China's Financial Reporting Standards: Will Corporate Governance Induce Compliance in Listed Companies?

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I. INTRODUCTION

As of January 1, 2007, the Chinese government requires listed companies to abide by new accounting standards.[1] These new accounting standards will bring China closer in line with International Financial Reporting Standards (IFRS)[2] and will give investors the capability to more easily compare Chinese listed companies with companies listed on other international stock exchanges if the reports are of comparable completeness and accuracy.

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1. ERNST & YOUNG, CHINA BOARDROOM BRIEFING: NEW STANDARDS, NEW ERA—SPECIAL EDITION ON THE CHINESE ACCOUNTING STANDARDS, NO. 1, at 1 (2006).

2. *Id.*

The wild Chinese stock markets are often called *dubo ji* (the slot machine) by the Chinese.[3] This is partially due to the lack of reliable information about the listed companies, which is necessary for investors to make well-informed decisions.[4] Although the market is volatile, many Chinese citizens are placing much of their savings in the Chinese stock markets.[5] Thus, investors participating in the Chinese stock market are in essence just gambling, and therefore, when rumors emerge, the fragile Chinese stock markets are at risk of collapse.[6] This is evident as recently as February 2007, when frantic sell-offs on the Shanghai market dropped shares almost 9%, and simultaneously caused shares on the Shenzhen market to fall 9.3%.[7] These sell-offs were supposedly sparked by a rumor of looming government investigations on illegal bank loans.[8]

This Comment examines the relationship between the new financial reporting standards and the Chinese corporate governance system. More specifically, it considers whether the corporate governance system provides adequate enforcement mechanisms to induce companies to follow these new financial reporting standards, and in so doing, provides investors with an accurate assessment of listed companies' financial situations. Part II explains the history of the Chinese capital markets as well as current developments. Part III considers the evolution of China's accounting standards, while Part IV looks at financial reporting practices. Part V examines China's corporate governance development and enforcement problems. Finally, Part VI speculates that current corporate governance mechanisms will not induce accurate financial reporting.

II. OVERVIEW OF CHINESE CAPITAL MARKETS

A. *Development of Chinese Capital Markets*

1. Privatization of State-Owned Enterprises

The shape of the Chinese business structure has changed significantly in the last thirty years. Beginning with its rise to power in

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3. David Barboza, *From Shanghai's Stock Market, a Shock Heard Around the World*, N.Y. TIMES NEWS SERV., Mar. 02, 2007, at 9, *available at* http://www.taipeitimes.com/News/editorials/archives/2007/03/02/2003350670.

4. *Id.*

5. Wieland Wagner, *Chinese Investors Fear Burst of Stock Bubble*, SPIEGEL ONLINE INT'L, June 14, 2007, http://www.spiegel.de/international/world/0,1518,druck-488609,00.html.

6. *Id.*

7. Barboza, *supra* note 3.

8. *Id.*; Chinadaily.com, CBRC Bans Loans for Stock Investment, http://www.chinadaily.com.cn/bizchina/2007-01/30/content_796538.htm (last visited July 9, 2007).

1949, the Chinese Communist Party developed an economic system controlled centrally by the government.[9] The Communist Party nationalized almost all private companies into State-Owned Enterprises (SOEs), eliminating the free market.[10] This system of nationalized companies produced economic hardship in China. The economic hardship resulted partially from companies' lack of incentives to perform efficiently and partially from the lack of accountability because there were no decisive owners to monitor the firms' performance.[11]

In 1978, China began a path of economic reform by implementing an "open door" policy.[12] The government tried different systems throughout the 1980s to improve the performance of the SOEs; each system progressed temporarily but ultimately had drawbacks that outweighed the benefits.[13] In 1993, the National People's Congress (NPC) endorsed the corporatization of SOEs.[14] In a short time frame, the government turned many of the small- and medium-sized SOEs into independent legal entities, keeping the State as the controlling shareholder.[15] The State also listed these entities on the Shanghai and Shenzhen stock markets.[16] Changing the SOEs to corporations gave the government access to a whole new financial market—the use of private capital in addition to government funds.[17] The addition of private capital forced the Chinese government to address the issue of corporate governance in this new system of shared ownership.[18]

2. China's Stock Markets

On December 19, 1990, the Shanghai Stock Exchange (SHSE) was created with five listed companies.[19] Only seven months later, the Shenzhen Stock Exchange (SZSE) was formed with two listed companies.[20] When they were created, the SHSE and the SZSE belonged

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9. K. Matthew Wong, *Securities Regulations in China and Their Corporate Finance Implications on State Enterprise Reform*, 65 FORDHAM L. REV. 1221, 1221 (1996).

10. *Id.*

11. JIAN CHEN, CORPORATE GOVERNANCE IN CHINA 38 (2005); William I. Friedman, *One Country, Two Systems: The Inherent Conflict Between China's Communist Politics and Capitalist Securities Market*, 27 BROOK. J. INT'L L. 477, 477 (2002).

12. Friedman, *supra* note 11, at 478.

13. CHEN, *supra* note 11, at 38-39.

14. *Id.* at 39.

15. *Id.*

16. *Id.* at 40.

17. Friedman, *supra* note 11, at 478-79.

18. CHEN, *supra* note 11, at 40.

19. *Id.* at 35.

20. *Id.*

to their own municipalities (Shanghai and Shenzhen respectively); they were not nationally controlled stock exchanges.[21] However, in 1997, the State Council brought both of the exchanges under direct control of the China Securities Regulatory Commission (CSRC).[22] Over the last seventeen years, these stock exchanges have had a huge impact on the number of Chinese public companies; by 2000, the total number of listed companies on both exchanges had grown to 1121 from only 10 in 1990.[23] In that same ten-year period, the amount of capital raised went from .43 (RMB bn) to 207.10 (RMB bn).[24] Today, most companies listed on the Chinese stock exchanges are privatized SOEs, though recently a number of new private enterprises have gone public.[25] The former SOEs still tend to be controlled by the State through state-owned holding companies.[26] Statistics show that 987 of the 1377 listed companies were controlled by such holding companies, equaling 71.7%, in 2004.[27]

Even with this great increase in capitalization, the Chinese stock exchanges have not received a large amount of foreign investment.[28] Generally, this is due to the structure of the types of stock that Chinese-listed companies can issue.[29] There are four core types of shares that a Chinese-listed company can issue: state shares, legal person shares, A-shares, and B-shares.[30] A-Shares can only be owned by Chinese citizens and can only be traded on the Chinese national stock markets.[31] B-Shares were initially created for foreign investors (including residents of Hong Kong, Macau, and Taiwan) and are denominated in foreign currency.[32] In 2001, the CSRC allowed Chinese individuals to begin trading in B-

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21. *Id.*
22. *Id.*
23. *Id.* at 35-36 tbl. 3.2.
24. *Id.* at 36 tbl. 3.2.
25. P.R.C. SEC. REGULATORY COMM'N, INFORMATION DISCLOSURE AND CORPORATE GOVERNANCE IN CHINA I.2, http://www.oecd.org/dataoecd/6/60/1931117.pdf (last visited Sept. 21, 2007); Erica Fung, *Regulatory Competition in International Capital Markets: Evidence from China in 2004-2005*, 3 N.Y.U. J. L. & BUS. 243, 246 (2007).
26. Org. for Econ. Co-Operation & Dev., *Overview of Governance of State-Owned Listed Companies in China*, *in* 2005 POLICY DIALOGUE ON CORPORATE GOVERNANCE IN CHINA 1 (2005), *available at* http://www.oecd.org/dataoecd/14/6/34974067.pdf [hereinafter OECD].
27. *Id.*
28. CHEN, *supra* note 11, at 36.
29. *Id.* at 36-37; Dan Hu, *The Usefulness of Financial Statements Under Chinese-GAAP vs. IAS: Evidence from the Shanghai Stock Exchange in PRC* 2 (Kobe U, Japan Nonograph Working Paper No. 0215, 2002), *available at* http://ssrn.com/abstract=314001.
30. Sonja Opper, *Enforcement of China's Accounting Standards: Reflections on Systematic Problems*, 5 BUS. & POL. 151, 162 (2003), *available at* http://bepress.com/bap/vol5/iss2/art2.
31. 2 CHINA BUSINESS LAW GUIDE, ASIA BUSINESS LAW SERIES 38,214 (2005).
32. Hu, *supra* note 29, at 2.

Shares as long as they had the ability to trade in foreign currency.[33] However, Chinese entities are still not allowed to enter the B-Share market.[34] A-Shares and B-Shares are equal in terms of voting rights and profit distribution; however, A-Shares tend to be priced four to five times higher than B-shares due to the lack of reliable information about the local Chinese economy and companies available to foreign investors.[35]

A more recent development has allowed for more foreign investment. China announced the Qualified Foreign Institutional Investor (QFII) plan in November 2002.[36] The QFII scheme allows foreign institutional investors to purchase A-shares.[37] However, there are stringent requirements for a foreign institutional investor to qualify as a QFII, including certain asset-management criteria, like holding at least US$10 billion in management assets, setting high levels of minimum capital, and maintaining a strong operating history.[38] The plan also imposes restrictions on the amount of A-shares a QFII can purchase.[39] A QFII cannot purchase more than ten percent of total stock in any one listed company, and combined QFII ownership in a listed company cannot be more than twenty percent.[40]

The Chinese stock markets are also unique from other national stock markets in that they segment stock into tradable shares (TS) and nontradable shares (NTS).[41] Due to this bifurcation, only a small percentage of issued stock is tradable on the market.[42] In 2000, about ninety percent of the issued shares were state shares, legal person shares, and A-Shares.[43] State shares and legal person shares have always been NTS and could only be transferred with state approval.[44] A-Shares and B-Shares were allowed to trade on the market, but a large proportion of A-Shares were also nontradable.[45] As of 2006, only forty-five percent of

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33. CHINA BUSINESS LAW GUIDE, *supra* note 31, at 38,392.
34. *Id.*
35. Hu, *supra* note 29, at 3.
36. Patrick Cichy, *QFII Regulation Opens China's Domestic Markets to Foreign Investment*, GTNEWS, May 4, 2004, http://www.gtnews.com/article/5456.cfm.
37. *Id.*
38. *Id.*; Norwood P. Beveridge, *Investing in China, by Winston Ma, Risk Books, London, 2006*, 6 U.C. DAVIS BUS. L.J. 27 (2006), *available at* http://blj.ucdavis.edu/article/639.
39. Cichy, *supra* note 36.
40. *Id.*
41. Andrea Beltratti & Bernardo Bortolotti, *The Nontradable Share Reform in the Chinese Stock Market* 2 (Fondazione Eni Enrico Mattei, Working Paper No. 131.06, 2006), *available at* http://cei.ier.hit-u.ac.jp/news/paper/Bernard.pdf.
42. Hu, *supra* note 29, at 3.
43. Opper, *supra* note 30, at 162.
44. *Id.*
45. Hu, *supra* note 29, at 3.

all outstanding shares were tradable on the market.[46] Moreover, the State owned almost all of the remaining fifty-five percent of shares which were nontradable.[47]

B. Nontradable Share Reform

The purpose behind the segmentation of shares into TS and NTS was both for the State to keep control over the former SOEs and to increase the capital raised during Initial Public Offerings (IPOs) by creating a fake scarcity of supply.[48] Most of the fifty-five percent of total shares designated NTS were held under state control.[49] The Chinese government soon realized the negative impact that the low availability of TS was having on the market.[50] The government saw that the domestic market was "extremely illiquid, volatile and thus prone to market manipulation and insider trading."[51]

In 2005, the CSRC implemented two trial programs to test how the transformation of NTS to TS would affect the market.[52] The successful completion of the second trial program in August 2005 involved forty-two companies that accounted for ten percent of the total capital of the Chinese stock markets.[53] Following this success, the government extended the reform of NTS to TS to all listed companies with a completion date set for the end of 2006.[54]

To achieve this, the government implemented reform guidelines that gave freedom to the tradable shareholders to bargain with the company for the terms on the transfer of shares.[55] This allowed the tradable shareholders to be compensated for any losses they would incur from the reform.[56] One favored form of compensation was bonus shares, which gave additional TS to the current shareholders.[57] During the second trial program, the companies on average compensated tradable shareholders with 3.49 additional shares for every 10 transferable shares they held.[58]

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46. Beltratti & Bortolotti, *supra* note 41, at 2.
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.* at 3.
53. *Id.*
54. *Id.*
55. *Id.* at 5.
56. *Id.*
57. *Id.* at 7.
58. *Id.*

The reform also laid out guidelines that addressed the potential problem of these new shares flooding the market and driving down share value.[59] It suspended trading by holders of NTS for twelve months from the date of the transfer of shares.[60] The reform also required that at the end of this lock-up period, holders of NTS with more than five percent of total shares issued by a company could not trade more than five percent of those shares for one year and no more than ten percent of those shares for two years.[61] It also went further, restricting nontradable shareholders owning more than five percent of NTS from trading more than five percent of the company's total NTS for one year and up to ten percent for two years.[62] By March 2006, 769 companies, over half of those listed, had attempted the reform, with 585 of them having successful results.[63]

III. CONVERGENCE OF CHINESE ACCOUNTING STANDARDS

As the Chinese capital markets have evolved, the Chinese accounting system has also undergone enormous change. In the early 1950s, China adopted the Uniform Accounting System (UAS), which was the system of the Soviet Union.[64] For the socialist economy, the UAS gave the government the ability to monitor the firms' financial statements and receive "consistent and comparable information" that helped the government in planning and decision-making.[65] With the adoption of the "open-door" policy in 1978 came the beginning of reformation of the Chinese accounting system.[66] China's first step in aligning its standards with international accounting standards (IAS) came in 1985, when the Minister of Finance (MOF) announced the Accounting System for Sino-Foreign Joint Ventures.[67] When the SHSE and SZSE were formed in the early 1990s, the government issued three other sets of accounting standards: the Accounting System for Joint Stock Limited Enterprises (JSLE), the Accounting Regulations for Foreign Investment Enterprises (FIE), and the Accounting Standards for Business Enterprises—Basic Principle (ASBE).[68] The ASBE was considered the

59. *Id.* at 5.
60. *Id.*
61. *Id.*
62. *Id.*
63. *Id.* at 6.
64. Chun Jiang, *"Optimism" vs "Big Bath" Accounting—A Regulatory Dilemma in Chinese Financial Reporting Practices* 4 (July 1, 2006) (New Eng. Bus. Sch., Univ. of New Eng., Working Paper), *available at* http://ssrn.com/abstract=922484.
65. *Id.* at 5.
66. *Id.*
67. *Id.* at 6.
68. *Id.* at 6-7; Opper, *supra* note 30, at 154; Hu, *supra* note 29, at 4.

"conceptual framework of [the] Chinese accounting system."[69] The JSLE was applicable to all corporations and was designed to reduce the differences between the Chinese accounting standards and the IAS, while the FIE was applicable to all enterprises with foreign investment.[70]

In 2001, these accounting systems were replaced by one comprehensive system.[71] The MOF issued the new ASBE, which both joint stock limited enterprises and foreign investment enterprises were to follow.[72] This system brought the Chinese accounting standards closer to the international standards and allowed different types of enterprises to be compared more easily.[73] However, there were still many differences between the IAS and the ASBE.[74] Some of the Chinese system's central accounting principles were substantially different from those of the IAS.[75] For example, under the ASBE, the valuation of revenues was done "according to the amount stipulated in the sales contract," whereas, the IAS requires revenue to be valued "at the fair value of the consideration receivable."[76] Another stark contrast was the Chinese principle of asset valuation based on historical cost, coupled with the nonallowance of reevaluation.[77]

The latest step in bringing Chinese accounting standards toward the IAS occurred on February 15, 2006, when the MOF announced a set of new accounting standards to replace the current ASBE.[78] The new accounting standards include a revised version of the ASBE—Basic Standard, sixteen revised accounting standards, and twenty-two completely new standards.[79] The revised ASBE—Basic Standard and the thirty-eight specific standards went into effect for all listed companies on January 1, 2007.[80] This new system is a convergence of Chinese accounting standards with the IFRS.[81] Some of the new standards are an extreme shift away from the prior Chinese accounting standards; however, some of the new standards still differ from the IAS.[82] One of

69. Jiang, *supra* note 64, at 6-7.
70. Hu, *supra* note 29, at 5-6.
71. *Id.* at 6; Jiang, *supra* note 64, at 8.
72. Jiang, *supra* note 64, at 8.
73. *Id.*; Hu, *supra* note 29, at 6.
74. Opper, *supra* note 30, at 154; Hu, *supra* note 29, at 7.
75. Opper, *supra* note 30, at 154.
76. *Id.*
77. *Id.* at 155.
78. ERNST & YOUNG, *supra* note 1, at 1.
79. *Id.*
80. *Id.*
81. *Id.*
82. *Id.* at 11.

the biggest areas of change is in the measurement of fair value requirements, with many reporting areas moving from book value toward fair value measurements.[83] For example, before the new standards were introduced, many of the areas, like debt restructuring or nonmonetary transactions, were valued at book value, and any realized gains from them were not allowed to be recognized.[84] It is more difficult for enterprises to measure transactions at fair value than to rely on book value, but this change will give investors a clearer image of the true value.[85]

Another area where the new accounting standards will have a large impact is the requirement of disclosure.[86] In addition to the clearer value of the company that is created by fair valuation, Chinese listed companies will now be required to provide more detailed disclosure of useful investment information.[87] Companies will have to provide their earnings per share and segment reporting.[88] Companies are also required to disclose their financial risk exposure as well as the basis used for determining significant accounting policies and accounting estimates.[89]

ASBE 36 expands the definition of related party relationships to include

> any party that is a close family member of key management personnel of the parent company [or] any entity that is controlled, jointly controlled or significantly influenced by (a) key investor, (b) key management personnel, or (c) a close family member of any individual referred to in (a) or (b).[90]

While this definition aligns closely with IAS 24, one significant discrepancy is that ASBE 36 specifically states that "[s]tate-controlled entities should not be regarded as related parties simply because they are subject to control from the State," where, under IAS 24, state-controlled entities are included in related party relationships.[91] As a result, the

83. *Id.* at 1, 5.
84. *Id.* at 5.
85. *Id.*
86. *Id.* at 7.
87. *Id.*
88. *Id.*
89. *Id.*
90. *Id.* at 34.
91. *Id.*; DELOITTE TOUCHE TOHMATSU, CHINA'S NEW ACCOUNTING STANDARDS: A COMPARISON WITH CURRENT PRC GAAP AND IFRS 46 (2006); INT'L ACCOUNTING STANDARDS COMM. FOUND., TECHNICAL SUMMARY OF IAS 24 RELATED PARTY DISCLOSURES, http://www.iasb.org/NR/rdonlyres/5D53347E-1221-4D83-947D-2B72DD1D9615/0/IAS24.pdf (last visited Sept. 21, 2007) ("A party is related to an entity if: (a) directly, or indirectly through one or more intermediaries, the party: (i) controls, is controlled by, or is under common control with, the entity (this includes parents, subsidiaries and fellow subsidiaries); (ii) has an interest in the entity that gives it significant influence over the entity; or (iii) has joint control over the entity; (b) the

government can presumably enter into transactions with former SOEs on nonarm's length transaction terms without disclosure of this fact.

These new standards are necessary for the growth of the Chinese economy and the stability of its capital markets.[92] With the success of the SHSE and SZSE, there is a strong demand from investors for financial reporting that improves the level of transparency and comparability between these and other global capital markets.[93] However, there is a question as to whether the new standards will improve the financial reporting practices because "international accounting standards are built on foundations that China does not possess, such as experience of truthful record-keeping and deep, clean, markets so that 'fair' valuations can be placed on financial instruments."[94]

IV. FINANCIAL REPORTING FRAUD

Even though China has come a long way in implementing accounting standards, it has not had much success with the actual enforcement of these standards.[95] The trend in the past has been for listed companies to overreport earnings.[96] The detection rate of financial misreporting of listed companies is around one percent, while it is assumed that around forty to fifty percent of firms misreport.[97]

One reason for the overreporting of earnings is because of incentives given by the government.[98] Under China's Old Company Law, company rights were created based on levels of profitability over time.[99] Profitability was required for a company to apply for an IPO and to remain listed on the stock exchange.[100] China's Old Company Law was replaced with China's New Company Law in 2006, but other incentives

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party is an associate . . . of the entity; (c) the party is a joint venture in which the entity is a venturer . . . ; (d) the party is a member of the key management personnel of the entity or its parent; (e) the party is a close member of the family of any individual referred to in (a) or (d); (f) the party is an entity that is controlled, jointly controlled or significantly influenced by, or for which significant voting power in such entity resides with, directly or indirectly, any individual referred to in (d) or (e); or (g) the party is a post-employment benefit plan for the benefit of employees of the entity, or of any entity that is a related party of the entity.").

92. ERNST & YOUNG, *supra* note 1, at 2.

93. *Id.*

94. *Chinese Accounting: Cultural Revolution*, ECONOMIST, Jan. 13-19, 2007, at 63.

95. Jiang, *supra* note 64, at 9.

96. Opper, *supra* note 30, at 155.

97. *Id.* at 166.

98. Qiao Liu, *Corporate Governance in China: Current Practices, Economic Effects and Institutional Determinants*, 52 CESIFO ECON. STUD. 415, 440 (2006), *available at* http://www.cesifo.oxfordjournals.org.

99. Opper, *supra* note 30, at 155.

100. *Id.*

to overreport earnings still exist. The CSRC uses the companies' accounting numbers to regulate them.[101] "The CSRC regulates that a firm has to maintain a minimum of 6 percent of reported ROEs [Returns on Equity] and a 3-year average of 10% of ROEs in order to obtain the rights to offer new shares."[102] This requirement makes reporting earnings above six and ten percent very important and creates a strong incentive for firms below these thresholds to overreport earnings.[103]

Another reason for the overreporting of earnings is that companies incorrectly use "optimism" in their accounting methods and forecasting.[104] Optimistic accounting methods mean overreporting income and asset value and/or understating liabilities and expenses. This is usually achieved by recognizing income early and/or deferring recognition of expenses.[105] Companies may also use optimistic growth rates to overstate their expected earnings.[106] Both of these methods may mislead investors when they are deciding on an investment.[107]

To enforce accurate reporting, China adopted a strict auditing policy of implementing independent auditors.[108] In the past, auditing firms had always been associated with the government, so a large part of this new policy involved auditing firms detaching themselves from the government in an attempt to increase auditor independence.[109] However, instead of hiring high-quality auditors, companies fulfilled this requirement by hiring low-quality auditors who would not modify the company's reports.[110] In addition, one 2005 study found that even companies that hired a Big Five auditing firm had no increase in the quality of their issued reports.[111] Because the Big Five will not likely run into legal problems in China, they focus more on gaining market share than ensuring accurate reporting.[112]

Moreover, a 2004 Audit Analysis by the Chinese Institute of Certified Public Accountants of the 1376 audit reports of listed companies found that after these audits were completed there was a total

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101. Liu, *supra* note 98, at 440.
102. *Id.* at 440 n.23.
103. *Id.* at 440.
104. Jiang, *supra* note 64, at 11.
105. *Id.*
106. *Id.*
107. *Id.*
108. Liu, *supra* note 98, at 443.
109. P.R.C. SEC. REGULATORY COMM'N, *supra* note 25, at IV.3.
110. Liu, *supra* note 98, at 443.
111. *Id.*
112. *Id.*

adjustment of profits by RMB 64.1 billion.[113] This was equal to 21.66% of total profits before they were adjusted.[114] In 2001, the CSRC found that around 100 listed companies had supplied unreliable financial data to the public.[115] Also in 2001, the Chinese government randomly investigated sixteen auditing companies to check the accuracy of their audits.[116] It found that twenty-three of thirty-two reports contained false information.[117] Moreover, these twenty-three reports came from fourteen of the sixteen auditing companies examined, totaling 85% of the firms investigated.[118] Clearly, the independence of auditors does not seem to enhance the accuracy of listed companies' financial reports.

V. CHINA'S CORPORATE GOVERNANCE

A. *Company Law*

1. Old Company Law

Company law or business enterprise law did not formally exist in China until 1993.[119] Due to the creation of the stock markets and other new issues that capital markets brought, the NPC passed the Company Law of the People's Republic of China (Old Company Law) in 1993.[120] This law had similar concepts to company law in Westernized countries, but many underlying issues from China's history and its transformation toward a market economy have kept these Western concepts from being applied in the same way.[121] The core issue that underlies the Old Company Law is the "relationship between the Chinese Company Law and the SOEs."[122] The Old Company Law was created as a means to reform the SOEs into public companies; therefore, the Old Company Law was very preferential to the SOE itself over investor rights and did not truly embrace the market economy concept.[123]

Several weaknesses in the Old Company Law resulted from the preferential treatment given to SOEs. Like some Western countries, the Old Company Law gave shareholders voting rights, disclosure rights, and

113. Jiang, *supra* note 64, at 9.
114. *Id.*
115. *Id.*
116. *Id.* at 10.
117. *Id.*
118. *Id.*
119. GU MINKANG, UNDERSTANDING CHINESE COMPANY LAW 1 (2006).
120. *See id.*
121. *Id.* at 2.
122. *Id.* at 3.
123. *Id.*

the right to sue.[124] The power given to the Shareholder Meeting (SHM) was greater than that in common law countries.[125] China gave the SHM the right to determine the "company's business policies and investment plans," unlike common law jurisdictions where this power is given to the Board of Directors (BOD).[126] This was supposedly an attempt to control the abuse of the BOD; however, it was really another way to circumvent power going to the company and its investors and instead keeping power with the State.[127] Because the State is generally the largest shareholder, its vote controls the SHM and allows the State ultimately to decide the company's business policies and investment plans.[128]

The Old Company Law also gave shareholders the right to bring a lawsuit when their rights were infringed upon by the board.[129] However, the law did not explicitly state whether the suit should be brought as an indirect (derivative) suit or purely as a direct suit.[130] One common view was that the law did not create the right to a derivative action.[131] In fact, the first time a derivative action was brought to court it was rejected on the basis that the action must represent the interests of all the shareholders, and to achieve this, the shareholders bringing the suit must receive consent from each individual shareholder.[132] Therefore, even though the BOD was supposed to implement the resolutions from the shareholder meeting, it was practically impossible to hold the BOD responsible because there was no clear right to a derivative action.[133]

Another problem was that the Old Company Law gave virtually no protection for the rights of minority shareholders.[134] An example of this was the dominance of the majority shareholder in electing the BOD.[135] In 1999, the average size of a BOD was 10.3 directors, and because the average holding amount of the largest shareholder was 47.97%, the majority shareholder elected around half of the BOD.[136] Moreover, the largest shareholder is generally—directly or indirectly—a state institution, so the BOD is more likely to be aligned with the interests of

124. *Id.* at 118-19 (in particular the United States).
125. *Id.* at 121.
126. *Id.*
127. *Id.* at 121-22.
128. *Id.* at 122.
129. *Id.* at 125.
130. *Id.*
131. *Id.* at 128.
132. *Id.* at 129.
133. *Id.* at 3.
134. *Id.* at 4.
135. CHEN, *supra* note 11, at 56-57.
136. *Id.* at 56, 96.

the State.[137] This control over the BOD allows the State to manipulate the BOD from the inside and thereby hinders the ability of the BOD to make decisions that are best for the company.[138]

China's Old Company Law also did not specifically declare that the BOD had a fiduciary duty of loyalty, though this duty could be implied through different articles of the law.[139] Provisions that were similar to Westernized duties of loyalty required directors to uphold the interests of the company and not abuse their position.[140] Directors were also required to avoid conflicts of interest.[141] The Old Company Law did not address the duty of care either, and there were no specific requirements in the law that truly aligned with the Western concept of the duty of care.[142] These problems, among others, triggered the need to update the Old Company Law.

2. New Company Law

On October 27, 2005, the NPC issued the PRC's New Company Law.[143] The New Company Law became effective on January 1, 2006 and includes many updated provisions.[144] One new change is the introduction of a cumulative voting system for the election of the BOD.[145] In a cumulative voting system, instead of each shareholder receiving one vote per share, each shareholder gets an amount of votes equal to their shares multiplied by the number of director positions up for election.[146] Moreover, unlike a regular voting system where "stockholders must apportion their votes equally among candidates for director," cumulative voting allows all of a single shareholder's votes to be cast for one candidate.[147] This system allows minority shareholders to have a larger impact on the election of directors. However, the cumulative voting

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137. *Id.* at 96-97.

138. Tong Lu, *Defects in China's Independent Director System: A Case Study of Leshan Power Company* (Inst. of World Econ. & Politics, Chinese Acad. of Soc. Sci., Paper), *available at* http://en.iwep.org.cn/download/upload_files/uyhu4245rvwnqcyhdfitq4yt20070503114637.pdf (last visited Sept. 21, 2007).

139. MINKANG, *supra* note 119, at 147.

140. GUIGUO WANG, CHINA'S COMPANY LAW: THE NEW LEGISLATION 20 (1994) (translating art. 59).

141. *Id.* at 21 (translating art. 61).

142. MINKANG, *supra* note 119, at 150-51.

143. Jean-Marc Deschandol & Charles Desmeules, *One Hesitant Step Forward: New Company Law Brings Mixed Feelings*, P.R.C. L. & PRAC., Jan. 2006, at 13, 13.

144. *Id.*

145. *Id.* at 14.

146. *Id.*

147. *Id.*; JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 156 (Barron's Educational Series, Inc., 7th ed. 2006) (1985).

system is optional; the new law allows companies to put this system in place but does not require them to do so.[148]

Another change is a provision that allows senior management to transfer their shares in the company one year after the company has become listed on a stock exchange.[149] This is, to some extent, a restructuring of executive compensation.[150] The Old Company Law did not allow management to transfer their shares while they were working for the company.[151] This new provision puts the management's interests more in line with that of the shareholders, because if management takes more risks and the company profits, they have the ability to act on that gain by selling their shares.

A vast change in the law for minority shareholder rights is the new access to information. The New Company Law not only recognizes the shareholder's right to have access to the BOD's minutes and financial reports, but it also gives shareholders access to the company's accounting books.[152] The power of this right is coupled with new fiduciary duties found in the New Company Law and liabilities that exist in the new Securities Law for misrepresentation.[153] Article 149 of the New Company Law specifically states that duties of loyalty are placed on the senior officers and the BOD.[154] There is no specific duty for a manager not to provide false information to shareholders, but section vii is considered a catch-all where this duty should fall.[155] Article 149 is complemented by article 150, which holds senior management and directors liable for any violation of the New Company Law, as well as article 153, which provides shareholders with the right to bring these actors to court if their actions cause a loss to the shareholder.[156] In addition to these provisions, the new Securities Law passed in 2005 provides a cause of action to shareholders when senior management and directors have misrepresented company information in any disclosure materials.[157]

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148. Deschandol & Desmeules, *supra* note 143, at 14.
149. *Id.*
150. *See id.*
151. *Id.*
152. *Id.* at 15; Craig Anderson & Bingna Guo, *Corporate Governance Under the New Company Law (Part 1): Fiduciary Duties and Minority Shareholder Protection*, P.R.C. L. & PRAC., Apr. 2006, at 17, 22.
153. Anderson & Guo, *supra* note 152, at 20.
154. *Id.* at 19.
155. *Id.* at 19-20.
156. *Id.* at 20.
157. *Id.*

The New Company Law also clarifies how minority shareholders can exercise their rights in court. Several provisions in the New Company Law deal with specific liabilities that the senior management, directors, and controlling shareholders can be held accountable for and, therefore, gives shareholders a cause of action against them.[158] The New Company Law clarifies the right to bring a derivative action, which was unclear in the Old Company Law.[159] Article 152 of the New Company Law allows a shareholder to bring a derivative action for any violation under article 150.[160] Shareholders may also bring a direct lawsuit under article 153 "[i]f any director or senior manager damages the shareholders' interests by violating any law."[161] Beyond these derivative and direct lawsuits, a shareholder can also seek court intervention when a company refuses to comply with corporate governance laws.[162] Therefore, if a company refuses to let its shareholders see their accounting books, the shareholder can ask the court to require the company to comply with the law.[163] These private enforcement mechanisms are also meant to serve as a deterrent from wrong-doing to the major players in the company.[164] In theory, just the threat of a shareholder lawsuit would create an incentive for management to act lawfully.[165] However, it is unlikely that these private enforcement mechanisms have the effect of deterrence.

B. Corporate Governance Practice

In two recent studies comparing corporate governance levels around the world, China ranked quite low.[166] A 2004 survey by the International Institute for Management Development looked at sixty world economies and compared each country's corporate governance practices by looking at four factors: corporate boards, shareholder value, insider trading, and shareholders' rights.[167] The average of China's scores in all four

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158. Craig Anderson & Bingna Guo, *Corporate Governance Under the New Company Law (Part 2): Shareholder Lawsuits and Enforcement*, P.R.C. L. & PRAC., May 2006, at 15, 16.

159. *Id.* at 17.

160. *Id.*

161. Company Law of the People's Republic of China (revised in 2005) (promulgated by the Standing Comm. Nat'l People's Cong., Oct. 27, 2005, effective Jan. 1, 2006), art. 153, *translated in* http://www.chinadaily.com.cn/bizchina/2006-04/17/content_569258_13.htm (last visited Feb. 25, 2007).

162. Anderson & Guo, *supra* note 158, at 16.

163. *Id.*

164. *Id.* at 15.

165. *Id.*

166. Liu, *supra* note 98, at 431-33.

167. *Id.* at 431.

categories placed it at 41.5, fairly low on the list of 60.[168] Another survey, by the World Economic Forum in 2003, placed China's corporate governance practices even lower, at forty-fourth out of forty-nine.[169] This puts China below Malaysia, Thailand, and India and only slightly above Indonesia.[170]

Another report examined Chinese corporate governance practices concerning the financial data investors received. The 2006 assessment report by the Chinese Centre for Corporate Governance examined the practices of the top 100 listed companies in China.[171] It found that the areas that contained the most problems were shareholders' rights responsibilities of the BOD.[172] One factor looked at in particular was whether the companies provided their shareholders with a securities analysis report; the average score was only 10.61 out of 100.[173] Thus, generally, the companies do not even give the shareholders the information necessary to understand the company data they supply.

The corporate governance system in place in China is considered a control-based model.[174] The State, as the controlling shareholder, is concerned with the efficiency of the company, but it seeks to keep employment levels high, heightening social stability, rather than just maximizing profits.[175] The State's role as controlling shareholder puts it directly in conflict with the minority shareholder, because the State has the ability to use all available corporate governance mechanisms to its advantage while having different goals from the minority shareholder.[176] Therefore, the most common features that plague advancement toward best practices are the concentrated ownership structure, the prevalence of senior management on the BOD, and inaccurate financial reporting.[177] These issues make it very difficult for a minority shareholder to play a role in monitoring the BOD and the controlling shareholder.

One way for a minority shareholder to be protected from the inside of the company is if the BOD includes a significant number of independent directors. Independent directors are a way to have someone inside the company with a "completely impartial and impersonal position

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168. *Id.* at 432.

169. *Id.* at 432-33.

170. *Id.*

171. CHINESE CTR. FOR CORPORATE GOVERNANCE, CORPORATE GOVERNANCE ASSESSMENT REPORT OF THE 100 TOP CHINESE LISTED COMPANIES IN 2006, at 6-7 (2006).

172. *Id.* at 9.

173. *Id.* at 10.

174. Liu, *supra* note 98, at 418.

175. *Id.* at 427, 445.

176. *Id.* at 418, 445.

177. *Id.* at 418.

. . . [to] maintain the interests of all the shareholders."[178] China has set up requirements for an independent director system.[179] It requires that listed companies' BODs include at least two independent directors, or one third of total directors, to be independent, with at least one of those directors being an accounting professional.[180] Most listed companies have implemented the independent director system; however, due to several factors, it is still very difficult for an independent director to act independently.[181]

One of these factors is, again, the ownership structure. In many companies, the major shareholders are the ones who nominate candidates for the independent director positions, so these candidates are unlikely to be truly independent because of their ties to the controlling shareholder.[182] Another problem is that companies may try to keep unfavorable information away from the independent directors or prevent them from participating at board meetings.[183] On top of these constraints, nearly half of these independent directors also lack practical experience.[184] Many of them are scholars or professors who generally do not have management experience; in addition, they have limited time to devote to the company due to the part-time nature of the director position.[185] All of these constraints leave the independent director system without any real capabilities to affect the management of the company.[186]

C. Corporate Governance Enforcement

The New Company Law appears to address several of these issues by giving the minority shareholder a lot of protection. However, both public and private enforcement mechanisms in China are weak. China's public enforcement mechanisms are not sufficient to create optimal corporate governance practices.[187] The relationship between the government enforcement agencies and listed companies is too interwoven.[188] The CSRC is the main enforcement agency and it is "susceptible to political influence, local protectionism and other forms of corruption."[189] Because the State is such a large shareholder in many

178. Lu, *supra* note 138.
179. *Id.*
180. *Id.*
181. *Id.*
182. *Id.*
183. *Id.*
184. *Id.*; OECD, *supra* note 26, at 9.
185. Lu, *supra* note 138; OECD, *supra* note 26, at 9.
186. Lu, *supra* note 138.
187. Anderson & Guo, *supra* note 158, at 15.
188. Opper, *supra* note 30, at 160.
189. Anderson & Guo, *supra* note 158, at 15.

listed companies, it has a significant interest in establishing trust in its capital markets to attract more investors and to avoid calling attention to the unsound practices that companies entertain.[190] If the State were suddenly to reveal all of the fraudulent and unlawful behavior in the listed companies, it could cause a stock market crash and a potential loss of a large amount of State assets.[191] The lack of capital investment would also place major constraints on China's reform, which in turn could stunt the economic growth.[192] This causes the administrative and criminal penalties for corporate governance misbehavior to be too minimal to truly act as a deterrent.[193] Therefore, the main players in listed companies may choose to violate the law because of the unlikelihood that punishment will occur.[194]

Private enforcement mechanisms, such as civil lawsuits, are a way for shareholders to enforce sound corporate governance practices.[195] The New Company Law enhances the rights of shareholders to use these mechanisms.[196] However, it is not clear whether the new law will actually increase the ability of shareholders to supervise management through these legal avenues. In general, the Chinese judicial system is not adequately equipped to hear these types of cases.[197] China has a weak legal infrastructure, and many judges do not understand the securities market.[198] Moreover, if a Chinese court is faced with procedural gaps, it may refuse to hear the case at all.[199] Between 2002 and 2003, courts across China heard around 900 cases dealing with listed companies' fraudulent information disclosure; in that time frame, only two of the cases were settled through court mediation.[200] The New Company Law, though specifically creating these rights for shareholders, is somewhat vague regarding how courts should distinguish between derivative and direct actions.[201] Moreover, there is little case precedent to help guide courts through this distinction.[202] Article 152 provides basic procedures

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190. Opper, *supra* note 30, at 160.
191. *Id.*
192. *Id.*
193. Anderson & Guo, *supra* note 158, at 15.
194. *Id.*
195. Opper, *supra* note 30, at 167.
196. Anderson & Guo, *supra* note 158, at 15.
197. Tong Lu, *Corporate Governance in China* 2 (Inst. of World Econ. & Politics, Chinese Acad. of Soc. Sci., Paper), *available at* http://en.iwep.org.cn/download/upload_files/4we5sjm0ax41l3bu4ylecw5520070614180223.pdf (last visited Sept. 21, 2007).
198. *Id.*; Liu, *supra* note 98, at 446.
199. Anderson & Guo, *supra* note 158, at 17.
200. Lu, *supra* note 197.
201. Anderson & Guo, *supra* note 158, at 17.
202. *Id.*

for a derivative action, which include certain barriers to prevent strike suits from arising.[203] This will help clarify to courts when they should accept the case.[204] For instance, plaintiffs that bring a derivative action must have owned "at least 1% of the shares of the company for at least 180 consecutive days," either individually or collectively.[205]

The New Company Law, through these procedures, at least recognizes the existence of shareholders' rights and sets up a useful framework.[206] However, even if the shareholder can get to court, the implementation of these rights will be a slow process due to the lack of efficiency in the judicial system.[207] For example, a recent securities misrepresentation case, the *Daqing* case, was filed in 2002 and it took the court almost three years to accept it and give a final judgment.[208] Even now, the judgment is sitting at the Supreme People's Court awaiting enforcement after a series of appeals.[209]

VI. CORPORATE GOVERNANCE AS AN ENFORCEMENT MECHANISM FOR FINANCIAL REPORTING

If the new Chinese accounting standards are followed truthfully, they will be a great step toward creating transparency among Chinese listed companies; however, it is unlikely that the corporate governance system in China will induce listed companies to accurately follow the new standards. The deterrence effect is not great enough, and the minority shareholders do not have strong enough enforcement mechanisms to force management to accurately report according to the new accounting standards.

The ownership structure of most listed companies allows for fraudulent financial reporting because it creates a vicious circle. Most of the directors are elected by the controlling shareholder, and therefore, their interests are much more likely to align with the State rather than the minority shareholders.[210] Because the State wants to protect social stability and the appearance that Chinese companies are profitable, listed companies' reports will meet these goals by inaccurately reporting their earnings.[211] This fraudulent behavior will generally not be punished by

203. *Id.* at 17-18.
204. *Id.* at 17.
205. *Id.* at 18.
206. *See id.* at 21.
207. *Id.*
208. *Id.* at 16, 21.
209. *Id.* at 21.
210. CHEN, *supra* note 11, at 57, 96.
211. *See* Liu, *supra* note 98, at 427.

the State because the listed companies are owned by the State and penalizing the companies could cause investors to pull out of the market.[212] The government is more concerned with the prospect of losing its capitalization and stunting economic growth.[213] Therefore, there are minimal internal or public restraints on accurate accounting practices.

However, two recent developments may eventually have an impact on this. First, the share reform of NTS into TS may alter the landscape. The State holds the majority of the fifty-five percent of shares that were nontradable.[214] Once the restrictions that are in place to prevent a flood of the market have passed,[215] many of these shares will be available to purchase. If other shareholders purchase these shares in concentrated amounts, then the State may no longer be the controlling shareholder. The entire ownership structure will change, thereby eliminating some of the internal constraints on accurate reporting. However, just because these shares will be tradable does not mean that the State has to actually trade its shares. The State can choose to remain in control just by not selling them.

The second development is that the New Company Law addresses the issue of concentrated ownership by creating the choice for a company to implement a cumulative voting system.[216] If a company has cumulative voting, it gives small shareholders the opportunity to band together by casting all of their votes for one candidate and, therefore, placing someone on the board to champion their interests and influence the accuracy of the financial reporting. There are problems with those developments as well. First, the candidates are still nominated by the controlling shareholder, so even if the small shareholders pool their votes, that candidate will likely have ties to the State.[217] Moreover, a cumulative voting system is just an option, so many companies may choose never to implement it.[218]

The New Company Law creates both derivative and direct lawsuits for shareholders.[219] This could have an effect on accurate financial reporting both in deterring the senior management and the BOD from acting unlawfully and by shareholders actually bringing suits.[220]

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212. Opper, *supra* note 30, at 160.
213. *Id.*
214. Beltratti & Bortolotti, *supra* note 41, at 2.
215. *Id.* at 5.
216. Deschandol & Desmeules, *supra* note 143, at 14.
217. Lu, *supra* note 138.
218. Deschandol & Desmeules, *supra* note 143, at 14.
219. *See* Anderson & Guo, *supra* note 158, at 17.
220. *Id.* at 15.

However, at this point in time, it is unlikely that these shareholder rights will affect financial reporting at all. China's weak legal infrastructure, lack of precedent, and lack of knowledge by the courts on these corporate topics make lawsuits a very slow and likely unsuccessful choice.[221] If the threat of a lawsuit is minimal, then the deterrent effect on fraudulent behavior by senior management and the BOD is also very unlikely.

Shareholders have been given another solution to assessing and enforcing the accuracy of a listed company's financial reports. Under the New Company Law, shareholders have access to the company's accounting books.[222] Hence, minority shareholders could conduct their own audit of the company's financial situation and the accuracy of its reports. This ability in and of itself may serve as a deterrent to inaccurate reporting. However, many problems exist with this solution as well. Conducting an independent audit is extremely costly, and the shareholders who would spend this money would do so because they have a large interest in the viability of their investments. These investors are the largest shareholders, who again are predominantly the State. Smaller shareholders are more likely to take a free-rider position because they generally do not have the budget or the strong incentives to perform this task.[223] Therefore, even though the minority shareholders have access to the accounting information of companies, this capability is unlikely to improve the accuracy of financial reporting.

The independent director system could also eventually help the transparency of financial disclosures. The system is at least already in place, even though it does not function properly.[224] If it is developed further, this system may be helpful in the future to provide knowledgeable independent directors who are given strong incentives to behave independently.[225] With true independent directors, there will be an internal restraint on fraudulent reporting that will not require the need to use government enforcement or the legal system. This may be one of the most feasible mechanisms to increase financial transparency, but it is still a future aspiration.

The one shareholder that may be able to overcome these restraints is the institutional shareholder. In the past, domestic institutional

221. Liu, *supra* note 98, at 446; Lu, *supra* note 197, at 2.

222. Anderson & Guo, *supra* note 152, at 22; Deschandol & Desmeules, *supra* note 143, at 15.

223. Opper, *supra* note 30, at 162.

224. Lu, *supra* note 138.

225. *Id.*

shareholders have held around twenty-two percent of total shares.[226] With the introduction of QFIIs in 2002, foreign institutional investors are also getting a hold on Chinese listed companies.[227] If the institutional shareholders could work together, they could have an impact against the majority shareholder. This was recently seen during the share structure reform.[228] The reform of NTS to TS was done through negotiation and required an approval by a two-thirds vote of the tradable shareholders.[229] The institutional shareholders were able to force the companies to truly negotiate with them because it cost the institutional shareholders little to reject their offers, while the rejection of a compensation scheme could greatly affect the company.[230] This banding together created responsiveness from the senior management and is an example of how the institutional investors may have an impact on the actions of the company. Moreover, with share reform, domestic institutional investors may be able to increase their overall percentage of ownership because there will be greater access to the A-share market, thereby creating an opportunity for institutional shareholders to increase their power.

VII. CONCLUSION

With the recent stock market crash, it is extremely apparent that there is a need for these new Chinese accounting standards and for them to be accurately followed. However, after examining the current corporate governance mechanisms and the ownership structure of Chinese listed companies, it is unlikely that these mechanisms will act as an incentive for companies to accurately report their financial records. As the corporate governance scheme and legal structure develops in the future, there may come a time when these mechanisms are sufficiently reliable for true transparency. In the meantime, other solutions must be examined in an effort to create an environment where investors have trust in company reports, which will in turn help tame the volatility of the Chinese stock markets.

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226. CHEN, *supra* note 11, at 96.
227. Cichy, *supra* note 36.
228. Chao Xi, *Institutional Shareholder Activism in China: Law and Practice (Part 1)*, 9 INT'L COMPANY & COM. L. REV. 251, 256 (2006).
229. *Id.*
230. *Id.*