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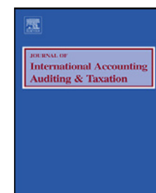

Corporate governance and operating performance of Chinese listed firms

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ABSTRACT

In this paper, we investigate the impact of corporate governance on firm performance and valuation in China. Our study introduces a composite measure of corporate governance to measure the association between corporate governance and Chinese firms' performance and valuation. Because agency theory suggests that companies with better corporate governance standards perform better, we propose that better governed Chinese firms would have greater performance and higher valuation. We find that our composite measure of corporate governance is positively and significantly associated with firm performance and valuation. These findings have implications for policy makers, researchers, managers, and investors in general and those in emerging markets in particular.

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1. Introduction

Due to the rapid growth of the capital market in China and the unique ownership characteristics of Chinese listed firms, there is growing interest in studying the impact of corporate governance on firm performance in China. Since the Shanghai Stock Exchange opened in 1990 and the Shenzhen Stock Exchange opened in 1991, Chinese equity markets have attracted large investments from both domestic and foreign investors. From 1995 to 2005, the number of listed companies in China increased from 323 to 1300, and market capitalization increased from $28.92 billion to $439 billion (Sami & Zhou, 2004; Tower & Yan, 2006). In recent years, significant changes occurred in the regulation of ownership of public companies in China. Starting in 2001, domestic shareholders with foreign currency accounts have been allowed to purchase B-shares, which previously had been sold only to foreign investors. This change provided more investment opportunities for individual shareholders and increased the public float. In addition, on June 12, 2001, China's State Council announced the sale of state-owned shares in Chinese companies.[1] More private enterprises have developed into larger corporations and/or have gone public in recent years. As a result, privately controlled firms increased dramatically, from 91 firms (7.84% of listed firms) at the beginning of 2001 to 245 firms (19.04% of listed firms) at the end of 2003 (Choi, Sami, & Zhou, 2010). Our paper attempts to shed light on the impact of corporate governance on firm performance and firm value in this unique setting. Specifically, our study introduces a composite (overall) measure of corporate governance and its association with firm value and performance of Chinese firms.

Corporate governance is a set of mechanisms that affect how a corporation is operated. It deals with the welfare and goals of all the stakeholders, including shareholders, management, board of directors, lenders, regulators, and the economy

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[1] http://www.pbs.org/nbr/site/research/educators/060106_14c.

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as a whole. The purpose of corporate governance is to achieve the best overall welfare for all stakeholders and promote economic efficiency. Empirical research on corporate governance is based on the theoretical framework of agency theory advanced by Jensen and Meckling (1976), Fama (1980) and Fama and Jensen (1983). In corporations, the principal–agent problem occurs when the interest of managers (the agent) is not in line with the interest of owners (the principal). Agency theory provides a framework to explain how to create an effective monitoring and incentive scheme under uncertainty and incomplete information.

In particular, agency theory suggests that a better-governed firm should have better performance and higher valuation due to lower agency costs. This prediction is supported by many empirical studies. For example, Gompers, Ishii, and Metrick (2003) find that better corporate governance is associated with higher firm valuation as measured by Tobin's Q. Brown and Caylor (2006, 2009) find that better-governed U.S. firms have higher return on equity (ROE), higher return on assets (ROA), and higher Tobin's Q. Dittmar and Mahrt-Smith (2007) find that good corporate governance has a substantial positive impact on U.S. firms' value.

Agency theory also predicts that a better-governed company is associated with higher ownership concentration, which is further associated with firm performance. For instance, Gedajlovic and Shapiro (2002) find a positive relationship between ownership structure and firms' financial performance in Japan. Joh (2003) finds Korean firms with low ownership concentration have low firm profitability. These findings validate the claim that ownership concentration improves corporate governance and firm performance.

Most prior research focuses on corporate governance in developed markets, especially the U.S. equity markets following the accounting scandals of Enron and WorldCom in 2002. Gompers et al. (2003) find that better-governed U.S. firms during the 1990s have higher operating performance and higher market value, suggesting investors in the United States factor in corporate governance when making their investment decisions. Studies in emerging markets, in general, and those related to China, in particular, investigate mostly the impact of single measures of corporate governance on firm value and performance (e.g., Bai, Liu, Lu, Song, & Zhang, 2004; Black, Jang, & Kim, 2006; Jingu, 2007; Li, Naughton, & Hovey, 2010; Qi, Wu, & Zhang, 2000; Singh & Gaur, 2009; Wu & Cui, 2002). No study uses an overall (composite) measure of corporate governance based on archival data to investigate the association between corporate governance and firm value and/or performance. Although Black et al. (2006) and Cheung, Jiang, Limpaphayom, and Lu (2008) construct composite measures of corporate governance using survey data, the method involves self-reporting bias. The measures based on survey data would not be as reliable as those based on archival data reported to the regulatory agencies. Since Chinese firms have unique characteristics of ownership structure, one of the important facets of corporate governance, they provide an interesting setting to study corporate governance and its relationship to firm performance and valuation.

In addition, the results of corporate governance studies are mostly mixed. For instance, Gompers et al. (2003) find better governed US firms have better net-profit-margin and sales growth but not higher ROE. Also, Wu and Cui (2002) find a positive association between ownership concentration and accounting profit for Chinese public companies. However, they find that ownership concentration has a negative relationship to market performance measured by market to book ratio and price to earnings ratio. Therefore, further investigation is needed to determine if different measures of accounting performance, market performance and corporate governance affect the reported results. In our study, we use ROE, ROA and Tobin's Q, which are common measures of firm performance and valuation. We find that our composite measure of corporate governance is positively and significantly associated with firm performance and valuation. The results indicate that the quality of corporate governance has a positive association with firm performance and value in China.

The paper proceeds as follows: in the next section, we present the literature review and develop the hypothesis. The third section contains the research design. The details of data collection and empirical analyses are presented in section four, and section five summarizes our findings and discusses the implications.

2. Literature review and hypothesis

Although agency theory literature suggests that good governance could reduce agency costs and increase the return to shareholders, the empirical findings are mixed. One possible reason could be the different measures of corporate governance used. In general, two types of approaches are adopted in prior studies. The first approach uses a composite measure of corporate governance while the second approach focuses on single corporate governance attributes, such as ownership structure and board characteristics (e.g., Gedajlovic & Shapiro, 2002; Joh, 2003; Patibandla, 2006). Because our study focuses on the first approach, in our literature review, we discuss only the relevant studies with composite measures of corporate governance.[2]

[2] The studies using single corporate governance attributes include one stream of corporate governance research examining the relation between ownership concentration and firm performance (e.g., Joh, 2003; Gedajlovic and Shapiro, 2002; Weinstein and Yafeh, 1998; Beckman, Garner, Marshall, & Okamura, 2001; Beason, 1998; Patibandla, 2006; Lehmann and Weigand, 2000), and another stream on the impact of the characteristics of the board of directors on firm performance, valuation and cost of debt (e.g., Fosberg, 1989; Bhagat and Black, 2002; Bonn, 2004; Cho and Rui, 2007; Rosenstein and Wyatt, 1990; Yermack, 1996; Anderson et al., 2004). Among these studies, there is a group of studies investigating the unique ownership characteristics of Chinese listed firms and its impact on firm value and performance, such as Bai et al. (2004), Wu and Cui (2002), Qi et al. (2000), Xu and Wang (1999), Hovey, Li, and Tony (2003), Singh and Gaur (2009). However, their results are mixed.

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