

Corporate Governance, Performance and Management Turnover: An Empirical Analysis of Chinese Listed Companies

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This paper provides an empirical analysis of corporate governance (CG) efficiencies among Chinese listed companies (CLCs) under different types of ownership. Employing the data of over 700 CLCs in 2006, this study looks specifically into the effects of separation of controlling and residual claim rights upon CG (specifically management turnover) and firm performance under different shareholding patterns. The results under two sample firms are different, suggesting that state-owned enterprises (SOEs) and non-SOEs are subject to dissimilar pressures for corporate performance and management changing. It suggests that owing to the separation of controlling rights and residual claim rights the agency problem between major shareholders and minority shareholders is more serious among non-SOEs.

Field of Research: Corporate Governance

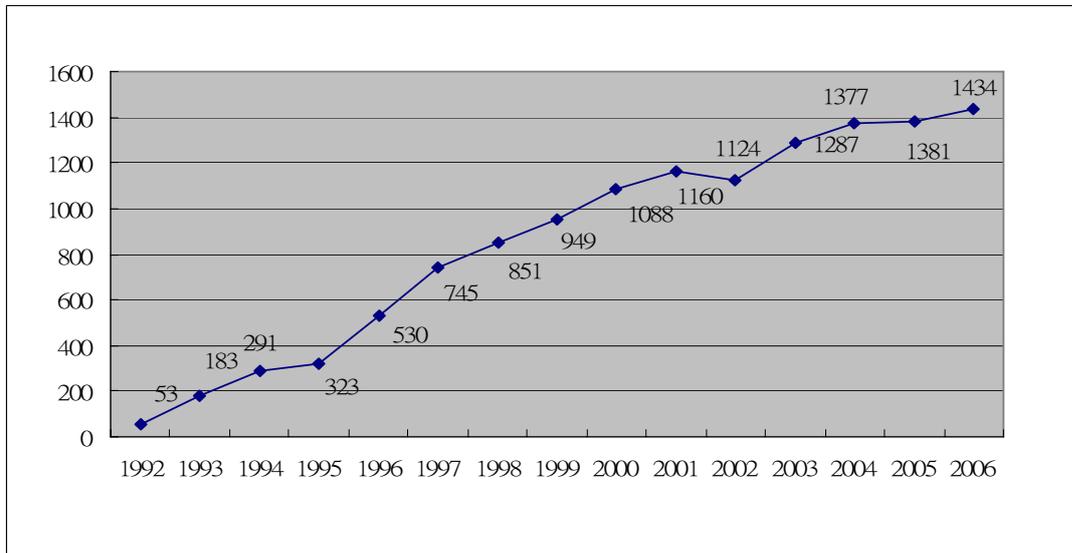
1. Introduction

The literature has generally recognized that the restructuring of State-owned enterprises (SOEs) was the key to the recent success of Chinese economy and Chinese SOEs have benefited considerably from public listing. The number of listed companies on the Shanghai Stock Exchange and the Shenzhen Stock Exchange has risen from 14 in 1991 when the stock market began to 1434 in 2006 (Figure 1). The total market capitalization reached to approximately RMB 8,940.4 billion (about US\$1224.7 billion) by the end of 2006. China's stock market has its uniqueness, including different forms of shares (e.g., A and B shares) owned by the state, legal-persons, employees and the general public. The non-tradable shares that mostly held by the state make up roughly two thirds of the listed companies' total shares. Only one third of equity shares of CLCs are traded predominately on the two domestic exchanges. The preservation of state-owned and legal-person shares was attributed to the government's long-term policy of maintaining state control over companies. Moreover, China's securities market is primarily made up of individual investors with a low level of individual holdings. Diffused shareholders are not well motivated to monitor management decisions. The non-state shareholders (mainly individuals) have very limited power or rights, and consequently it is state shareholders holding non-tradable shares actually control over the listed companies.

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Figure 1 The numbers of CLCs from 1992 - 2006

In China, the controlling shareholders of listed companies control the companies with different holding patterns. The largest shareholder of many listed companies is mostly the state represented by local finance bureaus and the Bureau of the State Asset Management. As state-owned capital dominates the stock market, most of these state-owned shares cannot be traded. Since state-owned shares are under control of the government, transfer of state-owned shares in private is strictly restricted. In this case, the appointment of management of SOEs is largely under the hands of the state authorities. This study aims to investigate corporate governance efficiencies among CLCs under different types of ownership. Employing the data of over 700 CLCs in 2006, this study looks specifically into the effects of separation of control and residual claim rights upon management turnover and firm performance.

2. Brief Literature Review

CG is an assurance to guarantee the interests of investors (Shleifer and Vishny, 1997) and it aims at promoting corporate fairness, transparency and accountability. Berkowitz et al. (2003) argue that CG is a must to the operation, management and sustainable development of modern companies. CG can indirectly affect the operating performance of a firm through influencing agency costs and organizational management efficiency. La Porta et al. (2002) argue that CG serves as an effective mechanism to protect investors' interests, to mitigate the agency problem between shareholders and management or between block shareholders and minority shareholders and to improve corporate performance. Also, they argue that under different ownership structures, the effectiveness of CG may differ, resulting in diverse corporate performance. This is partially because the separation of control and residual claim rights changes the control power and equity-holding of largest shareholders in a company.

The effects of a firm's ownership structure upon CG and performance have frequently been examined in the literature. Studies reveal that different means by which controlling shareholders hold the shares, which gives rise to the separation of

controlling and residual claims, could have important influences upon the effectiveness of CG and performance (e.g., La Porta et al., 2000; Claessens et al., 2002). Morck et al. (1988) discover a positive relationship between corporate ownership and the market value of the company when management ownership is between 0~5%, a negative and less pronounced relation in the range of 5% to 25%, and a further positive relation beyond 25%. Later, McConnell and Servaes (1990) carry out a study on ownership structure and corporate performance with similar approaches and they draw analogous conclusions. Cho (1998) finds that ownership structure affects investment and therefore corporate value. However, the empirical result of Demsetz and Lehn (1985) reveals no effect of a firm's ownership structure on its profitability. Most studies conclude that government controlled companies perform undesirably.

CG covers two interrelated perspectives: internal and external control mechanisms. The former is related to the board, management turnover and executive compensation, etc, whilst the latter associates with product market, market for corporate control, managerial market, auditor's monitoring and legal system. The board has long been taken as an important internal control mechanism (Fama and Jensen, 1983). Management turnover is a 'key variable' to understand the power to restrict management (Warner et al., 1988). Kaplan (1994) reveals that top executive turnover is negatively related to stock return and compensation levels. Warner et al. (1988), however, only find the negative correlation between top management change and stock returns. Fama (1980) argues that in the modern business world the restriction of managers is mainly through managerial market. The success or failure of a firm's operation reflects managers' ability in the managerial market. The CG system adopted by Chinese listed firms can be best described as a control-based model, in which the controlling shareholders (mostly the state) closely control over the listed firms through concentrated ownership and 'management friendly boards' (Liu, 2006). China's CG has recently received considerable attentions. A number of studies have attempted to investigate the impact of state ownership on CG (e.g., Cho, 1998; Tian, 2001; Bai et al., 2004). Most of the studies find a 'negative' role of state shares in CG.

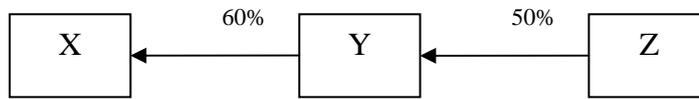
3. Methodology

Hypotheses

Under the separation of controlling and residual claim rights, the agency problem between controlling shareholders and minority shareholders is more serious. This agency problem is expected to negatively affect corporate performance. Thus this study hypothesizes the negative relationship between the separation of controlling and residual claim rights and firms' performance. It is defined in this study that the residual claim rights of controlling shareholders in listed companies equal to multiplication of ownership of all intermediate controlling firms in an ownership pyramid. Figure 2 provides a simple illustration. X is a company and Y is its largest shareholder, holding 60% ownership of X. Z is the largest shareholder of Y, which holds 50% ownership of Y. So the residual claim rights of Z in the listed company X are the multiplication of 50% and 60%, equalling to 30%. The more intermediate controlling firms are in the chain, the less residual claim rights the controlling shareholders have. To investigate the separation, the ratio of residual claim rights to

controlling rights is calculated. In this illustration, the ratio of residual claim rights to controlling rights of Z, the largest shareholder of X, is 30% over 60% (i.e., 0.5).

Figure 2 An illustration of residual claim and control rights



When a firm's performance is poor, its incompetent managers should be removed. Under the ownership pyramid, however, this can be difficult owing to the separation of controlling and residual claim rights in a company. As controlling shareholders have little ownership in the company, the improvement of firm performance cannot bring in major financial benefits to them and the removal of management therefore offers little incentive to these shareholders. Under poor management, it is rather easy for controlling shareholders to enhance their financial interests through other means instead of dividends and market value appreciation. Clearly, there is an interest conflict between controlling and other shareholders in considering approaches towards these inept managers. When controlling right is separated from residual claim right CG becomes vulnerable, to some extent, because when a firm's performance is poor, the firm cannot change its inept managers on time. In this study management turnover is used to denote the extent of management changes.

The earlier evidence shows that poor corporate performance is associated with top executives' turnover and there is an inverse relationship between the probability of a management change and a firm's performance (Denis and Denis, 1995; Kaplan, 1994). Ownership concentration influences management turnover and the efficiency of a company's performance. Concentrated ownership is expected to provide efficient management control, maximization of shareholders' interests and an availability of external sources for the company's financing (Shleifer and Vishny, 1997). This study also considers other relevant factors which might influence the corporate performance and management turnover, including managers' age, company size and borrowing. Those factors were often used in the literature as likely factors influencing corporate performance and management turnover. For example, the probability of management turnover grows and is very high among managers aged between 60 and 65 years. Jensen and Murphy (1990) confirm that the probability of management turnover on account of poor company performance increases among younger managers. Debt is another mechanism of management control, especially in companies with a dispersed ownership structure (Hart, 1995). The management-creditor relationship often leads to the moral hazard problem. Creditors' power to influence business decisions in the company arises from the fact that creditors may exercise their contractual rights when the company does not fulfil all of its responsibilities. Empirical studies confirm the significance of indebtedness as a variable that influences management turnover (Hotchkiss, 1995).

In summary, the following hypotheses are proposed:

H1 there is a relationship between the separation of controlling rights and residual claim rights of a firm and the firm's performance.

H2 there is a relationship between company size and corporate performance.

H3 there is a relationship between the level of borrowing and corporate performance.

- H4** there is a relationship between managers' age and corporate performance.
- H5** there is a relationship between management turnover of a firm and the level of separation of controlling rights and residual claim rights.
- H6** there is a relationship between company size and management turnover.
- H7** there is a relationship between the level of borrowing and management turnover.
- H8** there is a relationship between management turnover and managers' age.

Sample and Variables

Over 1300 CLCs in 2006 were initially chosen as the research sample. Finally, the sample excludes financial services companies, as they are subject to special capital requirements and the regulatory control. Also, firms that did not disclose the information of their ultimate shareholders were excluded. Overall 712 CLCs were included in the sample. Of 712 firms, 122 companies were not owned by the state (i.e., without state-owned and legal person shares). In this study *ROE* (Return on Equity) is used to approximate corporate performance. The ratio of residual claim rights to controlling rights (RCR) is used to represent the separation of controlling rights and residual claim rights. The smaller the ratio (RCR) is the higher level of separation of residual claim rights and controlling rights will be. Management turnover variable is a dummy variable, which takes the value 1 if a CEO is announced in 2006 to be replaced and 0 otherwise. The announcement by the company board of directors deems to be the change, instead of actual change. This is because there is a gap between the announcement of change and the actual replacement. The latter is subject to various factors including the time needed to find a new CEO. Multiple changes during the year are accounted as one change. Managers' age is measured by the age of CEOs in 2006. The other two variables company size and level of borrowing are defined and measured in conventional accounting terms.

4. Empirical Results

Table 1 shows the coefficient of the separation of controlling and residual claim rights (RCR) is not statistically significant to corporate performance. This suggests that the separation has no or little effect on firm performance. 83% of the firms in the sample are SOEs. For most SOEs the separation is not very high as over 75% of SOEs have the value of RCR equalling to 1. There is a possibility that the large proportion of SOEs in the sample whose controlling rights is not separated from residual claim rights has influenced the test result. For that reason, the effect of separation of residual claim rights and controlling rights on firm performance of non-SOE companies is also investigated. In the non-SOE case as shown in Table 1, the coefficient of the separation is -0.7671, significantly at 5%. The overall result could suggest that owing to the separation of controlling rights and residual claim rights the agency problem between major shareholders and minority shareholders is more serious among non-SOEs.

Table 1 Empirical results – corporate performance

<i>Variables</i>	All firms sample		Non-SOEs sample	
	Coefficient	P Value	Coefficient	P Value
Intercept	19.7007 ^{***}	(0.000)	26.5504 ^{***}	(0.000)
RCR	-0.1321	(0.392)	-0.7671 ^{**}	(0.030)
SIZE	-0.8293 ^{***}	(0.000)	-1.1999 ^{***}	(0.001)
LEV	0.5994 ^{***}	(0.001)	0.5919	(0.172)
AOM	0.0469 ^{***}	(0.000)	0.0578	(0.163)
Observation	712		122	
Adj-R ²	0.4228		0.4991	

Note: ^{***}, ^{**} and ^{*} denote significance at 1%, 5% and 10% level.

The result shows that firm size is negatively related with firms' performance, indicating that the larger the firm the worse the performance. The result also reveals the coefficient of debt level (LEV) is significantly positive, suggesting that when firms have more debt there is high pressure on managers for better performance. The test result shows that the coefficient of managers' age (AOM) is 0.0271, which is statistically significant at 1%. This might indicate that older managers intend to produce better corporate performance than young-aged managers. Interestingly, under non-SOEs sample, there are no significant relations between both the level of borrowing and age of managers and firm performance.

Table 2 shows the test results of the factors influencing management turnover. It reveals that the coefficient of interaction of a firm's performance measure, which was measured by ROE and RCR, is -3.5356, significantly at 1%. H5 is supported. The result suggests that when the performance of a firm is poor, a firm with a higher separation of controlling and residual claim right will be less likely to change managers. This implies that the separation weakens the negative relationship between manager turnover and firm performance. Indeed, when controlling shareholders have little ownership in the firm, they have less incentive to remove the managers. Because of owning major controlling rights of a firm, the controlling shareholders can easily utilize firm assets to make profit for themselves (e.g., using firm assets to back low-rate borrowing). Weak management may provide a better opportunity for the controlling shareholders to benefit themselves. The level of borrowing on managers' turnover is also tested, revealing significantly positive coefficient of debt (LEV). This may imply that when firms have more debt the possibility of managers' turnover will increase. This finding is largely confirmed with the previous studies.

The results of non-SOEs sample are comparatively the same as for the all firms sample as shown in Table 2, except for the variable of ROE. Under non-SOEs case, there is a positive relationship between the management turnover and corporate performance, as suggested by the coefficient of 0.812, statistically significant at 5%. This result confirms the prior findings in the literature. However, there is a different picture under all samples; suggesting poor corporate performance is not a significant factor driving management changing, particularly for SOEs. This study also considers the managers' age as a variable. The result shows that the coefficients of managers' age (AOM) are 0.0271 and 0.0185, which are statistically significant at 1% and 10% respectively under two samples. This might indicate that older managers are more

likely to be changed than young ones. This result is different from the previous findings by among others, Jensen and Murphy (1990). The reason for this is due to China's policy of lowering top managers' age. Chinese authorities set up various ceilings of age for different levels of managers including corporate executives. The managers with an age approaching to the ceilings are more likely to require leave the job than younger managers. Corporate performance is largely used as an indicator to change old managers with young ones. No evidence has been found as to the influence of company size on the management turnover.

Table 2 Empirical results – management turnover

<i>Variables</i>	All firms sample		Non-SOEs sample	
	Coefficient	P Value	Coefficient	P Value
Intercept	0.5305	(0.789)	0.8334	(0.332)
RCR	-0.8438	(0.870)	-0.531	(0.548)
ROE	0.7031	(0.217)	0.812**	(0.007)
ROE×RCR	-3.5356***	(0.001)	-4.4872***	(0.003)
SIZE	-0.1044	(0.275)	-0.1374	(0.479)
LEV	0.6151**	(0.043)	0.7315***	(0.004)
AOM	0.0271***	(0.007)	0.0185*	(0.098)
Observation	712		122	
Adj-R ²	0.0679		0.1134	

Note: ***, ** and * denote significance at 1%, 5% and 10% level.

5. Conclusions

This study analyses CG efficiencies among CLCs under state-owned and non-state-owned listed firms. The results under two sample firms are different, suggesting that SOEs and non-SOEs are subject to different pressures for corporate performance and management changing. It suggests that owing to the separation of controlling rights and residual claim rights the agency problem between controlling shareholders and minority shareholders is more serious among non-SOEs. This study contributes to extant literature. Firstly, it takes the holding pattern as the key variable of ownership structure to investigate the effect upon CG and corporate performance of CLCs, which has rarely been studied in the literature. Secondly, this study separates non-SOEs from SOEs with a view to revealing the difference of results due to unlike ownership patterns under two types of firms. This study also has its limitations. The study only considers the data of one year, which can limit the generalization of results. Also, this study uses accounting rate of return as measure of corporate performance; the limitation of this measure is widely recognized. Moreover, this study considers management as the CEO, exclusive of the influences of other top levels of management either as a collective (e.g., boards of directors) or individual (e.g., key board of directors, and the communist part secretary). In China, the communist party plays significant role in corporate affairs, including the appointment/sacking of top managers of SOEs. The future research should expect to overcome the limitations.

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