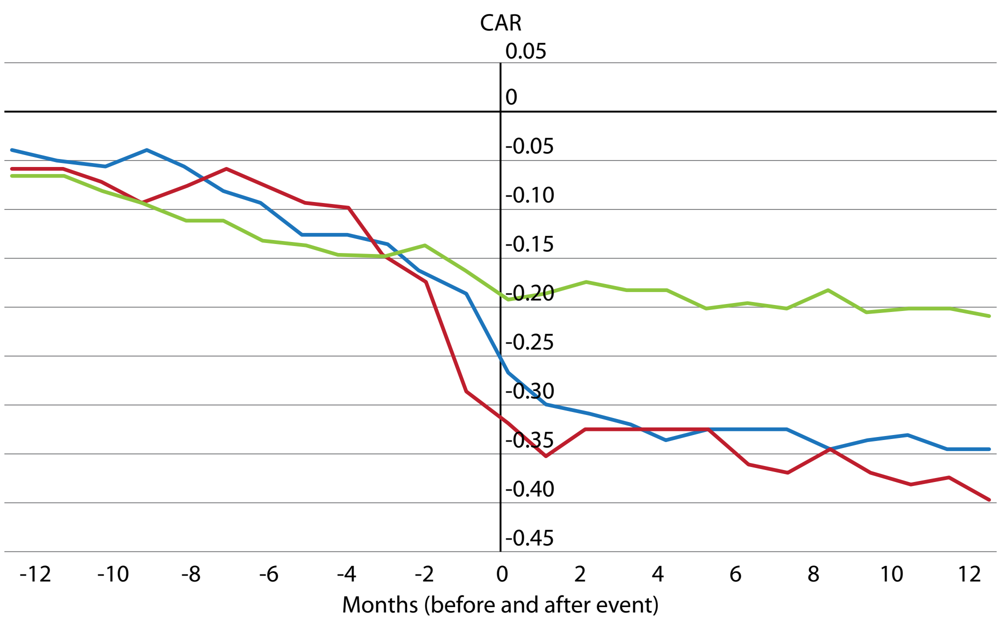
But this masks a more important story. Only when a scandal damages, or even severs relations between the company and government – which researchers refer to as a "relationship-based" scandal – then stock returns tend to plummet some 30.8 percent. Researchers examined scandals within various time frames – these figures refer to performance six months either side of the scandal. Even though suppliers, customers and shareholders may be initially unaffected by news of corruption, the company suffers.

In their research, academics have unearthed some 26 relationship scandals – including the case of the Little Swan Co, once the third largest washing machine manufacturer in the world, whose CEO was jailed for 11 years for bribing a provincial government official. "Such scandals may not hurt a firm's ability to conduct market-based contracting, but they damage the firm's political networks because the state will lose trust in the firm's board and may even arrest the government official who previously granted favours," says Prof. T. J. Wong. "Loss of political networks is more damaging than loss of market credibility."

"Mixed scandals", which involve both accounting and relationship scandals – say bribing and manipulating earnings, for example, or embezzlement within state-owned companies - prompt stock returns to drop 24.5 percent - again worse than accounting scandals. "If you take money from minority shareholders, you upset the market, and if you take money from the government you upset the state too," researchers explain.

The graph below illustrates that the change in Cumulative Abnormal Returns (CAR - share price worth based) for mixed, relationship and market based scandals from one year before the event date to one year after. The drop of CAR for mixed and relationship scandals is much greater than that of market scandals. Researchers took care to examine share price reactions over periods as long as two or three years to allow for the fact that markets might have already discounted bad news, and to allow for political fallout after cases had come to court.

Cumulative Abnormal Returns by Different Types of Scandals



Corporate Culture in China

To understand why the markets in China care more about how well a company gets on with the state than how open and honest it is in its accounting requires a fundamental change in mindset from a Western business model. Many of China's listed firms are state-owned enterprises – and to these, the government can appoint key executives to control loans and subsidies. Even private companies need to nurture their contacts within the state to win favors. It is estimated that China loses as much as 10 percent of government spending in bribes and corruption. Firms "…just don't do business based on building a reputation of transparency in China. Corruption is common and ethical standards are very different," say researchers.

Political ties for Chinese firms are therefore very much a double-edged sword. A relationship-based system can encourage stability and longer term vision and strategies. However, companies which fall out with the state in the wake of a scandal, either locally or on a national level, not only see their stocks plummet; they still tend to bear the brunt of excessive government control and intervention but without the benefits of government favours. Overheads remain high as companies are still expected to provide jobs, roads, schools and hospitals, but they may no longer enjoy favorable taxes, contracts or trading environments.

What Does This Mean For Investors?

Investors should examine a company beyond its accounting performance, which may not reveal the full picture – often legislation around company accounts isn't followed to the letter. Potential shareholders should assess ownership, corporate structure, and crucially the political environment in which the company operates. Knowing how the company is controlled, and by whom, is a crucial indicator of how it might perform in a more market-led environment. Conflicts of interest can arise between shareholders and management when a company is part-owned or controlled by the state and holds responsibilities beyond making profit.

Foreign investors currently hold interests in just a tiny fraction of Chinese businesses, although the government is gradually increasing quotas that foreign institutions can hold in Chinese shares.

Can China Change?

In order to appeal to international markets, Chinese businesses must "clean up" their accounting and adapt to fit international mechanisms. "Modernizing is not just a question of importing different accounting standards or hiring a few accountants," say researchers, who point out that China already has a respectable regulatory framework. Instead business must confront a substantial problem – how to remove the distorted incentives behind state interests.

Traditionally change in China is gradual. Some 60 percent of companies remain under state ownership, and while a watchdog exists, enforcement has still been rather weak. Minority shareholders, many of them day traders, aren't motivated to be sufficiently vigilant and mechanisms for market monitoring are weak.

Some observers believe market pressures will ultimately bring about change, which will first become evident in China's coastal regions, specifically within faster-moving and market-oriented sectors. "I hope outside pressure will push Chinese firms to reform a bit faster, but I don't think they're ready yet," says Prof. T. J. Wong. "It will take a couple of generations. When you compare China to the United Kingdom or the United States, the stock market is messy – the transparency and professionalism is not there. But when you compare it to China 30 years before, it has changed significantly."

Hong Kong's Place in China's Future

And while Chinese markets crawl towards modernization, Hong Kong, which straddles both domestic and international markets, has a role to play as a financial centre more aligned with abroad. While outsiders are barred from investing directly in Shanghai and Shenzhens' stock markets, they can already invest in companies – largely major state enterprises - listed on Hong Kong's exchange, which will remain a vital means of raising capital within mainland China.

Helena Pozniak

1 Prof. Mingyi Hung (University of Southern California) and Prof. Fang Zhang (Hong Kong Baptist University)

For more information on Prof. T.J. Wong's work, visit: http://www.cuhk.edu.hk/acy2/Staff/tjwong/main.html

How China's companies use international regulation

Only in 1992 did China begin to have stock exchanges, marking the birth of the first public companies. Shares were offered to the public through a balloting process, which was often marred by accusations of favoritism and in some cases naked corruption. But public owners were at least able to trade shares freely on stock exchanges with transparent pricing.

By the time China's first company law came into the effect in July 1993, both the Shanghai and Shenzhen exchanges had been trading for over a year and the stock market was the hottest game in town.

Chinese public companies also offered their shares to the public outside the Mainland before the advent of Chinese company law. In June 1993, shares of Tsingdao Beer Company Limited were listed on the Hong Kong Stock Exchange. These shares became known as H shares, and now account for more than half of the Hong Kong's stock market capitalization and daily turnover. This practice spread to other shores; first to the United States, and then to Toronto, Singapore, Australia and London. Listing such shares was a way for state-owned companies to raise capital outside China.

China's entrepreneurs had also found another way of raising capital overseas before the advent of PRC's (the People's Republic of China) company law – by the public offering of the shares of an overseas holding company created to hold assets and business operations based exclusively within the PRC. These are in effect Chinese companies in the skins of special overseas holding vehicles. Shares in these companies became known as Red Chips, presumably "red" referring to China's national flag.

The first Red Chip company to be incorporated in Bermuda was China Brilliance, which owned one of the largest motor vehicle manufacturers in Northeast China at that time. It was listed on the NASDAQ after a full registration with the US SEC (Securities and Exchange Commission) in 1992. Following quickly on the heels of China Brilliance came Denway Motors. In this case, majority shareholders of a Guangzhou joint venture to manufacture Honda motor cars injected the assets into a Hong Kong-listed shell, renaming it Denway Motors.

After the public offering and listing by Brilliance China, the Red Chip phenomenon soon exploded, not only in Hong Kong but in the United States and beyond. Of the 200 companies now listed on London's AIM and the 60 plus companies listed in the Toronto Stock Exchange which hold exclusively Chinese assets and businesses, nearly all are Red Chip companies - namely companies incorporated outside China.

Anthony Neoh

The Chinese phenomenon of raising corporate capital from the public both domestically and overseas before the advent of any company law in China would have been unthinkable if it had happened in the West. By 1993, Western company law in its modern form had already been in place for 150 years, and securities law for over 60 years. These laws have become so vast and complex that they tend to be the exclusive domain of specialist lawyers, accountants and regulators. Where there is no law, the Western assumption is that there can be no markets. But markets in Chinese shares grew wings at home and abroad before there was law. How and why did this happen?

There was clearly a demand for investible assets in the last decade of the 20th Century. Savings rates in Asia have historically been very high. Equally, the 1990s saw the beginnings of investment into the emerging markets and China seemed like a good bet. But the spread of Chinese stocks could not have happened without the ability of Chinese companies to leverage the laws and regulations in the developed world.

China's stock market managed with a combination of the 1993 company law and ad hoc regulation borrowed liberally from international securities laws, until early 1999, when a new securities law came into effect.
China's stock market enjoyed state-of-the-art information technology, but was weak on information both in terms of the quality of information disclosure and misuse of information by insiders. A market must cultivate a culture of fair information disclosure and use, but this takes time.

The growth of overseas public shares offering by Chinese companies took place because Chinese companies were able to leverage regulation abroad. In Hong Kong, Chinese firms listing H shares and Red Chips were able to rely upon local regulatory and legal structures to reassure investors. The same goes for Red Chip companies listed elsewhere such as Singapore, Australia, London, the United States and Toronto. This at least gave these markets some confidence that Chinese companies listed there would comply with certain minimum standards of disclosure and corporate governance.

But over the years many problems have emerged with Chinese companies, in both H shares and Red Chips listed abroad, precisely because no listing jurisdiction has complete power over any Chinese company or its directors.

> *"....no listing jurisdiction has complete power over any Chinese company or its directors."*

Listing jurisdictions can only regulate the market activities of such companies. This means that directors and management are regulated only by the securities laws but not the corporation law of the place of incorporation of these companies.

Securities laws generally regulate disclosure of information, and they could place requirements on corporate governance practices as a condition for trading of shares. But they can't regulate rights between minority and majority shareholders, nor the duties of directors towards their companies. More importantly, securities laws are enforceable only within the borders of each jurisdiction. But international authorities can't investigate suspected breaches of law within China itself – so directors and officials can't be effectively investigated.

When problems do occur, such as incomplete, inaccurate or even fraudulent disclosures, there is little that authorities can do but halt trading in shares of the offending company - but this could penalize innocent investors.

Although China has agreements in place with international regulators to investigate malpractice, this has so far proven ineffective. Initial confidence created by the imposition of overseas regulation upon Chinese companies has waned after poor quality disclosures and the corporate governance of Chinese companies.

Accusations of fraudulent disclosures and accounting for example by Sino Forest, listed in the Toronto Stock Exchange, have not been satisfactorily dealt with, and uncertainty prevails. Many Red Chip companies in the United States have met with SEC queries over their disclosures and the quality of their audits. Despite bilateral agreements to investigate, these problems continue to plague Red Chips in the United States.

And further uncertainty lingers because many of these companies are incorporated in Caribbean tax havens with scant shareholder protection and where courts are ill-equipped to deal with disputes, so protection of shareholders' rights is flimsy.

Although Chinese companies have been initially successful in raising capital overseas and are subject to regulation by the securities laws of much of the developed world, serious questions remain over the quality of their disclosure and corporate governance. That is why international markets have long placed a risk premium on Chinese companies listed overseas, as can be seen from a divergence between the pricing of H shares and A shares (those traded in mainland China, of the same company).

In recent years the difference in pricing of H and A shares of better companies has narrowed, showing that international markets are rewarding these firms for their observation of international standards by lowering the risk premium. In time, more companies will learn that it pays to be seen to be observing international standards.

Anthony Neoh

QC, SC, Former Chairman of Hong Kong Securities and Futures Commission and Former Adviser of China Securities Regulatory Commission

CUHK Business School- Inaugural conference on ***China Institutions, Governance and Accounting***

On July 13-14, 2012, the inaugural conference on "China Institutions, Governance and Accounting" was held at the CUHK Shenzhen Research Institute in Nanshan, Shenzhen. The conference was organized by CUHK Business School's Center for Institutions and Governance (CiG) and supported by the School of Accountancy. There were over 70 academics in attendance, flying in from all over world and many of the world's leading experts had the opportunity to present their research under a variety of formats including lectures, interactive workshops and panel discussions.

The two-day conference started with an inspirational keynote speech – "IFRS: Where Are We Headed?" delivered by Prof. Ray Ball from the University of Chicago, kicking off academic discussions throughout the rest of the conference. The second keynote speech, "Overview of Corporate Governance Research: Implications for China" was delivered by Jerold Zimmerman from University of Rochester.

The conference featured a number of research papers under three themes: 1) Accounting Information and Financial Intermediaries; 2) Corporate Governance and Corporate Finance; 3) Accounting Information and Standards. Discussion during each presentation was lively and passionate with a good deal of thoughtful debate – it's what one would expect from leading authorities all gathered in one seminar room!

The two-day conference ended with a panel discussion session on the topic of "Regulations and Corporate Governance of Chinese Listed Firms". The panel included Mr. Anthony Neoh, QC, SC, Former Chairman of Hong Kong Securities and Futures Commission and Former Adviser of China Securities Regulatory Commission, Mr. Zhonghui Zhou, Member of International Advisory Council of China Securities Regulatory Commission, Former Chief Accountant of China Securities Regulatory Commission and Former Senior Partner of PricewaterhouseCoopers, Mr. Rui Yang, Deputy CEO of Bosera Asset Management Co. Ltd. The discussion was facilitated by Prof. T.J. Wong, Dean of CUHK Business School.

Feedback from participants on the conference has been very positive. The conference has provided a tremendous platform for international scholars to come together to exchange ideas on ways to improve the governance and accounting environment in China. The conference is expected to be held every two years.

Lydia Huang

For more information on CiG and the conference:
Email: cucig@cuhk.edu.hk
Website: www.baf.cuhk.edu.hk/research/cig

Close political bonds won't guarantee a healthy share price

Investors beware – contrary to expectations, a close relationship between business and government won't guarantee good returns for investors, say researchers at Hong-Kong-based universities. While good links with government seemingly offer a host of benefits for businesses, such as favorable taxes, monopoly rights and even subsidies, the cost of such a relationship can be high, especially as firms embark upon privatization.

How well a company's stock performs during the first period of privatization depends on who sits at the helm – and directly beneath. Businesses led by managers with close political ties actually perform 18 percent worse than their professionally-led counterparts during the three years after initial privatization on China's exchanges, research published by the China University of Hong Kong (CUHK) and City University of Hong Kong shows.

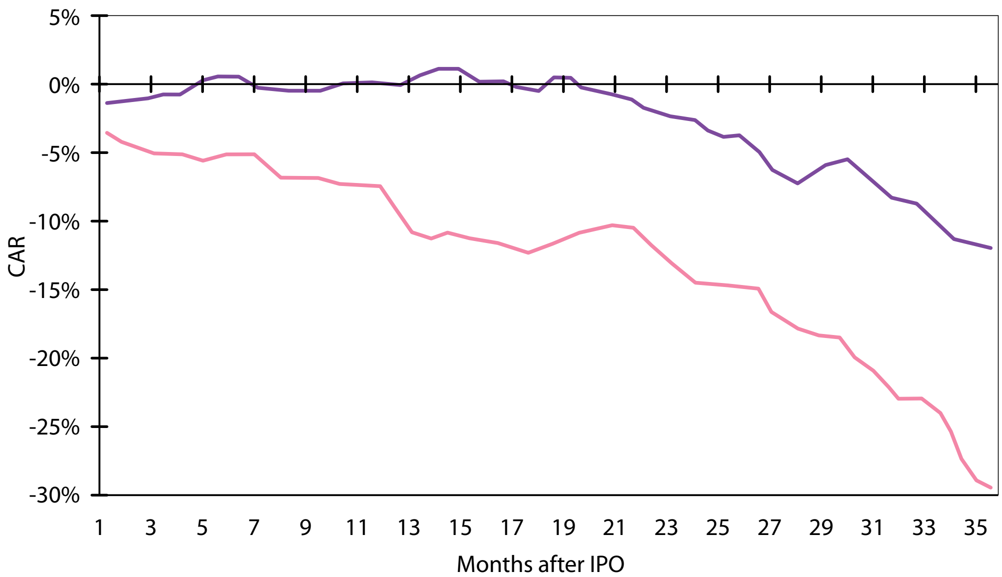
Nowhere is this clearer than among China's largest four banks (Bank of China, China Construction Bank, Industrial and Commercial Bank of China, Agricultural Bank of China) which have all made an IPO within the last few years. Yet, despite healthy fiscal performance - each institution has only seen a return on equity of around 14 percent - shares have stagnated since their initial offering.

"In every case, the (share) price does not go up," says Anthony Neoh, formerly chief adviser to the China Securities Regulatory Commission (CSRC) and board member since 2006 on one of the institutions, Bank of China. "These banks are owned 60 to 70 percent by the Chinese government," he says. "So the lingering question in the market is this: to what extent are these banks carrying out a government function?" Would these institutions bend to government pressure to improve credit in a particular sector, for instance?

"Our main message is that partially-privatized state enterprises do not run professionally if they have ex-government officials as CEOs and on the boards – they still have political obligations," says Prof. T. J. Wong of CUHK, who collaborated with professors Joseph P. H. Fan and Tianyu Zhang to complete the research. China's former central control still extends a strong legacy – the government retains the power to appoint CEOs to listed companies and large state-owned enterprises (SOEs) are prominent, especially in vital infrastructure industries. "In the past we've believed in countries such as China, political connections are a good thing because they provide support and favors," says Prof. T.J. Wong.

Data from the research below based upon 790 partially privatized firms in China shows the difference in CAR (Cumulative Abnormal Returns) over a three year period. The pink line represents the firms which have a CEO who is a current or former government official – after 35 months an 18 percent gap in CAR is evidenced.

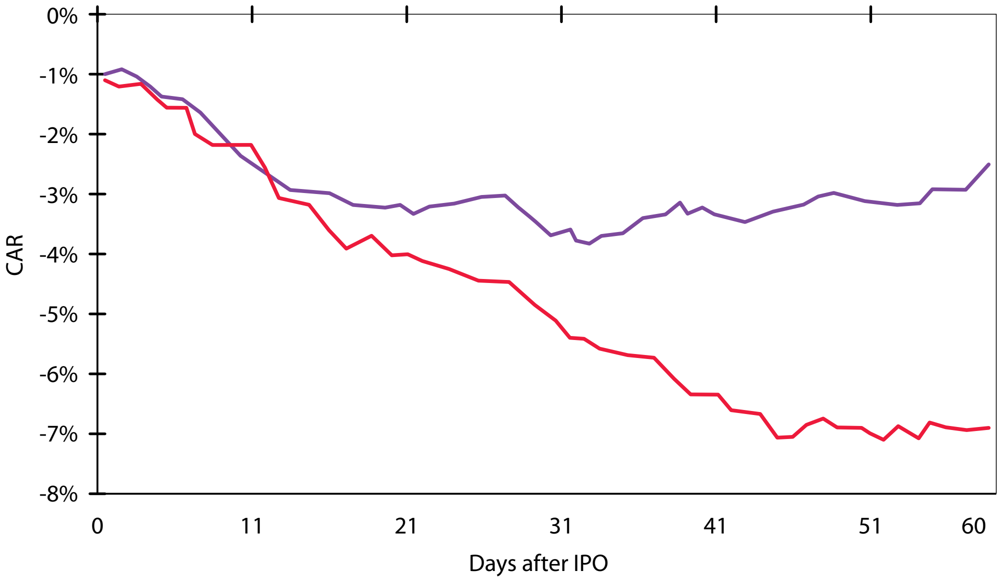
Post IPO cumulative abnormal returns after 35 months



Over the last three decades, China has moved away from a centrally-controlled economy to allow private enterprise and some foreign investment. Some 790 companies that have been partially privatized on China's stock exchanges between 1993 and 2001 were examined during the three years after their initial public offering (IPO). Of those companies, almost 27 percent of CEOs were former or current government officials – perpetuating state control on a significant slice of Chinese commerce – with greatest hold in strategic sectors such as natural resources and utilities, while finance and real-estate retain the lowest state presence. Companies with a politically-connected CEO also tend to have more bureaucrats and fewer professionals on the board, with older directors who are more likely to be men, researchers found.

Investors immediately anticipated effects of political connections, research shows. This was reflected in initial low returns on stocks after two months, which remained lower in the longer term. This graph below shows a 4.4 percent difference in CAR after 60 days, with the red line representing the firms which have a CEO who is a current or former government official.

Post IPO cumulative abnormal returns after 60 days



These findings might have implications for potential investors. Knowing how the company is controlled, and by whom, is a crucial indicator of how it might perform after an IPO, both in the short term and longer term. Additionally, the pricing of IPO shares varies according to the level of state control: companies with no political ties tended to under-price IPO shares more so than politically connected firms - a signal of their greater freedom from state intervention, research suggests.

A lack of separation between state and business creates a conflict of interest. "The overall evidence is consistent with the 'grabbing hand' argument that bureaucrats and politicians extract resources from listed SOEs under their control to fulfil objectives...not consistent with firm value maximisation," researchers said in the report. Company owners and managers also have social objectives that don't sit well with their commercial responsibilities. "In China, social stability is very important," says Prof. T.J. Wong. "And the government needs to retain tight control despite pursuing economic reform – and these (state-controlled) firms do provide stability. In some cases, they own the entire city. They provide schools, hospitals, day care, and infrastructure. These responsibilities remain after privatization, and conflicts are even greater if CEOs are ex-government."

However critical this social role, this is likely to be challenged by ensuing generations. Competition for China's vast domestic market will inevitably grow more intense – and if national firms are to compete, they will need to modernize, says Prof. T.J. Wong. Sectors such as retail and technology might move faster than typically strategic industries, and eventually become completely privatized. "If China wants to promote domestic consumption these sectors need to be more competitive – but I hope it will open up the car industry and manufacturing eventually. China needs to be careful otherwise its domestic market will be taken over by competitors."

Helena Pozniak

For more information on Prof. T.J. Wong's work, visit:
http://www.cuhk.edu.hk/acy2/Staff/tjwong/main.html

CUHK BUSINESS SCHOOL

Cheng Yu Tung Building
No.12, Chak Cheung Street
Shatin, N.T., Hong Kong

www.baf.cuhk.edu.hk

香港中文大學
The Chinese University of Hong Kong