RELATED-PARTY DISCLOSURES IN THE TWO-TIER BOARD SYSTEM IN CHINA: INFLUENCES OF OWNERSHIP STRUCTURE AND BOARD COMPOSITION

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Abstract

This study concerns related-party disclosures by listed companies in China, in a corporate context of a high concentration of government-linked ownership, a two-tier board system, and the engagement of directors, key managers and major shareholders in direct and indirect transactions and business relationships with their company. Using content analysis of annual reports of listed companies in China over 5-years from 2001 to 2005, results show that the comprehensiveness of related-party disclosures is positively affected by companies' domestic ownership concentration and the proportion of independent directors on the corporate board. But the proportion of supervisory board members with professional knowledge and experience is, unexpectedly, found to have a significant inverse relationship with the extent of related-party disclosure. Reasons peculiar to the context in China are proffered, particularly the likelihood of internal censorship of the more professionally qualified members of supervisory boards.

Keywords: Board governance; ownership structure; two-tier board, related-party disclosure; China

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1. Introduction

Private sector corporations, securities markets and corporate governance are rapidly changing phenomena in transitional economies such as China. Before 1980, most Chinese enterprises were state-owned and the Government was the only user of financial statements. Thus, there were few concerns about public disclosures and few incentives for enterprises to engage in the external reporting practices of earnings management and tunnelling[27]. Since the beginning of the transition from a planned economy to a market economy and, in particular, the appearance of securities markets in 1990, agency problems of ownership structure and corporate governance have emerged at the forefront in China for policy makers, regulators and corporate players.

The principles of corporate governance in developed economies centre on transparency, accountability and fairness. With the potential to develop into an economic superpower, China faces the enormous task of developing modern and market-oriented institutions. A market-oriented economy requires effective corporate governance. In China, ineffective corporate governance has allowed state-owned enterprises that are now privatised and listed to engage in accounting and management practice that have the potential to produce scandals and a lapse of state and corporate assets. Thus, over the last several years, China's regulators have been actively reviewing and strengthening corporate governance and transparency requirements. However, researchers still find problems exist within the Chinese corporate governance system, such as opaque related-party transactions, ineffective supervisory boards, weak independence of the boards of directors, and highly concentrated ownership structures (Lin, 2004).

The first objective of this study is to identify the extent to which listed companies in China disclose information about their direct and indirect transactions and negotiated relationships with their directors, key management personnel, and shareholders, and whether such related-party disclosures have significantly increased in the period following the introduction of *The Code of Corporate Governance for Listed Companies in China* (hereafter "*The Code*") in 2002. Such descriptive statistics can indicate whether *The Code*, issued by the China Securities Regulatory Commission (CSRC) as a non-enforceable guideline, has been an effective means of increasing the comprehensiveness of corporate disclosure in a culture know for secrecy (Hofstede, 1984) and in a disclosure

[27] The term of tunnelling is to describe the transfer of resources out of firms for the benefit of controlling shareholders.

area sensitive to corporate directors, top management and large shareholders.

If the CSRC's code on corporate governance is found to effectively facilitate an increase in related-party disclosures, then the research question arises as to whether the presence of other corporate governance characteristics have complementary effects on management's disclosure decisions. Do the corporate characteristics of ownership structure (where government ownership is high in China) and board composition (where a two-tier board system applies) impact on management's related-party disclosure decision?

The second objective, therefore, is to develop and test hypotheses about governance issues of ownership structure and board composition that affect managements' decisions to disclose more or less comprehensive corporate information about related-party transactions and relationships. In the context of studying corporate governance influences on related-party disclosures, this study especially addresses a gap in the literature concerning the high government ownership concentration and the two-tier board system of corporate governance. There is prior evidence that supervisory boards of listed companies in China are ineffective and tend to weaken board governance principles (Dahya et al., 2003).

2. Background to Research

The Chinese stock market was officially established in the 1990s. The Shanghai and Shenzhen Stock Exchanges were launched in 1990 and 1992 respectively. The appearance of the stock markets was a novelty for the Chinese people. Subsequently, agency problems have arisen, generating conflicts of interest between management and shareholders of listed firms. A major source of agency conflict can arise from transactions and relationships entered into by directors and top management with parties that are, or are deemed to be, related to the reporting entity. Under International Accounting Standard (IAS) 24 'Related-party Disclosures', two parties are defined as being related if there exists a direct or indirect control or significant influence of one party over the other party in making financial and operating decisions. Significant influence can be exercised over a reporting entity by representation on its board of directors, participation in its policy-making process, material inter-company transactions, interchange of key management personnel and statute or other agreement. According to IAS 24, related parties can be classified into three categories: corporate shareholders (e.g., subsidiaries, joint ventures and associated companies), individual shareholders (e.g., a major shareholder, close members of the family of these major shareholders, companies owned by major shareholders or their close family members), and key management personnel (e.g., directors and top managers, close family members of these individuals, enterprises owned by these individuals and their close family members). Related-party disclosures are expected to include a description of the company's relationship with each related-party, and a description of various transactions, including the pricing policy and amount involved in purchases, sales, rendering of services, write-offs, guarantees, management contracts, leases and licence agreements.

2.1 Legal Framework for China's Corporate Governance

Since the establishment of the Chinese Securities Regulatory Committee (CSRC) in 1992, more than 300 laws and directives concerning the securities and futures markets have been issued (Lin, 2004). The key legal framework for corporate governance in China consists of *The Company Law,* promulgated in December 1993 and revised in 2005, *The Securities Law,* promulgated in December 1998 and revised in 2005, and *The Code of Corporate Governance for Listed Companies in China (The Code)* issued by the CSRC and the State Economic and Trade Commission in January 2002 and also revised in 2005. As the primary government document dealing with corporate governance, *The Code* is a set of guidelines that states in its Preface that all listed companies in China are to "act in the spirit of *The Code* in their efforts to improve corporate governance". It is intended as a measuring standard for companies and their investors to self-evaluate whether or not good corporate governance is in place, rather than a legally enforceable piece of legislation or regulation.

2.2 Board Governance Model in China

In the early 1990s, China began to address aspects of corporate governance mainly because many enterprises and their directors were perceived as engaging in questionable related-party transactions. The selection of an appropriate corporate governance model became an integral element in China's development. International practices have been characterised in this regard by different selections, for instance, the Anglo-American model, the Continental model, and the Germany-Japan model (Tam, 2000; Cernat, 2004; Zhou, 2004). In the Anglo-American model, the governance concept is based on the agency relationship between shareholders and managers. Based on the concept of market capitalism, the Anglo-American system is founded on the belief that self-interest and decentralised markets can function in a self-regulating, balanced manner (Cernat, 2004). The Continental and the Germany-Japan capitalist models not only consider the interests of shareholders but also facilitate direct input from other relevant stakeholders (Cernat, 2004). Unlike the Anglo-American model, the Continental and the Germany-Japan models provide a two-tier board: the corporate board of directors and the supervisory board (Mak, 2006). This two-tier board structure is adopted by companies listed in China.

The major responsibility of a supervisory board is to oversee the corporate board of directors. *The Company Law* (revised in 2005) places several requirements on the composition and operation of the supervisory board. According to *Article 118*, the supervisory board comprises at least three members. Article 118 goes on to require that members of the supervisory board include representatives of shareholders and an appropriate percentage of representatives of the firm's employees. The proportion of representatives of employees shall account for not less than one-third of all members. The representatives of employees who serve as members of the supervisory board shall be democratically elected through the meeting of representatives of the firm's employees, shareholders' meeting or by other means. The supervisory board shall have one chairman, and may have a deputy chairman. The chairman and deputy chairman shall be elected by more than half of all members. Due to the independent nature of the supervisory board, no directors or senior managers may concurrently act as a member (reaffirmed in *Article 53*). According to *Article 53*, a member of the supervisory board has a three-year term of contract. Members may, after the expiry of their terms of contract, hold a consecutive term upon re-election.

According to Section 1 Chapter 4 of *The Code*, the supervisory board has five duties and responsibilities: (1) supervise corporate finance, the legitimacy of directors, managers and other senior management personnel's performance of duties, and protect the firm's and the shareholders' legal rights and interests (*paragraph 59*); (2) have the right to investigate the operating status, and have the corresponding obligation of confidentiality (*paragraph 60*); (3) receive necessary corporate information and assistance from management in order to satisfysupervisors' rights to be informed about the company's matters (*paragraph 61*); (4) prepare and present a report of the supervisory board as an important basis for performance assessment of directors, managers and other senior management personnel (*paragraph 62*) ; (5) report as a supervisory board, if necessary, directly to securities regulatory authorities and other related authorities (*paragraph 63*).

The corporate board of directors adopts similar characteristics to those of Anglo-American countries. According to *The Company Law,* the corporate board of directors comprises five to nine members, who have three-year contracts. These contracts are renewable. All listed firms shall have independent directors (*Article 123*). Since 2003 one-third of the directors have to be independent. Firth et al. (2007) argue that the effectiveness of the corporate board in China differs from the corporate board in the West because of the close connection between the dominant investors and the government (either central or provincial). The government may influence the appointment of directors and senior managers, and even interfere with the decision-making of a listed firm (Firth et al., 2007).

In Chinese firms, majority shareholders are typically very strong and individual minority shareholders are extremely weak and unable to counter the influence of the majority shareholders. Related-party transactions between controlling shareholders are often detrimental to minority shareholders. Minority shareholders are often regarded as speculators expecting to gain a "free ride" on the firm's performance (Lin, 2004). Thus, China's corporate governance is potentially relatively ineffective in the matter of protecting minority shareholders' rights.

One important aspect of protecting minority shareholders' rights is to disclose more information about related-party relationships and transactions. While good board governance would expect both the corporate board and supervisory board to strongly monitor and support related-party disclosures by the company, such disclosures can be sensitive to those board members who directly or indirectly enter business transactions and relationships with the company. Section 2 Chapter 1 of *The Code* states three requirements for related-party transactions. First, written agreements shall be entered into for related-party transactions between a listed company and its connected parties. Such agreements shall observe principles of equality, voluntariness, and fair value of compensation (*paragraph 12*). Second, efficient measures shall be adopted by a listed company to prevent its connected parties from interfering with the operation of the firm and damaging the firm's interests by monopolizing purchase or sales channels. Therefore, the company shall fully disclose the basis for pricing for related-party transactions (*paragraph 13*). Third, the firm shall adopt efficient measures to prevent its shareholders and their affiliates from misappropriating or transferring the capital, assets or other resources of the firm through various means (*paragraph 14*). On top of these requirements, the Chinese *Accounting Standard for Business Enterprises,ASBE* 36, prescribes requirements concerning related-party relationships and transactions disclosures.

3. Literature and Hypotheses

3.1 Ownership Structure

Under agency theory, corporate financiers (as principals) seek corporate governance monitoring mechanisms that can provide assurance that their funds are not expropriated by management (as agents) or wasted on unattractive projects (Shleifer and Vishny, 1997). An important factor shaping the corporate governance system is the type of ownership structure. A key aspects of corporate ownership is whether it is dispersed or concentrated, because the degree of concentration determines the distribution of power over corporate control (Aoki, 1995).

To generate the first hypothesis for this study, five empirical studies of the relationship between ownership structure and the extent of corporate disclosure are reviewed. Although these studies are taken from different contexts, they produce consistent findings. First, Ruland et al. (1990), using a sample of 146 US companies over period of 1980-1985, examine the relationship between ownership structure and disclosure of earnings forecasts. They argue that companies that release earnings forecasts have a higher proportion of outside ownership than other companies, and voluntary disclosure is expected to increase with the proportion of outside ownership. The empirical results support their hypothesis and show a negative relationship between proportion of inside ownership and management disclosure of forecast of earning. Second, McKinnon and Dalimunthe (1993) examine economic incentives motivating listed diversified companies in Australia to voluntary disclose segment information. They argue that the separation between a company management's decision-making function and its principals' decision-making function is greater when ownership diffusion exists. This ownership diffusion causes agency costs to be higher than when a company's shareholdings are concentrated.. They further contend that disclosure of performance according to business and geographic segments of the company allows diverse shareholders to better assess the company's risk/return profile and growth prospects and thereby, reduce the need for higher agency monitoring costs. A more diffused ownership, they hypothesize, would provide a greater management incentive to disclose segment performance information. Their results supported their hypothesis by finding a weak positively relationship between ownership diffusion and voluntary disclosure of segment information. Third, Barako et al. (2006) examine voluntary disclosure practices in the annual reports of listed firms in Kenya from 1992 to 2001. They argue that a higher proportion of shares held by the top 20 shareholders should be associated with a higher voluntary disclosure level because of pressure by large shareholders on management to disclose. But their results show that the higher the proportion owned by the top 20 shareholders, the lower the disclosure. Fourth, Berglof and Pajuste (2005), using a sample of 370 non-financial listed companies of ten Central and Eastern European stock exchanges[28], examine the voluntary disclosures made available on companies' websites and annual reports. They argue that companies with large controlling shareholders are less likely to depend on transparency because information can be transferred directly through informal channels. They hypothesize that more concentrated ownership is associated with a lower disclosure level. Their result is consistent with their hypothesis and shows that firms with more concentrated ownership structures disclose less information. Fifth, voluntary disclosure and ownership are part of a study in Turkey by Celik et al.(2006). They examine the factors influencing the decisions by managements of listed companies on Istanbul Stock Exchange (ISE) to disclose forward-looking information. Their results indicated that the extent of total disclosure of forward-looking information is negatively associated with ownership concentration. Consequently, it is hypothesized that:

H_1: *The higher the ownership concentration of listed companies in China, the lower is the extent of their related-party disclosure by those companies.*

There is evidence that the management of those listed companies that attract foreign ownership tend to increase the quantity or quality of corporate disclosure to meet the demands and interests of their existing and prospective foreign investors. Haniffa and Cooke (2005) analyse the 1996 and 2002 annual reports of 139 non-financial firms listed on the Kuala Lumpur stock exchange. They conclude that the significant positive relationship between corporate social disclosure and the proportion of foreign shareholders indicates that Malaysian listed firms use corporate social disclosure as a proactive legitimation strategy to obtain capital inflows and to please ethical investors. Xiao et al. (2004) analyse the factors behind the largest 300 listed Chinese companies' voluntary adoption of internet-based financial reporting. They find that the extent of Chinese companies' internet-based financial disclosure increases with their proportion of foreign ownership. This result supports the argument that Chinese listed companies do, in fact, respond to the information needs of foreign investors. Firth et al. (2007) argue that the type of shareholder can influence the quality of accounting information. They contend that listed companies in China need to provide higher quality financial information in order to proactively attract foreign investors and, further, these foreign investors put pressure on those companies to continue to improve their reporting quality. Accordingly, it is hypothesized that:

H_2: *The higher the concentration of foreign shareholders in listed companies in China, the greater is the extent of related-party disclosure by those companies.*

3.2 Board Composition

Ho and Wong (2001) describe the Germany-Japan-China model of corporate governance as a mechanism to delineate each group of stakeholders' rights and responsibilities, with transparency being important but problematic to its effective functioning. Dennis and McConnell (2003) articulate the Anglo-American view of corporate

[28] Ten Central and Eastern European stock exchanges are selected from Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic and Slovenia.

governance as a set of mechanisms, both institutional and market-based, that induces the self-interested controllers of a firm to make decisions that maximize the value of the firm to its owners. Both views of corporate governance represent ways to manage the agency problems arising when professional managers or stakeholders are delegated control. Shareholders' interests, especially minority shareholders' interests together with other stakeholders' interests are better met, it is deemed, under a good corporate governance system.

The guidelines in *The Code* of the CSRC give particular attention to two aspects of board governance, namely, he independence of directors on the corporate board, and the qualifications and knowledge of members on the supervisory board. First, in relation to independence of directors, a regulation issued by the CSRC as a supplement to *The Code* required that by 2003 at least one-third of directors on the corporate board be independent. The definition of independence is given in clause 49 of *The Code*. This clause states that "…independent directors shall be independent from the listed company that employs them and the company's major shareholders". Further, it states that they "…shall not hold any position apart from independent director in the listed company." The nature of independence of members of the supervisory board is not made specific. Clause 26 of The Code states that "… the supervisory board … shall operate in an independent manner" in terms of having "no subordination relationship" to "internal officers or controlling shareholders".

Fama and Jensen (1983) argue that independent directors are motivated to work in the best interests of the minority shareholders in order to maintain their good reputation in society. In empirical studies of board composition, Chen and Jaggi (2000) advocate that corporate disclosures in South-East economies are more important because firms in these countries have less incentives for transparency than Anglo-American firms (Ball et al., 2003; Mallin, 2007). The result indicates that a positive relationship between the comprehensiveness of financial disclosures and independent directors on a corporate board, and suggest that firms would disclose more comprehensive financial information by the inclusion of independent directors on corporate board. Lim et al. (2007) analyse the incentives within the agency framework for both inside and independent directors to disclose additional information voluntarily. The results show that board composition is positively associated to the level of voluntary disclosure in annual reports and find that independent directors provide more voluntary disclosure of forward looking information and strategic information.

In the context of two-tier board systems, two studies have provided evidence of a positive relationship between board independence and corporate disclosure. First, Cerbioni and Parbonetti (2007) examine the relationship between governance variables and voluntary intellectual capital disclosure in a sample of 54 European biotechnology firms. Their results reveal that the proportion of independent directors is positively associated with the disclosure of information about intellectual capital. Second, Patelli and Prencipe (2007) examine a sample of 172 non-financial Italian firms and find that the proportion of independent directors is positively related to the amount of corporate voluntary disclosure. Accordingly, it is hypothesized that:

H_3: *The higher the proportion of independent directors on the corporate board of listed companies in China, the greater is the extent of related-party disclosure by those companies.*

Second, in relation to supervisors' qualifications and experience, it is required in China's two-tier board structure that the supervisory board has responsibilities and duties to oversee the corporate board of directors and senior managements' performance and protect the companies' and stakeholders' rights and interests. In particular, under *The Company Law* the supervisory board has power to investigate their company's operating status without interference and report directly to securities regulatory authorities and other related authorities. Dahya et al. (2002) study a sample of 16 listed Chinese firms, and find the effectiveness of supervisory board is limited because of the transitional nature of the Chinese economy. They suggest that there is a need for future political reform, revision of corporate law and professionalization of supervisors. According to the requirements of the CSRC, a Supervisory Board Report is to be published each year. Dahya et al. (2003) examine the supervisory board's reporting process and users' perceptions of the usefulness of the report. They find that the absence of the supervisory board report in a sample of firm's annual reports is associated with a negative market reaction, and conclude that both the supervisory board report and the quality of the supervisory board are considered important by investors.

Xiao et al. (2004) argue that the role of the supervisory board depends on several key characteristics of the supervisors, such as the proportion of supervisors who are insiders and shareholders, and their professional knowledge or work experience. In terms of this latter point, the professional knowledge and experience of supervisors would be prerequisite to an ability to identify and advocate what should be disclose in the area of related-party relationships and transactions. Accordingly, it is hypothesized that:

H_4: *The higher the proportion of members with professional knowledge or work experience on the supervisory board of listed companies in China, the greater is the extent of related-party disclosure by those companies.*

A prior study by Dahya et al. (2003) of a qualitative research nature concerning the behaviour of supervisory boards in China raises research questions that go beyond the empirical analysis in this study. However, this study is briefly summarized here because it provides a perspective that can help interpret the results obtained under H_4 in this study. Dahya et al. (2003) undertake interviews of supervisory board members to gain deeper insights into the functioning of these boards in China. They identify four types of behavioural roles that supervisory boards can fall into, depending on the capacity and independence of their supervisor members In their study, Dahya et al. (2003) labels supervisory boards as developing one of the following types of roles: (1) an honoured guest; (2) a friendly advisor; (3) a censored watchdog; and (4) an independent watchdog. They argue that if the supervisory board adopts the role of honoured guest, friendly advisor or censored watchdog, its annual Supervisory Board Report is unlikely to provide useful information to minority shareholders and investors. Only supervisory boards that fulfill the role of "independent watchdog" will illicit greater corporate disclosure of relevance to minority shareholders and other investors. By inference, to fulfill the role of "independent watchdog", the supervisory board members will require the necessary capacity in terms of the knowledge and experience of members to act with independence and expertise.

4. Research Methodology

4.1 Empirical Schema

The hypothesized relationships between the variables in this study are depicted in Figure 1. The theoretical perspectives underlying the relationships are agency theory of the ownership structure and the board composition.

4.2 Sample and Data

This study focuses on A-share firms. In order to test the effect of foreign investors (hypothesis H_2) the sample of companies is classified into two groups: A-share and AB-share firms. A-share firms are the firms that issued A-shares only and are listed on domestic China stock exchanges. AB-share firms are those that issue both A-shares[29] and B-shares[30] with an initial A-share offering. They are also listed on domestic China stock exchanges. A sample size of 88 firms was selected from the currently listed firms in China's Shanghai SSE180[31] and Shenzhen SSE100[32] over the period 2001-2005 by using a stratified sampling method. As shown in Figure 2, 40 companies [33] were randomly selected from the AB-share group, and 48 companies[34] were randomly selected from the A-share group.

A total of 406 annual reports were derived from official websites of CSRC, Shanghai Stock Exchange (SHSE) and Shenzhen Stock Exchange (SZSE) over the five-year period from 2001 to 2005, and resulted in 406 observations. This study uses content analysis to count the extent of related-party disclosure using the number of relevant words in firms' annual reports. Consistent with the study of Brown and Deegan (1998), the words and numbers that are counted as equivalent to words, are summed to provide a measure of the extent of disclosure.

4.3 Model Development and Variable Measurement

The regression models to be empirically investigated in this study are stated as follows:

$$RPD_{i,t} = \alpha + \beta_1 POSTCODE_{i,t} + \varepsilon_{i,t} \qquad \dots(1)$$

$$RPDI_{i,t} = \alpha + \beta_1 TOP10_{i,t} + \beta_2 FS_{i,t} + \beta_3 INDP_{i,t} + \beta_4 SB_{i,t} + \beta_5 FSIZE_{i,t} + \beta_6 AGE_{i,t} + \beta_7 BIG4 + \varepsilon_{i,t} \qquad \dots(2)$$

This study comprises three categories of variables: two dependent variables, five independent variables, and three control variables. The definition and measurement of each variable is listed in Table 1.

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29 A-shares are common stock issued by mainland China firms, subscribed and traded in RMB, listed on mainland stock exchanges, and reserved for trading by Chinese citizens. The A-share market was launched in 1990.

30 B-shares are issued by mainland China firms, traded in foreign currencies, and listed on mainland stock exchanges. The B-share market was launched in 1992 and was restricted to foreign investors before 19 February 2001.

31 Shanghai SSE180 Index is created by restructuring and renaming SSE30 Index. It selects constituents with best representation through scientific and objective method. SSE is a benchmark index reflecting Shanghai market and serving as a performance benchmark for investment and a basis for financial innovation.

32 Shenzhen SSE100 is a benchmark index reflecting Shenzhen market and serving as a performance benchmark for investment and a basis for financial innovation.

33 These samples are random selected from those A-share firms also listed as B-shares.

34 These samples are random selected from A-share firms listed in Shanghai SSE180 and Shenzhen SSE100 after removing those dual listed firms (AB-share firms).

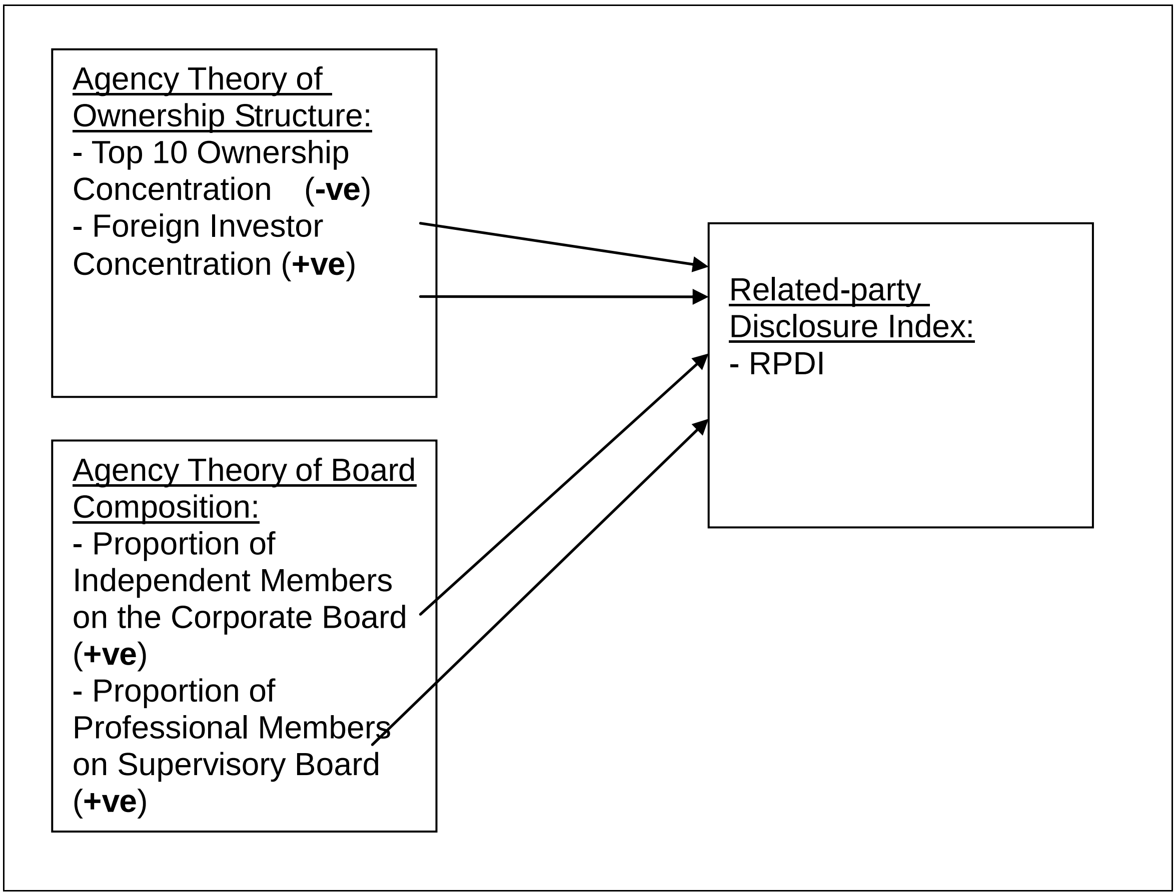

Figure 1. Empirical Schema

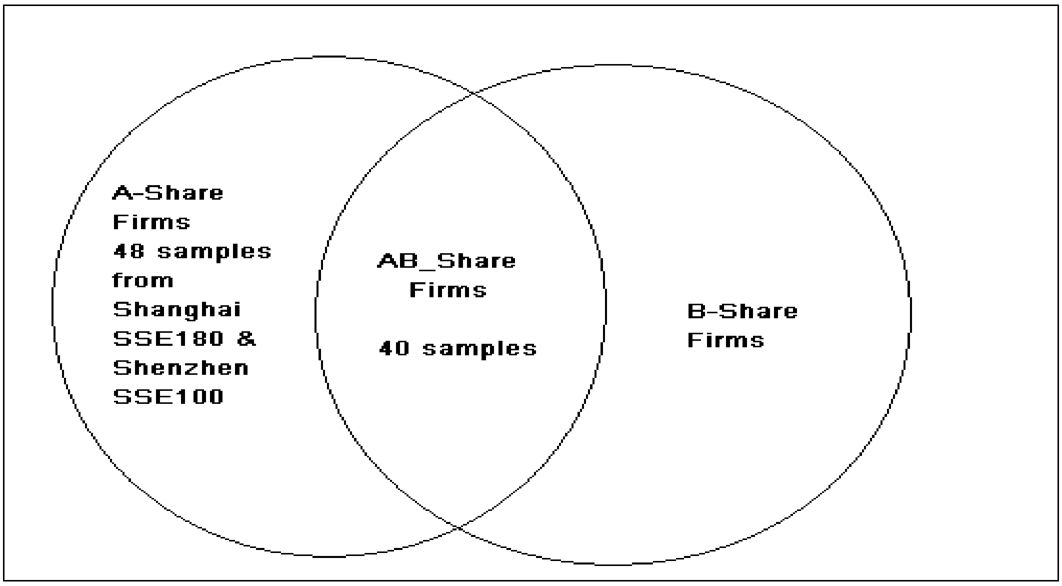

Figure 2. Sampling Frame

Table 1. Definition and Measurement Variables

Variable Acronym	Definition	Expected Sign to DVs	Measurement
Dependent Variables:			
RPD	Related-party disclosure - the absolute quantity of disclosure related-party	N/A	Number of words relevant to related-party transactions and relationships disclosed in the annual report by firms
RPDI	The related-party disclosure index - the relative quantity of disclosure	N/A	$RPDI_{i,t} = \frac{\sum d_{i,t}}{\mu_t}$ where, related-party $\sum d$ = total number of words disclosed; μ = mean of number of words disclosed in sample i = a sampled company t = a year
Independent variables:			
POSTCODE	Pre- and post-introduction of *The Code*		Coded as 1 for post-introduction of *The Code* in January 2002, otherwise 0
TOP10	Concentration of ownership by the top 10 shareholders	-ve	Number of shares held by top 10 shareholders divided by number of total shares
FS	Concentration of foreign investor ownership held by top 10 shareholders	+ve	Number of shares held by foreign investors in top 10 dividend by number of total shares held by top 10
INDP	The ratio of independent directors in the corporate board	+ve	Number of independent directors on the corporate board divided by number of directors in the corporate board
SB	The ratio of members with professional knowledge or work experience in supervisory board	+ve	Number of members with professional knowledge or work experience in SB divided by number of members in SB
Control Variables:			
FSIZE	Firm size	+ve	Natural logarithm of book value of total assets at the end of year
AGE	Firm age	+ve	Years of list
BIG4	Big 4 auditors	+ve	Coded 1 if the firm is audited by a Big 4 auditor, otherwise 0

5. Results

5.1 Descriptive Statistics

Descriptive statistics in Table 2 give a profile on corporate governance characteristics of listed A-share companies in China. First, it shows the mean ownership concentration (i.e., TOP10) is 58.87%, with a range of 21.45% to 85.59%. This is consistent with prior evidence by Xu and Wang (1999) and Deng and Wang (2006) that ownership concentration is very high in listed companies in China. Deng and Wang (2006) argue that China has a current potential for overwhelming dominance by the larger shareholders in listed firms. Second, in terms of board composition, the mean proportion of independent directors (i.e., INDP) is 26.88%, with a range of 0% to 50%. Figure 3(b) shows that appointing independent directors was rare before the year 2002. However, the CSRC issued guidelines in August 2001 about the proportion of independent directors. It required at least one-third of the directors to be independent, effective from 2003. As observed in Figure 3(b), rapid growth in INDP occurred between 2001 and 2003, whereas growth in INDP slowed between 2003 and 2005. Third, the mean proportion of supervisory board members with professional knowledge or experience (i.e., SB), as shown in Table 2, is 38.26%, with a range of 0% to 80%. The trend line in Figure 3(c) depicts a gradual growth in SB during the period 2001 to 2005. Such proportionate growth may have been induced by the issue of *The Code* by the CSRC in 2002, which states "supervisors shall have professional knowledge or work experience in such areas as law and accounting" (Ch 4, Sec 2, Para 64). Fourth, the mean concentration of foreign owners in the top 10 company shareholders (i.e., FS) is only 4.19%, with a range of 0% to 31.04%. Figure 3(d) shows that the percentage of foreigner shares in top 10 shareholders have been declined since 2002. Larger foreign investors appear to have lost confidence due to the bearish Chinese securities market between 2002 and 2005.

Table 2. Descriptive Statistics for Variables

Variables	Mean	Median	Min	Max	Standard Deviation
Sample:	2001-2005		Observations:	406	
RPDI	1.0616	0.9420	0.0643	4.0621	0.6507
TOP10	0.5887	0.5944	0.2145	0.8559	0.1294
FS	0.0419	0.0069	0.0000	0.3104	0.0734
INDP	0.2688	0.3333	0.0000	0.5000	0.1296
SB	0.3826	0.3875	0.0000	0.8000	0.1800
FSIZE	21.7330	21.7275	19.4861	27.0773	0.9532
AGE	8.0394	9.0000	1.0000	15.0000	3.4589

5.2. Movement in the Disclosure Index

The first objective of the study, to identify the extent of and movement in related-party disclosure, is addressed in this section. Table 2 gives descriptive statistics for the related-party disclosure index (RPDI). There is a wide range of relative quantity of disclosure among the 88 sample firms over the period 2001-2005, as indicated by the RPDI range of 0.0643 to 4.0621.

The result in Table 3 shows that the extent of related-party disclosure is positively associated with the years of post-introduction of *The Code*. This result indicates that the relative comprehensiveness of disclosure has sustained a significant increase over the years following the introduction of the guidelines for related-party disclosure in *The Code*. Further support for the upward movement in the annual RPDI can be observed in Figure 3(a). It shows annual RPDI for the period 2001 to 2005 to be 1.00, 1.22, 1.21, 1.31 and 1.36, respectively. The greatest annual increment (22%) occurs between 2001 and 2002, and this increase is sustained over the 4-year post-Code period from 2002 to 2005.

These findings establish that the CSRC's strategy of issuing guidelines as soft corporate disclosure directives, rather than legally enforceable mandatory disclosure requirements, has been effective in increasing the extent of corporate disclosure in a sensitive area. The area is sensitive because is concerns information about transactions that transfer resources, services or obligations between the reporting company and directors, key executives and large shareholders, especially including governments. Other than the introduction of The Code, the regulatory environment affecting related-party disclosures in China did not change during the period of 2001 to 2005. The relevant accounting standard, ASBE36 'Disclosure of Related Party Relationships and Transactions' was issued by the Ministry of Finance with an operative date from 1 January 1997 and was not revised through to 2005. ASBE36 is based on IAS24 'Related Party Disclosures' issued by the International Accounting Standards Committee in 1986. Since then, the only revisions to IAS24 became operative after 2005.

Table 3. Simple Regression Analysis

Dependent variable:	RPD			
Sample:	2001 – 2005			
Cross-sections:	88	Panel obsv:	406	
Adjusted R^2:	0.61	R^2:	0.70	
F significance:	0.000	F-statistic:	8.24	
Independent variables:	Expected sign	Standardized coefficient	Standard error	t-statistic
Constant		1973.2950	133.8001	14.7481***
POSTCODE	+	907.8142	148.2553	6.1233***

**significant at 5% level; ***significant at 1% level

5.3. Multivariate Analysis and Hypothesis Testing

Generalized least squares (GLS) fixed effects techniques are used for testing in this study. A panel regression model (see equation 2) was estimated using two ownership structure variables, two board governance variables and three control variables as independent variables. The possible existence of multicollinearity was tested. Gujarati (2003) argues that correlations between the independent variables should not be deemed harmful for multivariate analysis unless they exceed 0.8. As shown in Table 4, there are no correlations between independent variables that reach this level. However, a certain degree of multicollinearity can still exist even when none of the bivariate correlation coefficients is very large. The reason is one independent variable may have a linear function with a set of several independent variables (Gujarati 2003). Hence, multicollinearity is also tested by the Variance Inflation Factor (VIF[35]). The result, not reported in a table, is that the largest VIF is 1.46 and the VIFs of all other independent variables are below 1.34. Thus, there is no serious multicollinearity presence in the regression model.

[35] The critical value of the VIF to test for multicollinearity is 10. Gujarati (2003) argues that there is no evidence of multicollinearity unless the VIF of a variable exceeds 10. All values used in this study were well below this critical figure.

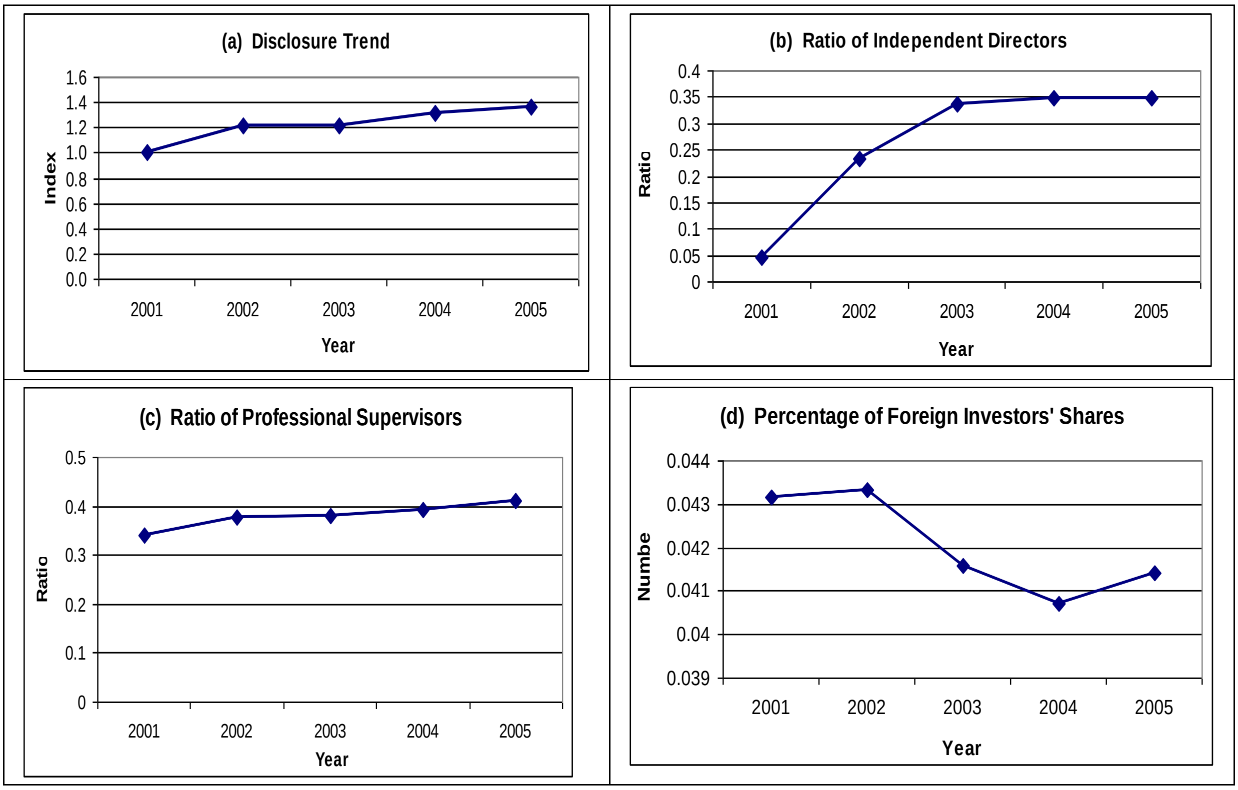

Figure 3. Trends for Variable Means between 2001 and 2005

Table 4. Correlation Matrix

	RPDI	TOP10	SB	INDP	FSIZE	AGE	BIG4	FS
PRDI	1.000							
TOP10	-0.050	1.000						
SB	-0.053	0.100**	1.000					
INDP	-0.063	0.004	0.094	1.000				
FSIZE	0.096	-0.184***	0.016	0.142***	1.000			
AGE	0.143***	-0.397***	0.036	0.215***	-0.032	1.000		
BIG4	-0.095	-0.077	0.151***	-0.032	0.157***	0.151***	1.000	
FS	-0.130***	0.092	-0.074	-0.001	-0.002	0.148***	0.100**	1.000

**significant at 5% level; ***significant at 1% level

Table 5 provides the panel regression results to test the four hypotheses. It reveals a high adjusted R^2 of 0.70, indicating that a high percentage of the variation in the disclosure index can be explained by variation in the chosen set of independent variables.

The results in Table 5 are now discussed in terms of each of the four hypotheses established in this study. The first hypothesis states that a higher level of ownership concentration is associated with a lower level of related-party disclosure. This negative effect on disclosure is deemed to arise from the agency conflict between outsider investors and controlling shareholders (Shleifer and Vishny 1997). The measured degree of ownership concentration is assumed to reflect the distribution of power within in a firm. The results in Table 5 show that there is a negative relationship between the related-party disclosure index and ownership concentration, which is consistent with agency theory and the findings of Ruland et al. (1990), McKinnon and Dalimunthe (1993), Berglof and Pajuste (2005), Barako et al. (2006) and Celik et al. (2006). Thus, the first hypothesis is supported.

The second hypothesis states that a greater percentage of shares held by foreign investors is associated with a higher level of related-party disclosure. The expectation is that, in China, companies whose management seeks to attract foreign equity will increase corporate disclosure to meet the demands of foreign investors. The result in Table 5 is not significant and, therefore, H_2 is not supported. Such a result is inconsistent with the findings of Xiao et al. (2004), Haniffa and Cooke (2005) and Firth et al. (2007). This non-significant result may be an artifact of the sample in this study because sampled companies that have dominant foreign shareholders were mostly established before 1997 as AB-share companies. Due to their longevity, they will have relatively steady market power and, unlike newly listed companies, they do not need to provide higher quality financial disclosures in order to attract foreign investors (Firth et al., 2007).

Table 5. Panel Regression Results

Dependent variable:	Related-party Disclosure Index - RPDI			
Sample:	2001 – 2005			
.Cross-sections:	88	Panel obsv:	406	
Adjusted R^2:	0.70	R^2:	0.77	
F significance:	0.000	F-statistic:	10.57	
Independent variables:	**Expected sign**	**Standardized coefficient**	**Standard error**	**t-statistic**
Constant		-2.2215	1.4925	-1.4885
Overall ownership concentration - TOP10	-	-0.3222	0.1515	-2.1272**
Foreign ownership concentration – FS	+	-0.0858	0.5589	-0.1535
Proportion of independent directors on the Corporate Board – INDP	+	0.3253	0.0875	3.7164***
Proportion of qualified and experienced supervisors on the Supervisory Board – SB	+	-0.4919	0.1985	-2.4785**
Firm size – FSIZE	+	0.1578	0.0542	2.9107***
Age of the company since listed - AGE	+	0.0187	0.0434	0.4309
Whether the principal auditor is a big-4 audit firm - BIG4	+	-0.0107	0.0408	-0.2623

**significant at 5% level; ***significant at 1% level

The third hypothesis states that the extent of related-party disclosure will be greater, the higher the proportion of independent directors on the corporate board. The result in Table 5 shows that there is a positive relationship between RPDI and the independent director ratio and thus, H_3 is accepted. This result is consistent with studies of Chen and Jaggi (2000), Cerbioni and Parbonetti (2007), Lim et al. (2007), and Patelli and Prencipe (2007). It adds weight to the agency argument of Fama and Jensen (1983) that independent directors are motivated to work in the best interests of shareholders in order to maintain their good personal reputation, and supports Chen and Jaggi's (2000) findings that independent directors will improve corporate disclosure even in countries that have less incentives for transparency.

The fourth hypothesis states that the extent of related-party disclosure will be greater, the higher the proportion of supervisory board members with relevant professional knowledge or work experience. The argument is that the supervisory board will require high professionalism from its members to effectively carry out its role of overseeing the performance of the corporate board and management and protecting stakeholders' rights and interests (Dahya et al., 2002). Higher expertise enables the supervisory board to identify and advocate what should be disclosed in the area of related-party transactions. However, the result in Table 5 is unexpected. It shows a significant relationship between RPDI and supervisory qualifications and experience (SB), but this relationship is in the opposite direction to that hypothesized by H_4. How can the evidence be explained that more highly qualified and experienced supervisory boards are associated with lower corporate disclosure of related-party transactions and relationships? It can be speculated that supervisory boards of listed companies in China have tended to become "censored watchdogs" in the words of Dahya et al. (2003) during a period when rapid corporate expansion and the dominance of the corporate board has occurred. In a prior study that interviewed those supervisory board members who worked full-time for the listed company or its linked entity in China, Xiao et al. (2004) concluded that it is no surprise when an 'insider' supervisor is asked about the work of the supervisory board that a typical response is: "You sometimes have to open one eye and close the other" (p.47). If "censorship watchdog" is the role of the supervisory board, then perhaps a phenomenon occurring is that the more qualified are the supervisory board members, the more internal effort is made to censor their review work in areas like related-party disclosures which could be information sensitive to corporate board directors an major shareholders.

6. Conclusion and Implication

Related-party transactions and relationships between listed companies and their directors, managers and major shareholders are important information for minority shareholders and other stakeholders in monitoring if their interests are being protected. The extent of, and influences on, related-party disclosures by listed companies in China are investigated in this study. The context of an evolving securities market, a high concentration of government-linked ownership of companies, and a two-tier board system makes this investigation an interesting corporate governance research study.

The purpose of this study has been to first identify whether the CSRC's non-enforceable guidelines on related-party disclosures in its 2002 code of corporate governance has been effective in sustaining an increase in the comprehensiveness of related-party disclosure by listed companies over the period of 2001 to 2005. The descriptive findings, based on a sample of 88 A- and AB-share companies over this 5-year period, revealed a significant increase in the comprehensiveness of disclosures post the introduction of *The Code* in January 2002. While this result revealed that the introduction of government-released guidelines has had a positive impact of related-party disclosures, it does not answer the question of how such disclosure decisions of companies are affected by corporate governance characteristics. To this end, hypotheses are developed and tested using panel regression analysis. Both ownership concentration and the proportion of independent directors on the corporate board are found to have a positive impact on the extent of related-party disclosure. These results are consistent with Western-developed hypotheses and findings.

However, the credentials of members of the supervisory board, in terms of their qualifications and experience, are found to have an unexpected negative effect on related-party disclosures. In order to interpret this result, current literature on supervisory boards in China is reviewed, and also biographies of supervisory board members in the sampled companies are perused. Dahya et al. (2003) perceived many supervisory boards in China as a "censored watchdog" due to the dominant role of corporate board directors and senior managers. Furthermore, the investigation of biographies revealed that almost all of supervisors are insiders rather than outsiders. They either work directly for the firm or have close connections with the firm, its parent firm or its subsidiaries. In such circumstances, they would lack independence and may be subjected to internal forms of censorship from the corporate board, especially if they are potentially able to report in a more critical way about the corporate board's performance because they are more highly qualified and experienced.

The implication arising from this study is that moves by the CSRC to require improved qualifications and experience of members on supervisory boards of listed companies is not sufficient to ensure that these boards can properly fulfill their role of overseeing and publicly reporting on the performance of the corporate board and management, especially in the sensitive area of related-party transactions and relationships. Rather, there is a case to give some specific externally-derived authority to supervisory boards. Such externally-derived authority may emerge in the form of imminent revisions to the international accounting standard, IAS 24 *Related Party Disclosures*. In February 2007, the International Accounting Standards Board (IASB) published an Exposure Draft of proposed amendments to IAS 24 that addressed disclosure requirements for state-controlled entities when they transact with similar entities and also broaden the definition of a related party. The revised IAS 24 expects to be issued sometime during 2008. If these revisions are adopted in ASBE 36, the equivalent accounting standard in China, this can provide a strengthening of the source of external authority for supervisory boards with professionally qualified members to push for more comprehensive related-party disclosure by their company.

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