

The Audit Committee as an Additional Mechanism of
Corporate Governance in China

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Accounting and Finance

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Abstract

The University of Manchester

Pao-Chen Lee

The Degree of Doctor of Philosophy in the Faculty of Humanities

Thesis Title: The Audit Committee as an Additional Mechanism of Corporate Governance in China

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As the title suggests, this thesis focuses on the issues arising from the establishment of audit committees in listed companies in China, which hitherto have been adopted by companies on a voluntary basis alongside the pre-existing structure of supervisory boards, rather than as a mandatory requirement. Regarding this unique practice in China, this thesis attempts to address three research objectives:

1. To understand the effectiveness of supervisory boards (SBs) and audit committees (ACs) in China
2. To understand how the operations of SBs and ACs improve the effectiveness of supervisory governance functions in China.
3. To understand the co-ordination between SBs and ACs in organisations

The first objective is investigated by applying quantitative methods of ordinary least squares (OLS) regression and analysis of panel data. It is discovered that the companies with audit committees have more effective supervisory functions when compared to those without audit committees. The second objective was pursued by applying qualitative methods in the form of two case studies constructed using interviews and surveys conducted both via telephone and in face-to-face interviews. It is found that in both the case studies audit committees were established with the expectation of enhancing the effectiveness of the companies' supervisory functions. Furthermore, the face-to-face interview survey of five listed companies reveals that companies with audit committees in China still face issues of overlapping and missing supervisory functions between supervisory boards and audit committees. Thus the third research objective, regarding the co-ordination between the supervisory board and the audit committee in the organisation to find solutions to this very problem, is particularly relevant for corporate governance in China. This objective is investigated by interviewing two governors and conducting telephone surveys. The results highlight that there is the general expectation that these structures should be co-ordinated as one unit. There is also a demand to establish an independent control system to strengthen oversight functions, to reduce oversight costs, and to ensure the independence of the supervisors and audit committee members in order that they can execute oversight tasks, and to empower them against the executive directors and senior managers by promoting their status in the organisation.

Declaration

No portion of the work referred to in the thesis has been submitted in support of an application for another degree or qualification of this or any other university or other institute of learning.

Signed..... *Lee, Pao-Chen*

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Dedication

I humbly dedicate this thesis to our divine and eternal Heavenly Father, the Lord Jesus Christ and the Holy Spirit whose grace has guided and inspired me during my study at Manchester.

As it is written:

“God may count you worthy of his calling, and that by his power he may fulfil every good purpose of yours and every act prompted by your faith. We pray this so that the name of our Lord Jesus may be glorified in you and you in him, according to the grace of our God and the Lord Jesus Christ.”

(2 Thessalonians 1:11-12)

And

Dedicated with all my love and respect to:

THE MEMORY OF MY FATHER, HSIN-DOW LEE;

To

My beloved mother, Mi-Tao Hong,

Who always pray for my fulfilling God's will;

To

My dearest husband, Teh-Yung Frank Yang,

Who has been so understanding and patience throughout the period of my study at the University of Manchester;

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Manchester Chinese Christian Church

Who have helped me in many memorable ways.

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The Author

I received my Bachelor's degree in Accounting from Min Chuan University, Taipei, Taiwan in 1990 and my Master's degree in Accounting from Oklahoma University, USA, in 1994. After graduation, and since 1994, I worked for foreign and Chinese banks in Taiwan, such as Citibank, Standard Chartered Bank, and Tai-shin Bank. I left my job after being admitted to the PhD programme at the University of Manchester in 2006. My previous career and main responsibilities involved leading and managing the Auditing Department as well as sitting in the AC as required under the Sarbanes Oxley Act.

While in Taiwan, I also worked as a part-time teacher of accounting: I have a keen interest and strong desire to become an accounting educator later in life. I have thus accumulated practical and valuable experience in my part-time career as a lecturer at the National Open University, Taiwan, from January 1994 to June 2006, and as a lecturer at the Taiwan Academy of Banking and Financing from January 2001 to December 2005.

Regarding my research experience and academic activity as a PhD candidate, I submitted a paper entitled "The Development of Supervisory Mechanisms of CG in the West and China" to the Journal of Management and Governance for publication in 2008. Another paper, entitled "The Effectiveness of SBs in China", was presented to the ESRC seminar in Oriel College, Oxford University, and was accepted for inclusion into the volume on the conference proceedings in 2009. A third paper I wrote, on "The Contribution of AC in Improving Internal Auditing in China", was presented at the China Postgraduate Network Conference 2009 in Manchester University. Before my PhD research, several publishing houses in Taiwan published my books. Amongst these are "Basic Accounting", published by the CTS Publishing as the standard textbook for the Supplementary Junior College of the National Open University, and "Internal Control System", published by the TABF Publishing as a book for students preparing to undertake the licensing examination for internal control of financial institutions and for training of accounting personnel. Both of these publications have contributed immensely to the development and improvement of Taiwan's financial institutions.

Pao-Chen Lee, as of Sep. 25, 2010

Chapter 1 Introduction

1.1 Introduction

This chapter highlights the internal supervisory mechanism as the focal point of the analysis of Corporate Governance (hereafter referred to as CG), and goes on to discuss China's adoption of its own form of Audit Committees in addition to Supervisory Boards (hereafter referred to as SB) based on voluntary choice to form a unique internal supervision mechanism in the country. It is an intriguing development within a non-Western environment, which spurred the motivation to conduct the present study at the beginning of this chapter and this thesis. The conclusion of this chapter highlights the thesis' structures for every chapter on this topic.

1.2 Research Motivation

The Audit Committee's (hereafter referred to as AC) role in CG has been one of the most significant monitoring themes of research. In the aspect of governance, CG seeks to establish a mechanism to maximise the corporate value of promoting what is beneficial, such as pursuing the maximum returns for stakeholders, shareholders, creditors and employees alike. In the aspect of monitoring, CG strives to create a mechanism to minimise the chances for what is harmful, such as reducing the possibility of fraudulent accounting practice (OECD, 1999; OECD, 2004a), such as in the case of Enron. The establishment of ACs has become a legal requirement, and directly exposed the responsibilities of management authorities to the possibility of facing public litigation.

- According to the Sarbanes-Oxley Act of 2002 Sec.2 (a) (3), the audit committee is a committee (or equivalent body) established by and among the board of directors of a listed company. The audit committee's purpose is to oversee the accounting and financial reporting processes of the issuers and to audit the financial statements of the listed company. If no audit committee exists within a listed company, the entire board of directors concurrently serves as audit committee members.
- As stipulated in the July 2003 Combined Code on Corporate Governance Sec.

C3.1, the board of directors of a listed company are required to establish an audit committee comprising at least three members, or in the case of a smaller company comprising two members, they are also both required to be independent non-executive directors. Additionally, the board of directors are required to see to it that at least one member of the audit committee has recent and relevant financial experience

Both Section 2(a) (3) of the US Sarbanes-Oxley Act of 2002 and Section C3.1 of the UK Combined Code on CG stipulate that an AC is required to be established by and among the BoD of a listed company. Establishing an AC is compulsory in both the US and UK, whereas China's Code of CG merely stipulates that the board of directors (hereafter referred to as BoD) of a listed company may establish an AC. In other words, establishing an AC is voluntary, not mandatory, in China.

However, the internal supervisory mechanism of CG is not compulsory in the "unique" process of some other countries too. National conditions determine whether these countries develop their own mechanisms of CG. The regulations of AC's forerunners, namely the US and UK, stipulate that establishing an AC is compulsory for every listed company (SOX, 2002; SOX, 2003; FRC, 2008; FRC, 2010). To the contrary, China's Securities and Exchange Commission's (SEC's) regulations for establishing the monitoring system of CG – ACs – states that establishing an AC is a voluntary choice, not a compulsory requirement. Accordingly, the dual systems of establishing a SB alone or SBs plus ACs may exist together at the same time. Thus, comparing Chinese regulations with those of the US and UK also raises the question of whether it is necessary to establish ACs in China. China's unique regulations prompted me towards this research through the empirical study surrounding the effectiveness, operations and co-ordination of the AC as an additional mechanism of CG in China.

- Section 52 of the Code of CG for Listed Companies in China stipulates that the board of directors of a listed company may establish a corporate strategy committee, an audit committee, a nomination committee, a remuneration and appraisal committee and other special committees in accordance with the resolutions of the shareholders' meetings. All committees shall be composed solely of directors. The audit, the nomination, the remuneration and appraisal

committees shall be chaired by an independent director and independent directors shall constitute the majority of the committees. At least one independent director from the audit committee should be a professional accountant.

These striking differences between the regulations in the West and in China suggest that the necessity of establishing ACs in China should be viewed as an educational issue. As has been mentioned, establishing an AC is not a must but merely a voluntary choice in China. The AC's structure was first developed in Western corporations; however, after being adopted in a non-Western environment, it has raised questions regarding its impact and appropriateness. Shareholders and creditors who invest their assets in a company may suffer losses if there are risks in the company (Spira and Page, 2003). Normally they are so-called third parties, who seek to safeguard their legitimate business interests by setting up and improving the mechanism of CG. Hence various international organisations and national CG have generally required, and in some cases proposed, the setting up of external and internal supervisory mechanisms.

In 2002, China started to enact CG. According to the Chinese "Code of Corporate Governance for Listed Companies", ACs may be established alongside the existing monitoring system of SBs at the same time. The regulations governing the establishment of ACs in listed companies in China have inspired in me the interest to conduct further research on this topic.

1.3 The Structure of This Thesis

The thesis is organised into seven chapters. After this introductory chapter, the remaining chapters cover the issues outlined below.

Chapter 2: Research Question

In 2002, China enacted its CG. According to China's "Code of Corporate Governance for Listed Companies", ACs may be established alongside the existing monitoring system of SBs. Thus in China, setting up an AC is not legally mandatory but a voluntary choice. Two groups of listed companies of SBs alone and SBs plus ACs co-

exist in China to form a special phenomenon of internal supervisory mechanisms, which are different from those practised internationally. Research questions are formulated through comparison of relevant components of the laws and regulations between SBs and ACs in China. Three key research objectives with five key questions and two sub-questions relating to the effectiveness, operations and co-ordination of two systems' listed companies of SBs alone and SBs plus ACs are defined for the purposes of this research.

Chapter 3: Research Theory and Literature Review

The effectiveness, operations and co-ordination of SBs and ACs may be explained distinctively by different theoretical perspectives. This thesis will apply two dominant theories of shareholder and stakeholder theories and the other four approaches by clarifying the relevant theories' influence to the current internal supervisory mechanism of CG, in order to justify the theories applied in this thesis.

Two dominant theories: First, the importance of AC's functions is highlighted by the assumptions of agency theory underpinned within the concept by a separation of ownership and control. Meanwhile, the concept of stakeholder theory expects SBs to take care not only of the interest of shareholders; but by expanding to the stakeholders. Both theories are key dominant to the assessment of reliability: by monitoring the tendencies of manipulation in financial reporting, internal control and auditing. Therefore, the operations and co-ordination by SBs and ACs in China will be explored by both theories in this thesis.

The other four approaches: Managerial hegemony theory forms a concept with which to study the effectiveness of supervisory functions. Political model theory and institutional ownership theory both lead this study to introduce the political and shareholding background: forming the chapter of "The Background" in this thesis. The resources dependence theory is employed to understand the roles of ACs played in China: in order to reveal whether the sub-committees of BoD – ACs – contribute to the companies in addition to exercising independent control.

Viewing ACs from a conceptual perspective, the setting up of ACs as newcomers in addition to SBs is assumed to improve the effectiveness and relevant characteristics of

supervisory functions, in order to advance the CG. It is therefore down to the review of the regulations and academic works of researches relating to ACs to identify the possible factors of dependent and independent variables for evaluation of the effectiveness, operations and co-ordination of the Chinese internal supervisory mechanism. Afterwards, the research hypothesis and variables for evaluating this effectiveness are selected and applied; the implementation processes associated with the operation are identified; and the dynamic relationships between ACs and SBs are defined as the attributes for assigning the research methods in this thesis.

Chapter 4: The Background

This chapter examines the development of supervisory mechanisms in CG in China. It shows how that development has involved the adoption of components of governance from differing governance models internationally, and considers whether the resulting combination of mechanisms is likely to be appropriate and effective in the Chinese context. In the next section of the chapter, the historical development of the “standard” CG model of the UK and the US is examined, in order to illustrate the development of the supervisory mechanism. The following section contrasts different CG models, to illustrate how each reflects particular contextual factors and problems, and discusses the principles of CG regarding supervision. The development of supervisory mechanisms of CG in China is then introduced and the problems in governance and supervision are analysed. In particular, an overview of the Chinese political environment relating to the development of supervisory mechanisms of CG and an overview of the relationship between the shareholding structure and internal supervisory mechanism in China are discussed as the background to the Chinese internal supervisory mechanism.

China’s internal supervisory structure involves a unique interaction between two mechanisms of ACs and SBs, and the function’s effectiveness, operations and co-ordination between these two governance elements represent important subjects for research. Therefore, the following chapter of research design and method to achieve three objectives of empirical studies are then introduced.

Chapter 5: Research Design and Methodology

This chapter employs applied research methods in order to achieve three key objectives, which in turn will provide the evidence to answer five key research questions and two sub-questions. This research examines three phases' empirical studies of the effectiveness, operations, and co-ordination of SBs and ACs in China by deploying both quantitative and qualitative methods.

Objective I: The effectiveness is explored by the quantitative method of t test and linear regression of Panel data model by Stata / SE 9.1. The p value of t test is appraised for evaluating which system is more effective of SBs alone or SBs plus ACs in China. Meanwhile the growth trend of the market response to earnings (PER) is observed to enhance the understanding of the effectiveness. The AC's contributions to the effectiveness in improving the characteristics of supervisory functions in China are explored by the linear regression of Panel data model via Stata / SE 9.1. Furthermore, the test results with significance are compared between two systems of SBs alone and SBs plus ACs in China: the better system being supplied with a better impact with significance after the comparison.

Objective II: The operations are explored by the qualitative method of interviewing the members of SBs and ACs of two listed companies in China. The role of ACs played in China is revealed through a telephone survey of 330 listed companies; and the overlapping status of supervisory functions between SBs and ACs is assessed by preparing the checklist of process operating items as the basis for face to face surveys of five listed companies. The operating items are defined through the studies of the related regulations and charters; and the overlapping items and percentages between two supervisory institutions are researched through the survey of five listed companies with experience in implementing the ACs. The operations of the two supervisory institutions by the methods of interview and survey is recorded and compared to conclude the findings of this phase's research.

Objective III: The co-ordination is explored by the qualitative method of interviewing two governors and the telephone survey of 330 listed companies in China. With 330 listed companies among 635 companies that have implemented the ACs in 2007, this constitutes over 50% of all the listed companies in China. The two systems with or

without ACs exist according to the understanding of two governors' assertions and opinions on the framework of legislation and management of government; and the preferred co-ordination is collated from the telephone survey, analyzing the responses of interactions between SBs and ACs in different organisations. The findings are then summarised, which will conclude this phase's study.

Chapter 6: The Empirical Studies

The empirical study is aimed to find the evidence in order to attain the three defined research objectives of answering five key research questions and two sub-questions, defined as the following:

6.1 Objective 1: Effectiveness

The SB and AC structures were introduced at different stages of China's economic and business development. The introduction of ACs in addition to SBs is assumed to confirm that SBs had failed to fulfil their function in practice. Many Chinese companies have been willing to voluntarily install ACs in order to enhance supervisory governance within their companies. In order to achieve the first research objective – to understand the effectiveness of SBs and ACs in China – this section provides for two hypotheses to answer two questions by comparing two groups of listed companies with and without ACs. This section summarises the hypothesis and the definition of variables and measures; defines the empirical models; describes the sample by demonstrating the industry, correlation and coefficient analysis; and descriptive statistics for the sample, evidence for proving two hypotheses and to analyse the results of t test, trend analysis, OLS and Panel data analysis as the findings for answering two questions. After the comparison of the findings, the effectiveness of the listed companies after adding in ACs is appraised and presented in the summary.

6.2 Objective II: The Operations

The Chinese approach to supervisory CG structures in companies contains a combination of the AC of the British and American governance models and the SB founded in the German model. This dual-layered governance structure has been created to suit China's unique economic, social and political environment. The

implementation of the singular governance structure of the AC on top of the bipolar one of the SB with dual monitoring institutions in the internal supervisory mechanism in China is also explored. The criteria of independence, expertise and operation of implementing supervisory functions are examined in turn by conducting interview members of SBs and ACs and surveying the listed companies. This phase's study includes the evidence of two sampled companies and the interviewees, the features of SB/AC within both sampled companies, and the background of SB/AC members in both companies. Face to face interviews are recorded and summarised; and two sub-questions of the role of AC played in China and the overlapping status between two supervisory institutions answered by the findings from the surveys. In terms of functions, this research adopts both different CG models, as both are the supervisory institutions functioning in one model, and finds that the function of both SBs and ACs has led to overlapping, redundancy and even conflict between them in fulfilling their functions in financial reporting, auditing and internal control. By way of face-to-face survey with five listed companies in China, the functions of the SB and the AC in practice are identified in order to clarify the overlaps and gaps in their respective functions and to promote effective supervision.

6.3 Objective III: Co-ordination

The current relationship between the AC under the BoD and the SB under general shareholder meetings in China has remained ambiguous. Both have been set up as supervisory institutions and both also perform internal supervisory functions. In terms of the future, the two systems with or without ACs exist according to the understanding of two governors' assertions and opinions on the framework of legislation and management of government. In terms of organisation, no vertical relationship between the SB and the AC is identified. The constructive interactions between them are yet to be established. To suggest a viable structure of the supervisory mechanism for mutual interaction in practice, this research proposes various organisational charts and analyses their specific points. The preferences of Chinese companies for the linked interactions presented in these charts are obtained through the telephone survey of 330 listed companies. This survey indicates the connections and interactions in the hierarchy between the two different supervisory institutions. Their preferred organisational interaction is illustrated according to the statistics derived from the survey.

Chapter 7: Conclusion

After three objectives' empirical works have been carried out and presented accordingly, the achievements of the research objectives in terms of the consistency between the findings and questions will be assessed in this final chapter. First, the empirical research results will be checked, in order to establish whether these conflict or support the two main applied theories and the other four approaches relied upon in this thesis. This chapter integrates the empirical studies of three objectives by summarizing the findings on the effectiveness, operations and co-ordination based on the criteria of independence, expertise and operation in order to enhance the effectiveness of the internal supervisory mechanisms between two supervisory institutions of SBs and ACs in China. Following on each of the summarised findings, the limitations of this research conclude with a discussion of several areas suitable for further research in the future. It concluded by summarizing whether the research goals have been achieved and academic works been contributed to by this thesis.

Chapter 2 **Research Question – The Regulation**

Comparison between the AC and the SB in

China

2.1 Introduction

Passed in December 1993, the Chinese Company Law was the legislation that first specified that every listed company establish a SB to supervise the company's financial activities and the conduct of its directors. Subsequently, additional regulations regarding the appointment of independent directors were introduced. In 1997, this course of action was optional, but became compulsory for listed companies in 2005. The main stages of this development are presented in the table below:

Table 1. Timeline of the Development of the System of Independent Directors in China
(Source: Author, as supported by reference contained within)

| <i>Time</i> | <i>Related Documents</i> | <i>Regulation</i> |
|---------------|--|---|
| December 1997 | Section 112 of the Guidelines on the Constitution of Listed Companies | Optional regulations on the installation of the independent directors by the listed companies. Companies can appoint independent directors if necessary. |
| 1999 | On Further Promotion of Regulated Operation and Reform of Offshore Companies | Companies should increase the percentage of the independent directors. Upon reorganisation of the BoD, independent directors should hold more than half of the posts and there should be at least two independent directors. |
| August 2001 | On the Installation of Independent Directors by the Listed Companies | The introduction of the system of independent directors to listed companies. |
| January 2002 | Section 52 of the Code of CG for Listed Companies in China. | "The BoD of a listed company may establish a corporate strategy committee, an AC, a nomination committee, a remuneration and appraisal committee and other special committees in accordance with the resolutions of the General Meetings of Shareholders. All committees shall be composed solely of directors. The AC, the nomination committee, and the remuneration and appraisal committee shall be chaired by an independent director, and independent directors shall constitute the majority of the committee. At least one independent director from the AC shall be an accounting professional." |
| October 2005 | Section 123 of the Company Act | The detailed regulations on independent directors in listed companies are determined by the state department. The appointment of independent directors by listed companies is made mandatory by the China Securities Regulatory Commission. The legal position of independent directors is officially defined by the revision of the Company Act. |

Governance systems relying on independent directors typically include related structures with specific supervisory functions, such as ACs made up of independent directors. In countries such as the US and the UK, it is compulsory for listed companies to establish an AC to oversee aspects of the company's internal control and financial reporting (SOX, 2002: Sec.2 (a) (3); Combined Code, 2003: Sec.C3.1). In China, under the equivalent regulation in the Code of CG for Listed Companies in China (CSRC and SETC, 2002: Section 52), the establishment of an AC is voluntary rather than mandatory. This has resulted in a dual system in practice, wherein some companies have ACs in addition to and separate from the SBs while others have only established SBs. It should also be noted that the SB in the Chinese system has some similar functions to the AC in the Anglo-American system.

This chapter begins by assessing the willingness among listed companies in China to voluntarily install ACs, in order to justify the formation of the research objectives in this research. Furthermore, it reveals the gaps from the comparison between SBs and ACs in China, and analyses the reasons of these gaps, so that further research questions are engendered.

2.2 Research Objectives

In practice, an increasing number of Chinese companies have installed ACs in recent years. The statistics for the period between 2000 and 2007 on the proportion of listed companies with ACs increased from 1% (12 companies) to 41% (635 companies), as shown in the table below:

Table 2. Chinese Companies Introducing ACs between 2000 and 2007
(Source: Author, as supported by the CCER Database)

| Year | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | Average |
|--------------------------------|-------|-------|--------|--------|--------|--------|--------|--------|---------|
| No. of Co. | 1092 | 1140 | 1205 | 1266 | 1355 | 1351 | 1434 | 1545 | 1299 |
| Increase in No. of Co. | | 48 | 65 | 61 | 89 | -4 | 83 | 111 | 57 |
| Increase in % Of Co. | | 4.40% | 5.70% | 5.06% | 7.03% | -0.3% | 5.79% | 7.18% | 4.36% |
| No. of Co. with AC | 12 | 73 | 312 | 483 | 604 | 641 | 640 | 635 | 425 |
| Increase in No. of Co. with AC | | 61 | 239 | 171 | 121 | 37 | -1 | -5 | 78 |
| % of Co. with AC | 1.13% | 5.38% | 19.92% | 38.15% | 44.61% | 47.45% | 44.63% | 41.10% | 30.3% |

These figures suggest that there is positive willingness amongst listed companies in China to voluntarily install ACs, probably to enhance their internal supervisory

mechanisms and meet international expectations for governance structures for monitoring and supervision. Given that many Chinese companies have introduced ACs to their governance structures, it is interesting to consider whether this reflects a lack of public confidence in the effectiveness of SBs. This study addresses this question by investigating its effectiveness, to verify or disprove the assumption that the setting up of ACs reflects a lack of public confidence in the effectiveness of the SBs. By comparing two systems of listed companies with SBs alone and SBs with ACs together in China, it will be revealed which system has the more effective supervisory functions (Key Research Question 1(1.1)). More specifically, the first objective of this research is to understand whether ACs contribute to improving the effectiveness of supervisory functions in China relating to the three key attributes of independence, expertise and diligence (Key Research Question 2 (1.2)).

Additionally, though the implementation of the Chinese model of ACs is still at its experimental stage, questions should also be asked regarding its operations: it is indeed a peculiar system of implementing a singular mechanism of the AC on top of the bipolar supervisory mechanism of the SB. The purpose of establishing the AC is to strengthen the supervisory function of the BoD and to prevent internal manipulation, which is also the key purpose of implementing the SB in China. Because of this duplication of supervisory functions, it is assumed that there are problems and difficulties in implementing both the AC and the SB in the Chinese model. Accordingly, an assessment of the operations of the supervisory functions by these two institutions in China is set as the second objective of this research. It is especially needed in order to understand the operation process and the problems and difficulties faced by the supervisory institutions in implementation (Key Research Question 3 (2)).

As China's internal supervisory structure involves a unique interaction between the AC and the SB, their interactions in terms of organisation represent a further important subject for research. Thus the third objective of this research is to reveal the co-ordination between the SB and the AC in terms of organisation in the Chinese model. The third objective is achieved by answering two key research questions: How will the two systems with or without ACs exist in the future (Key Research Question 4 (3.1)) and what is the preferred interaction between the SBs and the ACs in organisation (Key Research Question 5 (3.2)).

2.3 Research Questions

2.3.1 Definition of the Supervisory Board

According to German regulations on CG, the SB (*Aufsichtsrat*) oversees and advises the BoD (Executive Board, *Vorstand*), and has control over fundamental and important decisions. According to Paragraph 1 of Article 111 of German Company Act (*Aktiengesetz*; AktG), the SB has the right and responsibility to oversee (*überwachen*) the operations of the company (Chen, 2007: 154).

The characteristic of the current German system of CG is that the SB plays the role of overseeing the operations and finance of the company. In addition to the appointment and removal of directors, the most important right and responsibility of the SB is to oversee the operations of the directors (Yang, 2004: 102).

In the Japanese system, the SB is responsible for overseeing the operations and finance of the company, whereas the BoD is responsible for both the execution and supervision of the operations of the company. The SB and the BoD are of the same rank and work in parallel, unlike the arrangement in the German system where the SB is for governance and the BoD is for management (Wu *et al.*, 2001: 81).

In the Chinese system of CG, there are two institutions under the Shareholders Assembly Meeting: the BoD is responsible of making important day-to-day managerial decisions, the removal of managers, and the execution of day-to-day operations, whereas the SB is responsible for the supervision of the company's finance, the violation of laws, regulations or company constitution by the directors and managers in their execution of their duties to the company (Yang, 2004: 165).

In both the German and Chinese systems, it is the right and responsibility of the SB to oversee the conduct of the BoD. In the German system, the SB is a rank above the BoD, whereas in the Chinese system, as well as the Japanese one, the SB is the same rank as the BoD. This structural difference might have some impact on the supervisory effectiveness, as well as the powers and roles, of the SB in both systems. Now, with the addition of the AC, there are two institutions in the Chinese system that both have the functions and responsibilities to supervise the finance and operations of the company. To understand this seemingly redundant arrangement, the position of the

AC is investigated by comparing its definitions in the various regulations and academic researches, e.g. SOX Section 404 (2002), Klein (2002), Collier (1992), Marrian (1988), Peat Marwick McLintock (1987), and Braiotta (1981). It is also compared and contrasted with the SB with regard to their service scopes and hierarchical levels, their compositions in terms of independence, nomination and appointment, expertise, their powers, functional positions and responsibilities, as well as their operations in terms of sizes and numbers of meetings. By understanding the differences, insights may be gained as to their effectiveness, operations, co-operation and interactions with each other in fulfilling their supervisory functions.

Below is a list of comparisons between the AC and the SB in terms of these characteristics. Based on these comparisons, areas worthy of further investigation will be identified and research questions can then be formulated.

2.3.2 A Comparison between the AC and the SB

A detailed characteristic-by-characteristic comparison between the AC and the SB is presented below.

Independence of Composition

The Chinese Company Act states that the SB comprises of employee supervisors and stakeholder supervisors. It is difficult for employee supervisors to be independent in carrying out their supervisory obligations because they themselves are subject to the company's administrative hierarchy, and their wages and positions are determined by the management. The Company Act provides no administrative protection against this threat. Therefore, questions need to be answered as to what extent this lack of independence impacts upon the effectiveness of SB in China. This will be performed in reference to the attribute of independence according to the studies of Beasley (1996), Abbott *et al.* (2002), Klein (2002a), Klein (2002b), Carcello and Neal (2003), Xie *et al.* (2003), Abbott *et al.* (2004), Bedard *et al.* (2004), Chiang (2006), Tsai (2009), and Kao (2009).

Table 3. Comparison of the Characteristics of the AC and the SB
(Source: Author, as supported by CSRC (2001), CSRC and SETC (2002), and NPC (2006))

| <i>Characteristics</i> | <i>The SB</i> | <i>The AC</i> |
|---|--|---|
| 1. Independence of composition | Composed by stockholders and employees | Composed by majority of independent directors |
| 2. Nomination and appointment | Directly elected from the stockholders and employees. | Independent directors are elected from nominees external to the company, and others are elected from the internal directors who are in turn elected from nominees amongst the stockholders. |
| 3. Expertise of Composition | Supervisors shall have professional knowledge or work experience in such areas in law and accounting (Code of CG for listed companies in China) | At least one is professional in accounting etc. |
| 4. Powers (cf. The comparison of the powers of the AC and the SB) | Does not have the right to engage external auditing or consulting institutions, and may consequently not be able to oversee due to lack of professional capabilities; does not have the right to nominate, appoint or dismiss the directors or senior managers. The effect of its oversight could be compromised consequently. | Does not have the rights to oversee the board of the management and directors' conducts, to directly report to the China Security Regulatory Commission and other institutions, or to demand the management or directors to correct their questionable conducts. The effect of its oversight could be compromised consequently. |
| 5. Size | At least 3 members | At least 3 members |
| 6. Annual number of meetings | At least once a year | At least once a quarter in a year |
| 7. Functional position and responsibilities (cf. The comparison of the functions and responsibilities of the AC and the SB) | Overseeing the BoD on behalf of the stakeholders. | Overseeing the management on behalf of the BoD and balancing the internal directors within the BoD. |
| | Overseeing the company's financial reporting, the directors' compliance to standards, disclosure principles as well as the management and directors' legal conducts. | Overseeing the company's financial reporting as well as the management and directors' questionable conducts such as related transactions. |
| | Overlapping with the responsibilities of the AC. | Overlapping with the responsibilities of the SB. |
| 8. Service scope and hierarchical level | Responsible to the society and the scope of its service extends beyond the company as it can report to the China Security Regulatory Commission and other institutions. | Responsible to the company and the scope of its service is within the company. |
| | Report directly to the general meetings of shareholders in overseeing the BoD, and subsequently the AC. | Reports directly to the BoD; its recommendations need to be approved by the BoD before their implementation. |

In the Chinese system, over half of the members of the AC need to be independent directors, but not all members need be independent. In comparison, in the US and UK,

every member of the AC is required to be an independent director. A comparison of chartered requirements of the AC in the US and UK and SBs in China is presented in the table below. A further comparison on the requirements of the charter of ACs across the American, British and Chinese systems are presented in Table 11 in Chapter 3. This difference suggests a number of potential deficiencies that could undermine the effectiveness of the SB and the AC in the Chinese system in implementing effective supervisory functions.

Table 4. The Comparison of Chartered Requirements for ACs in the US and UK and SBs in China
(Source: Author, as supported by SOX (2002), FRC (2008), FRC (2010), CSRC (2001), CSRC and SETC (2002), and NPC (2006))

| <i>Countries</i> | <i>US</i> | <i>UK</i> | <i>China</i> |
|-------------------------------|--|--|---|
| Supervisory Bodies | The AC | The AC | The SB |
| Relevant Laws and Regulations | The Sarbanes-Oxley Act | The Combined Code on CG of the UK | The Guidelines for Listed Companies on the Establishment of the System of Directors, the Company Act and the Code of CG for Listed Companies in China |
| Independence Requirements | Every member of the committee needs to be an independent director, and there have to be at least three members. | Every member of the committee needs to be an independent non-executive director, and there have to be at least three members or two for smaller companies. | There shall be at least three members on the board. The members consist of shareholders' and stakeholders' (employee) supervisors. (Company Act) "The members and the structure of the SB shall ensure its capability to independently and efficiently conduct its supervision of directors, managers and other senior management personnel and to supervise and examine the company's financial matters." (Code of CG for Listed Companies in China) |
| Expertise Requirements | "An AC financial expert" SOX Act mandates that the firm must disclose in its filings whether the committee has a financial expert, and if not to explain why. | At least one member of the AC has recent and relevant financial experience. | Supervisors shall have professional knowledge or work experience in such areas a law and accounting (Code of CG for Listed Companies in China). |

Since the intention of introducing the AC into the Chinese CG structure is to strengthen the control over the serious problem of internal control by internal people, the independence of the AC and its members should become the essential prerequisite to work out the supervisory functions in CG, yet the regulation does not demand all

members of the AC are independent. So it might be necessary to improve the laws and regulations governing the AC and the SB for its effective operations. To assess the situation, more research is needed on the independence of the AC and the SB in China.

Nomination and Appointment

The members of SBs are directly elected from the stockholders and employees. The AC's independent directors are elected from nominees external to the company, and others are elected from internal directors who are in turn elected from nominees amongst the stockholders. Although the law states that the employee supervisors are appointed by the shareholders' meetings and democratically elected by the employees, there is no explicit regulation concerning the rights to nominate and approve the candidates. Under the strong cultural influence of Confucianism, employees tend to be submissive to their employers, so it is not uncommon for the management and the BoD to nominate the candidates themselves. The 'elected' employee supervisors may have close personal relationships with the directors and managers, and are administratively controlled by the latter, so it may therefore be difficult for them to perform their supervisory duties effectively. If the general meeting of shareholders often simply rubber-stamps the decision, the independence of a SB can be seriously compromised. Obviously, greater attention should be given to the voting system for election of shareholders representing supervisors, in order to increase the effective voting power of the small shareholders and expand the opportunity for their voice to be heard in the SB.

By considering the essential attribute of independence to perform effective supervisory function, it is a challenge for China at present whether the independence of members of SBs can be strengthened by instituting regulations taking into account the interests of the stakeholders of the company, by preventing the members being influenced by insiders, and by setting the appropriate external independent directors. By stipulating that SB members should be independent directors, the protection of the interests of the small and medium shareholders can be enhanced. This would offer a check and balance against the high concentration of shareholdings in listed companies in China.

Therefore, given the shareholding structures and shareholdings of SBs in Chinese listed companies, these issues inevitably lead to concerns regarding insider control (These two indicators are thus considered as independent variables for evaluating the effectiveness of supervisory functions). As the stakeholder members of the SB are elected by the Shareholders' Meeting, there is no constraint against the big shareholders controlling a SB. It is therefore possible for big shareholders to control both the BoD and the SB, and in the event of serious conflicts between them, it would be difficult to maintain effective, just and objective supervision. .

China's regulations are such that only half of the members of the AC have to be independent; the independence of the rest being highly questionable. The key function of ACs is monitoring, yet independence is the most essential factor in executing this function. Therefore, it raises questions regarding the performance of the ACs since the remaining half of members may be formed by non-independent directors.

Even if more than half of the members of the AC are formed by independent directors, these directors might not be competent enough. Companies may overly focus on their social status and the reputation of individuals in appointing independent directors to the AC, regardless of whether the appointed person has the time or competence to hold the post. Currently, many independent directors are appointed by government officials, the BoD or its Chairs, and the power to appoint and remove the members rests in the hands of the senior management of the companies. Hence, the independence of the independent directors is compromised. There is no clear cut restraining mechanism for the independent directors as it is unclear who is to play the role of overseer.

Moreover, it is hard to guarantee independence: since candidates for independent director can be recommended by the BoD, the SB, and the shareholders singularly or collectively holding 1% or more shares of the company. It is also common to find companies dominated by one shareholder or controlled by internal persons. It is therefore questionable whether an independent director selected by a big shareholder would be able to protect the interests of small and medium investors. Furthermore, the positions of the independent directors are also tarnished by the rewards given them, significantly compromising their independence.

So what are the statistics on the number of independent directors in the BoD in China? (The percentage of independent directors divided by the size of BoD is defined as an independent variable, in order to evaluate the effectiveness of supervisory functions). This research examines whether the listed companies have at least three independent directors in ACs, according to the Anglo-American requirement of the composition of AC's. This research will also discover whether the listed companies in China have complied with local stipulations: i.e., one third of the members of the BoD and half of the members of the AC.

Expertise

Although Chinese guidelines discuss the need for supervisors to have professional knowledge or work experience in such areas as law and accounting (Code of CG for Listed Companies in China), it is not yet a mandatory requirement. That said, at least one member of a Chinese AC must have expertise in accounting, and at least one member must also have recent and relevant financial experience in the US and UK as shown in the previous table (Table 4) and Table 11 in Chapter 3.

A deficiency that could lead to ineffectiveness in SBs in China is the absence of a clear-cut requirement on the expertise of board members. Although there are some brief comments in the Code of CG for Listed Companies in China stating that the members should have expertise in law and accounting, the legal status of that code has so far not been established, and it therefore does not constitute an enforceable mandate. Hence, there is no guarantee that a SB has in its membership the basic expertise for the fulfilment of its roles. That could mean that SB membership is essentially an honorary title with no effective function in practice. Therefore, levels of expertise relating to the effectiveness of SB in China must be put under the microscope. (The financial, legal and internal audit expertises of SBs are defined as the independent variables for evaluating the effectiveness of supervisory functions.) The attribute of expertise is referenced from the studies of DeZoort and Salterio, (2001); Abbotte *et al.*, (2002); Abbotte *et al.*, (2003); Xie *et al.*, (2003); Abbott, Parker, and Peters, (2004); Bedard *et al.*, (2004); Defond *et al.*, (2004); Defond *et al.*, (2005); Tsai, 2009; Kao, (2009).

It is the common challenge for both supervisory systems to make efforts to guarantee the quality of members who execute supervisory functions. It is important to establish the mechanism for professional training of members of the supervisory institutions to ensure their professional level of competency. The requirement of expertise of AC members in China is similar to the Anglo-American system. The AC's implementation of practice concerning expertise in China is therefore interesting for further research.

Powers

A comparison of the powers of the SB supervisors and the AC independent directors, who form the majority of the members of the AC, is presented in the table below:

Table 5. The Comparison of the Powers of the AC's Independent Directors and the SB's Supervisors
(Source: Author, as supported by CSRC and SETC (2002), CSRC (2006), and NPC (2006))

| <i>Powers</i> | <i>The SB supervisors</i> | <i>The independent directors</i> |
|---|--|--------------------------------------|
| The right to propose the appointment and dismissal of the accounting firms | Yes | Yes |
| The right to propose the call for interim general meetings of stockholders | Yes | Yes |
| The right to independently engage external auditing and consulting institutions | Except when it needs assistance, it can only nominate the external auditing and consulting institution to appoint. | Yes |
| The right to confirm major related transactions (at least 3 million RMB or 5% of the latest audited net assets of the listed company) | No | Yes (right to consent) |
| The right to public call for stockholders' votes | No | Yes |
| The right to nominate, appoint or dismiss the directors | No | No but can issue independent opinion |
| The right to appoint or dismiss the senior managers | No | No but can issue independent opinion |
| The right to determine the rewards of the directors and senior managers | No | No but can issue independent opinion |
| The right to oversee the directors' and senior managers' performance | Yes | No |
| The right to directly report to the China Security Regulatory Commission or other institutions | Yes | No |
| The right to demand the directors and managers to correct their questionable conduct that may harm the interests of the company. | Yes | No |

As we can see, the SB do not have the right to engage external auditing or consulting institutions, and may consequently not be able to oversee due to lack of professional

capabilities; nor does it have the right to nominate, appoint or dismiss the directors or senior managers. The effect of its oversight could be therefore compromised. The ACs do not have the right to advise the board on the management and directors' conduct, to directly report to the China Security Regulatory Commission (CSRC) and other institutions, or to demand the management or directors to correct their questionable conduct. The effect of its oversight could be compromised in this case too.

From the comparison of the specified powers of the ACs' independent directors and the SBs' supervisors, it is found that not every responsibility as specified has a corresponding power in order to assist its operation. For instance, the SB does not have the power to directly engage external professionals to assist it in financial supervision. Neither does it have the power to nominate, appoint or dismiss the directors or the senior managers whom it is supposed to oversee. The AC is supposed to guard against the questionable conduct of the management, yet it does not have the power to demand the directors or senior managers correct their misconduct, nor can it directly report such incidences to the external regulatory institutions. As such, the effectiveness of its control is bound to be negatively affected. Even though the AC has the function of proposing the appointment or dismissal of the external audit institutions, such proposals cannot take effect until approved by the BoD. As the BoD is more than likely controlled by the major stockholders, it is difficult to ensure the independence of the external auditing simply by having the external chartered accountants appointed by the AC.

(A) What should be considered to be adequate rights and roles for SBs in China under laws and regulations by comparison with the situation in Germany, as an international comparison whereby an equivalent structure is also relied upon for supervisory governance?

Table 6. Comparative Rights and Roles of SBs in Germany and China
(Source: Author, as supported by CSRC (2001), CSRC and SETC (2002), NPC (2006))

| | <i>Rights</i> | <i>Germany</i> | <i>China</i> |
|-------------------------|---|----------------|---|
| 1 | The right to appoint and remove the directors | Yes | No |
| 2 | The right to approve specific business dealings | Yes | No |
| 3 | The right to limit the directors' commercial activities | Yes | No |
| 4 | The right to represent the company | Yes | Can take legal action against directors and senior managers |
| 5 | The right to supervise | Yes | Yes |
| <i>Stages</i> | <i>Supervisory Roles in Germany</i> | | <i>Supervisory Roles in China</i> |
| Prior supervision | (1) intended operational policies and other fundamental issues on the leadership of future operation | | Not specified |
| Concurrent supervision | (2) conditions of the company's profits and pay-back powers | | Not specified |
| | (3) conditions of current operation, especially sales | | |
| Post supervision | (4) Reviews of the annual accounts prepared by the accountants | | Not specified |
| Provisional supervision | (5) The SB and its members may request the BoD at anytime for special situation reports of the company. | | Not specified |
| | (6) The BoD must actively report to the chairperson of the SB any important decision or resolution it has made. | | |

Under the Company Act and the Code of CG for Listed Companies in China, SB members have the right to propose, supervise and report, but they have no powers to appoint or remove directors or determine their remuneration or benefits, while their German counterparts have powers and the rights that enable them to control the BoD. These include the right to appoint and remove directors, approve specific business dealings, limit the directors' commercial activities, and represent and supervise the company. The German and the Chinese system are compared in the following aspects:

(1). The right to appoint and remove directors

Section 84 of Die Aktien des Gesellschaftsrechts stipulates that the SB has the right to appoint and remove the chairperson and the members of the BoD, and decide their remuneration and benefits. The SB in the Chinese system has no equivalent power.

(2). The right to approve specific business dealings

Under the German system, a SB cannot replace the BoD in running the operation of the company but it can arrange for certain operation to be executed only with its approval, although it may not interfere with the managerial activities of the BoD. Given the practical difficulty of setting a clear-cut boundary between managerial and the supervisory responsibilities, this provision could lead to conflicts between SBs and BoDs. There is no equivalent right for Chinese SBs.

(3). The right to limit the directors' commercial activities

Members of the BoD in Germany cannot engage in any commercial activity outside the company's business or any commercial activity in the company that solely benefits themselves without the approval of the SB. Again the Chinese system has no provision of this kind.

(4). The right to represent the company

Under the German system, a company is normally represented by the BoD but, under certain conditions, it may be represented by the SB. The SB in the Chinese system does not have this right but it can bring cases on behalf of the company against the directors who violate the company's interests. The 2005 revision of the Chinese Company Act further provides that a SB can also call for and host the General Meetings of Shareholders when the BoD fails to do so. The SB in China owns the right to directly report to the China Security Regulatory Commission or other institutions.

(5). The right to supervise

The fundamental responsibility of a German SB is to supervise the BoD in their work of controlling the business operation. In order to supervise properly, it has the right to understand the operation of the company, and to examine relevant accounting books, documents and the financial situation. The BoD must therefore report to the SB about business development, business policies and corporate profits.

Having identified the supervisory right of SBs in China, it is necessary to further examine operational procedures in evaluating the quality of supervision exercised. Only three sections of the Company Act in China concern the operational procedures of SBs. Section 55 states that the SB may be presented at meetings of the BoD and raise questions or offer suggestions for resolutions at the meetings. The SB – or individual supervisors in the absence of a SB – may also investigate any suspected abnormality in the company's operation, and costs incurred in so doing will be covered by the company (Section 57). Section 151 stipulates a general provision that the directors and senior managers should provide correct data and information needed by the SB and should not obstruct its efforts or those of individual members in exercising their powers. In practice, because SBs do not have a role with respect to management decisions, their supervisory role effectively constitutes supervision after the event.

On the other hand, Section 90 of *Haftungsrecht* in Germany states that the BoD must report to the SB regularly. Information reported is for prior, concurrent, post and provisional supervision, as listed in the table above. The German system explicitly gives a SB the right to supervise the business operation of the company and to examine its financial condition. The Chinese system could possibly be enhanced by giving SB similar rights to regularly and provisionally investigate the business operation of the company and to demand reports from the directors.

(B) What should be considered to constitute adequate rights for ACs in China under laws and regulations by comparison with the situation in US, as an international comparison whereby an equivalent structure is also relied upon for supervisory governance and what should be the roles that ACs play in China?

The Sarbanes-Oxley Act (SOX, 2002) was produced in response to a series of scandals around the turn of this century, perpetrated by Enron and others. It extends the responsibilities and status of the AC. Sections 201 and 202 revise the powers of the AC in that all audit and non-audit services provided by the external auditors¹ to

¹ “An external auditor is an audit professional who performs an audit in accordance with specific laws or rules on the financial statements of a company, government entity, other legal entity or organization, and who is independent of the entity being audited. Users of these entities' financial

the company must first be approved by the AC. Section 301 significantly extends the overseeing powers of the AC. SEC prohibits the listing of companies which do not comply with the conditions listed in the table below:

Table 7. Comparison between the Powers and Rights of the AC as Specified in the Laws and Regulations in the US and China
(Source: Author, as supported by CSRC (2001), CSRC and SETC (2002), SOX (2002), and SSE (2000))

| | <i>Power</i> | <i>USA</i> | <i>China</i> |
|---|---|--|---|
| 1 | The power to appoint or remove external audit agencies | Yes: Section 301(m)(2) | Yes: CSRC and SETC 2002: Art. 54 |
| 2 | The power to independently employ outside experts to assist in the execution of tasks | Yes: Section 301(m)(5) | Yes: CSRC and SETC 2002: Art. 54 |
| 3 | The right to know (receiving complaints) | Yes: Section 301(m)(4) | No |
| 4 | The right of disposition managers | Yes: Section 301(m)(4) | No |
| 5 | The right to have funds available for its use | Yes: Section 301(m)(6) | No |
| | <i>Power</i> | <i>USA</i> | <i>China</i> |
| | Power 1: The power to appoint or remove external audit agencies | As specified in SOX Section 301 (m) "STANDARDS RELATING TO ACs", "(2) RESPONSIBILITIES RELATING TO THE REGISTERED PUBLIC ACCOUNTING FIRMS.— The AC of each issuer, in its capacity as a committee of the BoD, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work, and each such registered public accounting firm shall report directly to the AC." | According to Article 54 of CSRC and SETC (2002), the main responsibilities of the AC include "to recommend the engagement or replacement of the company's external auditing institutions". (CSRC and SETC, 2002: 7) |
| | Power 2: The power to independently employ outside experts to assist in the execution of tasks | As specified in SOX Section 301 (m) "STANDARDS RELATING TO ACs", "(5) AUTHORITY TO ENGAGE ADVISERS.— Each AC shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties." | According to Article 54 of CSRC and SETC (2002), the main responsibilities of the AC include "to recommend the engagement or replacement of the company's external |

information, such as investors, government agencies, and the general public, rely on the external auditor to present an unbiased and independent audit report." (Wikipedia, *Externall audit*, http://en.wikipedia.org/wiki/External_audit, as of July 2007)

| <i>Power</i> | <i>USA</i> | <i>China</i> |
|---|--|--|
| | | auditing institutions". (CSRC and SETC, 2002: 7) |
| <p>Power 3: The right to know (receiving complaints)</p> <p>Without a clear assertion of this right, the AC, having most of its members as independent directors who are external to the company, would find it difficult to get sufficient and up-to-date information of the company's operation for the vigilant and informed oversight of the quality of the financial reporting process and the effectiveness of the internal control of the company.</p> | <p>As specified in SOX Section 301 (m) "STANDARDS RELATING TO ACS",</p> <p>"(4) COMPLAINTS.—Each AC shall establish procedures for— (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."</p> | Not specified. |
| <p>Power 4: The right of disposition</p> <p>The AC can put sufficient pressure on the management if it has the power to dispose managers who have acted questionably.</p> | <p>As specified in SOX Section 301 (m) "STANDARDS RELATING TO ACS",</p> <p>"(4) COMPLAINTS.—Each AC shall establish procedures for— (A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."</p> | Not specified. |
| <p>Power 5: The right to have funds available for its use</p> | <p>As specified in SOX Section 301 (m) "STANDARDS RELATING TO ACS",</p> <p>"(6) FUNDING.—Each issuer shall provide for appropriate funding, as determined by the AC, in its capacity as a committee of the BoD, for payment of compensation— (A) to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report; and (B) to any advisors employed by the AC under paragraph (5)."</p> | Not specified. |

(B.1) Two of the five powers or rights specified in the American system are present in the Chinese system:

(1). China is equipped with the power to appoint or remove external audit agencies: both the Anglo-American and the Chinese models specify that the AC is responsible for the oversight of the external auditors. The AC is the only body that has the power to determine the continuation and termination of the employment of the independent auditors and the cost and reward of the auditing activities, as well as all other non-audit activities provided by the external auditors. This provision improves the truthfulness of financial reporting and strengthens the responsibility of supervising the independence of the external auditors. The provision that external auditors report to the AC instead of the management means that any new situation or development significantly enhances the independence of the external audit. The AC also benefits from this power in its unhindered communication with the management and the external and internal auditors because of its improved independence, objectivity and authority.

(2). The power to independently employ outside experts to assist in the execution of tasks: in the US, the AC has the authority to utilise advisers to engage whatever independent counsel and other advisers it deems necessary to carry out its duties. Yet in China the only stipulated responsibility of the AC includes “to recommend the engagement or replacement of the company’s external auditing institutions”. In other words, the AC in the US has more powers, and a much wider range in employing outside experts.

(B.2) Three of the five powers or rights specified in the American system are not present in the Chinese system:

(1). China is not equipped with the right to know of complaints about a company: without a clear assertion of this right, the AC, having most of its members as independent directors who are external to the company, would find it difficult to get sufficient and up-to-date information of the company’s record for vigilant and informed oversight of the quality of the financial reporting process and the effectiveness of its internal control;

(2). China has no right of disposition managers: the AC of US can put sufficient pressure on the management if it has the power to dispose managers who have acted questionably as specified in SOX Section 301 (m) “STANDARDS RELATING TO ACs”, “(4) COMPLAINTS.

(3). China has no right to have funds available for its use: each issuer shall provide for appropriate funding, as determined by the AC, in its capacity as a committee of the BoD, for payment of compensation to the registered public accounting firm employed by the issuer for the purpose of rendering or issuing an audit report; and to any advisors employed by the AC.

Based on the comparison of the powers of the SBs between the Chinese and German models, and the powers of ACs between the Chinese and Anglo-American models, only two identified powers of SBs and ACs are ever mentioned in Chinese regulations. Hence it remains to be seen whether the powers of SBs and ACs should be further regulated by legislation in order to strengthen its protection and supervision.

It is commonly understood that it is important to maintain the balance between the powers and the responsibilities of SBs and ACs. It can play its part in overseeing only if such balance is maintained. For CG, it is better to have a system in which the body that has the controlling right is also the risk-bearer and the body with residual claim. This is not the case under the Chinese model, where the AC has the oversight and control rights but is not the risk-bearer and does not have residual claim. Furthermore, compared to its American counterpart, the AC in the Chinese model does not have the right of disposition or the right to know about complaints. This means that in the Chinese model there is an imbalance between its powers and responsibilities (see the responsibility comparison presented in Table 8), and it becomes difficult for it to oversee the internal agents of the directors.

Size

The sizes of SBs and ACs are the same: at least 3 members. Under the Company Act the minimum number of members of a SB is three, and there is no specification of a maximum limit. In comparison, in Germany and Austria the range is 3 – 20 members and in France 3 – 12. The actual number is determined by the company, rather than the General Meetings of Shareholders, in accordance with the volume of its shares,

the number of employees and the relationship between investors and managers, as specified in its constitution. The SEC (1999) mandated that ACs consist of a minimum of three directors encouraged by the BRC and the accounting profession (IIA, 1991). In China the code of CG mandates at least 3 members in ACs – but its actual practice is still questionable. The statistics for the size of SBs and ACs across China are therefore reserved for more research. The size of supervisory institutions is referenced from Yermak (1996) and Eisenberg *et al.* (1998); SEC (1999); Xie *et al.* (2003). The size of the supervisory institutions is defined as the independent variable to evaluate the effectiveness and operations of supervisory functions.

Annual Number of Meetings

Section 56 of the Chinese Company Act stipulates that the SB has to hold at least one meeting annually. The international norm is that ACs have to hold at least three or four meetings annually. The meeting frequency has been noted as a measure of due diligence in executing the supervisory functions. The annual number of meetings of the SB and the BoD is defined as the independent variable to evaluate the effectiveness of supervisory functions by reference to the studies of McMullen and Raghunandan, (1996); Abbott *et al.* (2000) and DeZoort *et al.* (2002); Xie *et al.*, (2003); Abbott *et al.*, (2004)). The number of meetings including both specified in the charter and actually taken in practice can be used to gauge the level of diligence. In practice, the distribution of companies may hold different numbers of meetings year on year. Therefore, the annual number of meetings of supervisory institutions is defined as an independent variable to evaluate the effectiveness and operations of supervisory functions.

According to the comparative study of regulations of rights and the aforementioned elements in China and Germany and the US and UK, the following questions are raised:

Key Research Question 1 (1.1): Which system with or without ACs has more effective supervisory functions in China?

Key Research Question 2 (1.2): Will the AC contribute to the effectiveness of the supervisory functions in China?

Key Research Question 3: What are the operation processes, problems and difficulties faced in the implementation of the supervisory functions by SBs and ACs in empirical practice in China?

And Sub-Question 1 (2.1): What is the role of the AC played in China?

Functional Positions and Responsibilities

The SBs oversee the BoDs on behalf of the stakeholders. The ACs oversee the management on behalf of the BoDs and balance the internal directors within the BoDs. A comparison of the functions and responsibilities of the SB and AC is described in the Table below.

Table 8. Comparison of the Functions and Responsibilities of the SB and the AC
(Source: Author, as supported by reference CSRC and SETC (2002), NPC (2006) and SSE (2000))

| No. | The SB | The AC |
|-----|--|---|
| 1 | Examining the company's finance. | Auditing the company's financial information and its reporting. Examining accounting policies, financial conditions and financial reporting procedures of the company. |
| 2 | Supervising the directors and senior managers in the executions of their responsibilities. Giving recommendation of the dismissal of directors or senior managers on the violation of laws, regulations, company's constitution or shareholders' resolutions | Examining the company's observation of laws and regulations |
| 3 | Demanding corrections from the directors or senior managers against their harmful behaviours to the company | Examining and supervising the behaviours and regulations of the company |
| 4 | Submitting proposals to the general meetings of shareholders | Reviewing the internal control and internal auditing functions, supervising the company's Internal Auditing system and its operation. |
| 5 | Proposing the holding of provisional the general meetings of shareholders. Calling for and hosting the general meetings of shareholders when the directors fail to do so according to the regulation. | Giving proposals on the hiring or changing external auditory institutions; Giving recommendations and hiring accounting firms; Communicating with accounting firms following the auditing procedures. |

| No. | The SB | The AC |
|-----|--|---|
| 6 | Handling legal proceedings against the directors or senior managers who fail to call the General Meetings of Shareholders according to the regulations | Providing communication between the internal and external auditing bodies. |
| 7 | Providing supervisory reports as important evidences in the evaluations of the directors, managers and other senior management. | Examining and supervising all forms of risks, including financial risks and information systems security risks. |
| 8 | Providing supervisory reports directly to the BoD and the General Meetings of Shareholders; Reporting violations of regulations to the CSRC. | Examining the internal control ² of the company. |
| 9 | Other responsibilities specified in the company's constitutions | Other responsibilities given by the BoD |

The SB and AC are the supervisory institutions under different CG models. It is assumed that incorporating both into one model will result in functional overlaps and gaps. As the functions both of ACs and SBs are essentially supervisory, having both the AC and the SB may lead to overlapping, redundancy and even conflict between the two. From this comparison, it can be seen that there are two areas in which the functions of the two institutions overlap. First, both are internal supervisory

² “Under the COSO Internal Control-Integrated Framework, a widely-used framework in the United States, internal control is broadly defined as a process, effected by an entity's board of directors, management, and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: a) Effectiveness and efficiency of operations; b) Reliability of financial reporting; and c) Compliance with laws and regulations. COSO defines internal control as having five components:

- (1) Control Environment-sets the tone for the organization, influencing the control consciousness of its people. It is the foundation for all other components of internal control.
- (2) Risk Assessment-the identification and analysis of relevant risks to the achievement of objectives, forming a basis for how the risks should be managed
- (3) Information and Communication-systems or processes that support the identification, capture, and exchange of information in a form and time frame that enable people to carry out their responsibilities
- (4) Control Activities-the policies and procedures that help ensure management directives are carried out.
- (5) Monitoring-processes used to assess the quality of internal control performance over time.

The COSO definition relates to the aggregate control system of the organization, which is composed of many individual control procedures.” (Wikipedia, *Internal control*,

http://en.wikipedia.org/wiki/Internal_control#Definitions, as of July 2007)

institutions focusing on financial supervision. This could confuse the corporate structure and could lead to reduce effectiveness of supervision. Second, both are responsible for safeguarding against the possibility of illegal behaviour by the directors and managers, such as serious improper transactions, and this could cause conflict between the operations of both institutions.

It is therefore questioned:

Sub-Question 2.2: What are the overlapping and missing items and percentages between the SBs and the ACs in terms of functions?

Service Scope and Hierarchical Level

The SBs are responsible to broader society, and the scope of its service extends beyond the company, as it can report to the China Security Regulatory Commission and other institutions. The ACs are responsible to the company and the scope of its service is within the company. The SBs report directly to the general meetings of shareholders in overseeing the BoDs, and subsequently the AC reports directly to the BoDs; its recommendations need to be approved by the BoDs before their implementation. Both the ACs and the SBs are the internal supervisory organisation of the listed companies. The AC is one of the committees under the jurisdiction of the BoDs. The SB is the unit parallel to the BoD.

There is no vertical relationship between the SB and the AC. Constructive interactions between them are yet to be established. In order to construct a perceived structure of supervisory mechanism through the interactions of ACs and SBs in practice, and to explore the co-ordination between two institutions in their linkage of interactions, the following questions are raised:

Key Research Question 4 (3.1): How will the two systems with or without ACs exist in the future according to framework of legislation and management of government?

Key Research Question 5 (3.2): What is the preferred linkage of interactions between the SBs and the ACs in terms of organisation?

2.4 The Research Objectives and Questions Identified through the Comparisons

41% of 635 listed companies in China have already established ACs as of the end of 2007. This raises the assumption that the establishment of ACs reflects a lack of public confidence in the effectiveness of SBs. Meanwhile, imposing the singular mechanism of ACs on the bipolar supervisory mechanism of SBs in turn raises questions about the effectiveness of ACs in China. Therefore, to understand the effectiveness of SBs and ACs in China is set as the first objective in this study.

According to the regulation comparison, the actual practice of the operations of the supervisory functions by SBs and ACs in China is set as the second objective, in order to explore their operation processes and the problems and difficulties faced in their implementation.

Currently, there is no vertical relationship between the SB and the AC in organisation. The constructive interactions between them are yet to be established. In order to construct a perceived organisation structure of internal supervisory mechanisms of the interactions of the SB and the AC in practice, the priority is to explore the co-ordination between two institutions in functions, which inevitably have overlaps and gaps. Revealing the actual co-ordination of SBs and ACs is set as the third objective of this thesis.

Through the comparison of the laws and regulations between SBs and ACs in China, the research questions and corresponding research objectives are summarised in the list and table below.

Objective 1: To understand the effectiveness of SBs and ACs in China

Question 1.1: Which system with or without ACs has more effective supervisory functions in China?

- Question 1.2: Will the AC contribute to the effectiveness of the supervisory functions in China?
- Objective 2: To understand how the operations of SBs and ACs improve the effectiveness of supervisory governance functions in China.
- Question 2: What are the operation processes, problems and difficulties faced in the implementation of the supervisory functions by SBs and ACs in empirical practice in China?
- Sub-Question 2.1: What is the role of AC played in China?
- Sub-Question 2.2: What are the overlapping and missing items and percentages between the SBs and the ACs in terms of functions?
- Objective 3: To understand the co-ordination between SBs and ACs in terms of organization in China.
- Question 3.1: How will the two systems with or without ACs exist in the future according to framework of legislation and management of government?
- Question 3.2: What is the preferred linkage of interactions between the SBs and the ACs in terms of organisation?

Table 9. Research Objectives and Questions
(Source: Author)

| | | |
|--|--|---|
| Objective 1: To understand the effectiveness of SBs and ACs in China | | |
| Key Questions 1&2 | 1.1 Which system with or without ACs has more effective supervisory functions in China? | 1.2 Will the AC contribute to the effectiveness of the supervisory functions in China? |
| Objective 2: To understand how the operations of SBs and ACs improve the effectiveness of supervisory governance functions in China. | | |
| Key Question 3: (2) | 2. What are the operation processes, problems and difficulties faced in the implementation of the supervisory functions by SBs and ACs in empirical practice in China? | |
| Sub-Questions (2.1 & 2.2): | 2.1 What is the role of the AC played in China? | 2.2 What are the overlapping and missing items and percentages between the SBs and the ACs in terms of functions? |
| Objective 3: To understand the co-ordination between SBs and ACs in terms of organization in China | | |
| Key Questions (4 & 5) | 3.1 How will the two systems with or without ACs exist in the future according to framework of legislation and management of government? | 3.2 What is the preferred linkage of interactions between the SBs and the ACs in terms of organisation? |

Chapter 3 Research Theory and Literature Review

3.1 Research Theory

3.1.1 Introduction

The theory is under development rather than finalised, and the theory is applied in certain purpose with certain condition, so the theory is not almighty, cannot be applied in every condition, nor can be worked out in every environment (Wang, 2005). The theory is developed in certain condition by the human being, so it is essentially limited, but the theory can have critical influence when there are problems to be solved. Robert W. Hamilton (1971) states that the nature of the corporation is not final, but changes as soon as conditions are different. Therefore, it depends on the problems to be solved. Different CG theory will have its specific value, but every theory has its own limitation, so certain eras and certain conditions need certain CG theory.

The World Bank (1993) reports that the CG mechanism covers two parts of internal and external mechanism respectively. The internal mechanism mainly solves the relationship and structure problems among stockholders, directors and managers, such as the internal supervisory mechanism and inspiration mechanism. The external mechanism constitutes the external power to impact and control the behaviour and performance of the company, mainly covering two powers of the market and governance. Chang (1999) also acknowledges this: "The narrow definition indicates the system arrangements relating to the company's functions, structures of BoD, and the powers of the stockholders; the broad definition indicates a whole set of legal, culture and system arrangements relating to the company's control rights and the residual demanding right for allocation." OECD (1999) defines the structure of CG involving a series of relationships among the company's managers, BoD, stockholders and the other stakeholders. The position of the stockholders among the series of relationships is outstanding in the "Principles of CG" issued by OECD: one approach is to protect the rights of the stockholders; another approach is to request the BoD to take responsibilities for the stockholders. The narrow definition of CG structure

defines the shareholders as the target for protection; the broad definition of CG structure defines the stakeholders as this target.

The internal supervisory mechanism in connection with the effectiveness, operations and co-ordination of SBs (SBs) and ACs (ACs) in China is the key research objective for this thesis, as stated in the chapter of Research Questions. The effectiveness, operations and co-ordination of SBs and ACs may be explained by different theoretical perspectives. The various theories on CG seem ambitious in trying to explain the role of acting supervisory functions.

This section's study of research theories starts with an interactive model of CG structure, then moves on to clarify the relevant theories' influence upon the current internal supervisory mechanism of CG. The research theory is then reasoned and concluded with a summary of research theories applied in this thesis.

3.1.2 An Interactive Model of Corporate Governance Structure

An interactive model expressing the interactions amongst the political institutions, product markets, capital markets, stakeholders, shareholders, firms, BoD, SBs, ACs, internal auditors, external auditors, managers and employees is shown in the figure 1:

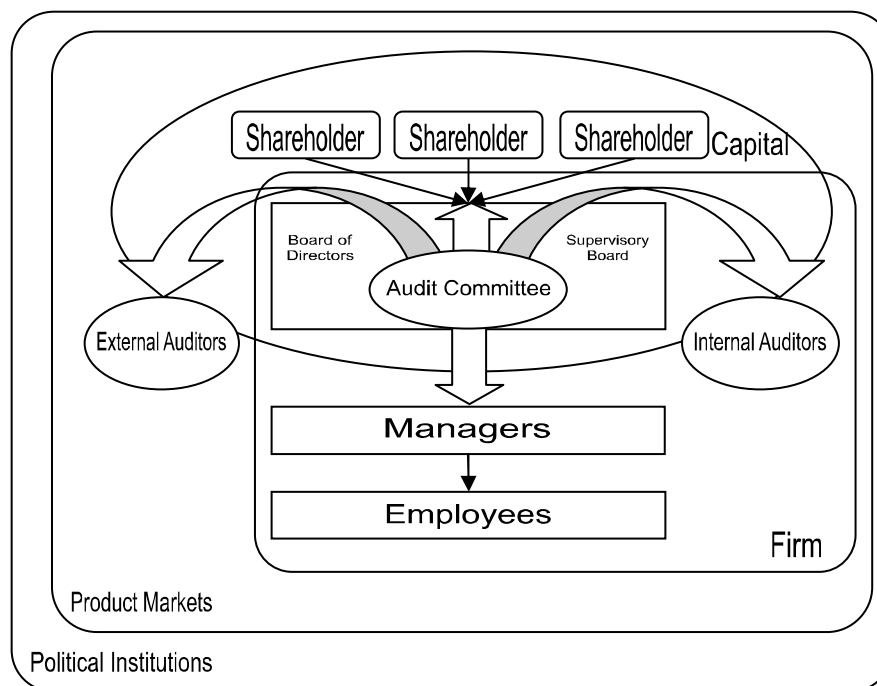


Figure 1. An Interactive Model of CG Structure
(Source: Author's adaptation of Yakasai (2001))

The shareholders, BoD, SBs, ACs internal auditors, managers and employees comprise the relationships within the company and interact within the CG structure. Many aspects of legal, economic, political, social and other forces continually involve in these interactions. This figure can help us to better understand the impact on the current internal supervisory mechanism and help to explore the future in attempting to improve the level of understanding of CG. The theories related to the CG of the company could enrich the benefits of every party. The various theories on CG are then studied and analysed as the following.

3.1.3 The Theories on Internal Supervisory Mechanism of Corporate Governance

The following theories of CG will now be referred to individually:

- (a) Shareholder Theory (Agency)
- (b) Stakeholder Theory
- (c) Managerial Hegemony Theory
- (d) Political Model Theory
- (e) Institutional Ownership Theory
- (f) Stewardship Theory
- (g) Resource Dependency Theory

Shareholders

Jensen and Meckling (1976) refer to moral hazards arising from conflicts of interest in the relationship between owners and managers. A basic assumption under agency theory is that managers will act opportunistically to further their own interests before that of shareholders, and that there are agency costs to keeping managers' interests aligned with those of the owners. Fama and Jensen (1983) further point out that CG research should focus on agency problems and how to reduce agents' costs. On the other hand, Shleifer and Vishny (1997) state, "The problem is that most future contingencies are too hard to describe and foresee, and as a result, complete contracts are technologically unfeasible" – but a basic conclusion of agency theory is that the value of a firm cannot be maximised because managers possess discretions which allow them to expropriate value to themselves. They emphasise that CG should be

established to safeguard the financial capital from investors and lenders, and to protect the returns on investment from that capital. In other words, they maintain the core task of CG is to ensure the capital suppliers' interests. The shareholder model, applied in the UK and the US, shows that when shareholder wealth is maximised, social wealth will also be maximised.

Shareholder's theory suggests that when the executives of enterprises are the same bodies as the owners of enterprises, they both have the right to ask for the enterprise's entire surplus, and are therefore motivated to work hard. When the executives of enterprises are different bodies from the owners of enterprises, it can give rise to proxy shareholder problems. The harder the agent works, the higher the cost of the agent's fee. The larger the incomes of enterprises, the more profits the owner will make, wherein the agent may become discontent, which may cause inevitable conflict of interests on both sides. The shareholder's proxy theory suggests that since the agent has more information than the shareholder there is an information asymmetry that may affect the shareholder's rights. The relationships between the agent, the shareholders and the executives can be defined as a contract and, because of the incompleteness of the contract, problems under agency theory are unavoidable. Vafeas and Theodorou (1998) state managers are pressured to produce immediate results, thus ignoring investments that could have long payback periods. Shareholder's proxy theory argues that the following four basic problems exist (Jensen and Meckling, 1976):

- (1) Since the executives pursue their own interests, there is no reason or evidence indicating that they are unselfish, or that they will keep unanimity with the shareholder's interests naturally;
- (2) There can be information asymmetry – no-one can have complete information, information is distributed between the individuals; it is likely that those inside the company (such as the BoD) will have more information than those outside (such as shareholders);
- (3) The risk of moral problems and reverse choice may exist. It is supposed that since the agents are prone to opportunism, this will result in the agent post being

neglected in the course of acting for, incurring damage to and encroaching on the shareholders' interests;

- (4) The market environment is full of uncertainty, making it difficult to judge whether the agent's behaviour indicates his having worked hard or not.

Cochran and Wartic (1988) asserted that CG solves specific problems through interaction among senior executives, shareholders, the BoD and other relevant parties within a company. In order to solve the aforementioned four basic problems of shareholder's proxy theory, the mechanism of CG can be improved through the triple channels of 1) restraint, 2) incentive and 3) recruitment of the right agent for reaching the goal of maximizing shareholder's interests.

1. The agent's restraint / supervision problem: The main theme of CG is to maintain mutual checks and balances between shareholders and managers within a company. The reason for this is that the agents and shareholders have the following information asymmetry problems:

- (1) The agents understand their own ability and partiality far better than the shareholders;
- (2) The behaviour of the agents is hard to judge when based only on appearance;
- (3) The agents understand far more clearly than the shareholders regarding:
 - (a) The true state of the company's external environment,
 - (b) The market change and
 - (c) Internal operation.

The information asymmetry increases the degree of difficulty for shareholders to supervise the agent and this in turn increases the cost of supervision.

2. The agent's incentive problem: Fama and Jensen (1983) believe that the past and present performance of managers will determine their future value in the market for management staff. The pressure of competition will compel the manager to work harder, thus reducing the agency cost and increasing the likelihood that the manager will seek a larger incentive.

3. The agent's recruitment problem: Developing human resources is a very important way in which the value of an enterprise is created and increased. Since the manager's ability is difficult to assess, a major challenge for owners is to design a set of mechanisms for distinguishing and selecting managers to recruit the most loyal and most competent managers, and to make them wholly responsible to the investors.

Shareholder's proxy problems not only exist among the shareholders and managers, but also between minority and large shareholders, also known as 'control shareholders' (Shleifer and Vishny, 1997). Normally, the minority shareholders have no will to participate in shareholders' meetings. Therefore, a problem develops as to who is going to control supervision in respect of shareholders and managers, which explains why it is more difficult to protect the interests of shareholders. The control of shareholders might deprive other shareholders of their utilities in much of the same way that the managers might deprive shareholders of their utilities. These two kinds of agency problems are often interlinked. The mechanism of CG is therefore to solve these two kinds of agency problems and to determine which mechanism can be regarded as a security measure for the protection of minority shareholders from the larger ones. In other words, it is mandated to protect the external body of shareholders from encroachment by the internal management and control shareholders.

Since the interests of the shareholders and managers are usually inconsistent, the mechanism of CG is used to alleviate the proxy problems between them. Its essence is to protect shareholder's interests from being infringed upon, and at its core is a set of rules and systems to provide protection for shareholders and to guarantee that shareholders can receive fair repayment from their investment. The owners' checks and balances on the managers are performed through the supervisory mechanism of CG. Shareholder's proxy theory is especially focused on the internal supervisory mechanism within the company, with a view to analysing the internal structure and internal relationships within the enterprise, which are not controlled by market strength. In essence, it is a kind of internal agreement, in that the shareholders hold the decision-making power to change the management team members' qualification, the corporate structure and the disbanding of the company. The aim is to design a good mechanism with the power of checks and balances to maximise the company's value.

Modern enterprises regarded combining internal management levels as the foundation of expanding business on a large scale; and therefore considered the division of the rights of control between ownership and management to be the essential feature. The difficulty lies in the balancing of ownership rights between owners (shareholders) and managers, for if this problem is not managed through an effective CG mechanism to resolve any imbalance in interests and information inconsistency, it will further escalate to involve the potential agency problem from the commission's management level of the company linkage. Eisenhardt (1989) assumes that managers are opportunists intent on gaining self-satisfaction instead of maximising profit on behalf of the principal, so she points out there is potential conflict of interest of risk sharing between the enterprises and agents. Furthermore, she argues that agency theory has a clear implication for the monitoring and control role of the BoD but its position regarding the strategy role is not definite. Zahra and Peace (1989) highlight the importance of the BoD role in establishing guidelines for operations and effective control. Fama (1980) states the BoD is viewed as "the ultimate internal monitor of the set of contracts called a firm". Hill (1995) concludes that agency theory does have implications for the strategy role of BoDs on the meaning of corporate control. McNulty and Pettigrew (1999: 50) comment that "little has been said by agency theorists about strategy as a means of control over managers."

It is generally acknowledged that the British and the American CG models fall under the category of the shareholders' model (Wang, 2005). This shareholders' agency model shows that when their wealth is maximised, social wealth will also be maximised. China adopted the ACs of the British and American CG system. ACs are established for the purpose of strengthening the internal supervisory mechanism to safeguard the interests of all shareholders, particularly the small ones.

Stakeholders

Fort and Schipani (2000) defined stakeholder theory of CG as ensuring the conditions of the responsibilities to the various stakeholders to create value and co-ordinate the management levels among various stakeholders including stockholders, employees, customers, creditors, suppliers, competitors, even the whole society.

Freeman (1984: 31) argues, “A stakeholder in an organisation is any group or individual who can affect or is affected by the achievement of the organisation’s objective”; and “those groups without whose support the organisation would cease to exist.” On the other hand, Blair and Machlary (1995) suggested that the interested parties are all those who contributed to the special purpose assets to the enterprise, and who become persons or groups to bear the result of risk investment. Moreover, Aggestam (2001) reports that stakeholders are involved in the operation of the firm as both contributors and recipients of benefits. Depending on the state of a company, in the case of normal management, the ownership of the company belongs to its shareholders. In the case of a state of bankruptcy, the ownership of the company is relegated to its creditors as the first order to claim on the company’s assets. Should the company be unable to pay the salaries of its staffs, the staffs become the legitimate controllers of the company. From the perspective of forming the company, relations with its suppliers and other cooperative partners shape the invisible cooperation that can help to continually reduce the cost of investment. The company, consumers and distributors form a reliable relationship, which can help to maintain a high rate of employment, so that the company’s existence and development, and the stakeholders, including the shareholders, creditors, staff, suppliers and consumers, are all closely related. Porter (1992: 17) suggests the “nominat[ing of] significant owners, customers, suppliers, employees, and community representatives to the BoD”.

Clarkson (1994: 322) defines stakeholder theory in these terms: “The firm is a system of stakeholders operating within the larger system of the host society that provides the necessary legal and market infrastructure for the firm’s activities. The purpose of the firm is to create wealth or value for its stake holders by converting their stakes into goods and services.” Sternberg (1997) reports stakeholder theory as the doctrine that enterprises should be run not for the financial benefit of their owners but for the benefit of all their stakeholders. Though there is no agreed definition of stakeholder theory, the term is widely described as the duty of the management to take into account the interests of anyone who has a significant “stake” in the firm (Rose and Mejer, 2003). Jones and Wicks (1999) state that the theory is concerned with the nature of these relationships in terms of both processes and outcomes and focuses on managerial decision-making; the interest of all legitimate stakeholders have intrinsic value, and no set of interests is assumed to dominate others. Therefore, stakeholders’

theory has suggested that a company should allow other stakeholders in addition to shareholders to participate in CG (Ezzamel and Watson, 1997; Hart, 1995).

Stakeholders' theory starts from a more extensive perspective observing the problems of CG, in order to attain an overview of the conflict of interest between the shareholders and stakeholders. The shareholders' interests lie in the protection of the interests of shareholders or minority shareholders, while the view of stakeholders' interest is to maximise the company's interests by emphasizing the internalization of the external stakeholders. Therefore, stakeholders' theory emphasises a specific set of rules and mechanisms to guarantee every stakeholder gets fair repayment on the investment in enterprises, and to protect those investors who offer external funds to the company. The stakeholders' theory also presents a set of rules and mechanisms to protect shareholders and creditors from deprivation by management and internal individuals.

Clarke and Clegg (1998) write that "stakeholder theory is not just a moral imperative but a commercial necessity in a world where competitive advantage stems more and more from the intangible values embodied in human and social capital". They also mention that enterprises should survive public supervision if the companies take into account long-term interests. Theoretically speaking, a company exists because it is a subject of responsibility as well as value creation. In other words, a company bears certain responsibilities to society to create wealth for the shareholders and society at the same time. While the process of the company's existence and development should consider the shareholder's interests, it must also consider the balance across other stakeholders' interests in order to realise a multiple win solution.

The German and Japanese CG models have been identified as stakeholders' models (Wang, 2005). Both models provide the possible means to liberate the management teams from shareholder pressure. Furthermore, the stakeholder model provides more rights and influence in the running of the company to interest groups, such as banks, customers, the general public and employees, who are not necessarily owners, including influencing the BoD. China adopted the SB of the German and Japanese systems in order to balance the interests of both large and minority shareholders through the shareholders meeting election of staff representatives to the SB.

Managerial Hegemony Theory

Managerial hegemony theory mainly asserted that the BoD is a legal fiction and dominated by professional management in the organisation (Mace, 1971; Vance, 1983; Lorsch and MacIver, 1989). “The BoD is an important ceremonial and legal fiction.” (Drucker, 1974) Most boards only perform effectively during the period of crisis (Mace, 1971; Clendenin, 1972). Hung (1998) adds that the governing board of a company serves simply as a “rubber stamp”. Whisler (1984) and Lorsch (1989) state that directors are constrained from setting strategies although they would often like to get involved. Ingley and van der Walt (2001) prove that, in practice, boards are not involved in setting up strategies. It may be due to boards lacking, in relative terms at least, the required knowledge of the organisation (Hung, 1998).

Some points have been ascribed for explaining managerial hegemony theory as follows:

- (1) On the assumption of the separation of ownership and control (Berle and Means, 1932; Jensen and Meckling, 1976), a state of diffuse ownership pattern perhaps lead to relative weakness in shareholder control, so as to give management a relatively stronger foothold over the board’s control of the company.
- (2) By the nature of information asymmetry between non-executive directors and management, clearly the management holds an advantage over in-house information. A board principally composed of non-executive directors would be deemed more passive regarding the activities and information within the company than the management.
- (3) Internal directors rely on the decision of the chief executive officer (CEO) for compensation and career advancement, and invariably report to him in practice. In this circumstance, it is unavoidable that the internal directors support the CEO at board level, which reduces the effectiveness of BoD by rendering the balance of power against external directors. Moreover, the management may escalate their influence in order to control the board.
- (4) Managers can also use retained earnings to decide financial investment independently (Mizruchi, 1983; Byrd *et al.*, 1998), allowing them to reduce control from the board.

(5) In most instances, the management handpick the board members (Pfeffer, 1972); therefore, the board directors are deemed to be in control by the management for selection processes.

Similarly, Herman (1981) states that the board only plays a superficial review and approval role, likened to a “rubber-stamp” function.

Some studies stand against managerial hegemony theory. Zeitlin (1974) argues that the growth of ownership by the large shareholders and interlocking directorships considerably reduce the ability of management to control boards. Mizruchi (1983) argues with some vehemence that the board has ultimate control over the management through their designated right to hire or fire the CEO. Therefore, Stiles and Taylor (2001) conclude that empirical support for hegemony theory is limited, emphasising its dependence on the definition of the term “control”.

Political Model Theory

Political model theory is defined as an approach “... in which active investors seek to change corporate policy by developing voting support from dispersed shareholders, rather than by simply purchasing voting power or control” (Pound, 1993). “This new form of governance based on politics rather than finance will provide a means of oversight that is both far more effective and far less expensive than the takeovers of the 1980s” (Pound, 1992). Accordingly, “an understanding of the political marketplace is essential to appreciate the role that capital-market mechanism can play in CG” (Gundfest, 1993).

In essence, political model theory stresses how governments favour their various constituencies, so that stakeholders influence allocations of corporate power, privileges and profits between owners, managers and other stakeholders. At the micro level, this is subject to the macro framework, which is interactively subjected to the influence of the corporate sector.

Compared to Western societies, CG – especially with regard to the internal supervisory mechanism – developed over a relatively short period of time in China. It developed as a consequence of the reform and transition from a planned economy to a socialist market one. Within China’s unique political environment, the settlement and

development of internal supervisory mechanisms has several characteristics. It has been subject to the external pressure of “government behaviour” (Zhuang, 1997). It is important for companies to establish and improve the self-control system in this period of transformation in China. Jou (1997) asserts that “at that time, such compulsory means was necessary for the open door policy, and was essential under the condition when the planned economy was turning to a market economy.”

Institutional Ownership

Institutional Ownership theory mainly argues that, as institutional shareholdings are so large, it is difficult to switch their invested capital from one firm to another. As a result, they play an important role in the decision-making processes of the firms in which they have invested (Changati and Damanpour, 1991). The key concept of this theory is the logic that the greater concentrated shareholders have greater impact upon the BoD. Changati and Damanpour (1991), argue that stocks owned by institutional investors are significantly associated with return on equity (RoE). Duggal and Millar (1999) find a positive relationship between bidder gains and institutional ownership, and that institutional ownership is greatly determined by firm size, insider ownership and the firm’s presence in the S&P 500 Index. Yet, Duggal and Millar (1999) and Craswell, Taylor and Saywell (1997) do not find evidence to support the idea that institutional ownership is an important determinant of corporate performance, and even no relationship at all between institutional ownership and firm performance.

In respect of supervisory function, the control over managers under institutional ownership theory is featured as a special background, influenced by concentrated shareholders. Institutional ownership theory can be viewed as a part of the political model theory to enhance the understanding of the background in influencing the control policy.

Stewardship Theory

The concept of stewardship theory derived from psychology and sociology and linked to the managerial behaviour literature (MaClelland, 1961; Argyris, 1964; Herzberg, 1966). Donaldson (1990: 375) stresses that managers are motivated by “a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby gain

recognition from peers and bosses”. Under stewardship theory, achieving high performance and the ability to use a high level of discretion to act for the benefit of shareholders are viewed as the key interest of managers (Donaldson and Davis, 1991).

Collectively, stewardship theory is considered within non-financial motives of managerial behaviour, which is opposed to that taken by agency theory. Perrow (1986: 234) argues the limitation of the shareholder agency theory, as it neglects “the enormous amount of neutral and other-regarding behaviour that exists...and the structures that might increase it”. This suggests that shareholder agency theory should enhance the relationship between the management and shareholder by providing a vivid and complete picture. Donaldson and Davis (1994) summarise the main features of stewardship theory in these terms: “Managers are good stewards of the corporations and diligently work to attain high levels of corporate profit and shareholder’s returns”. Furthermore, they assert that “managers are principally motivated by achievement and responsibility needs” and “given the needs of managers for responsible, self-directed work; organisations may be better served to free managers from subservience to non-executive director dominated boards”.

Davis *et al.* (1997) stress that stewardship theory “relies heavily on trust, between principles and managers”. The directors can be trusted and will act as stewards over resources of the enterprise because the directors’ fiduciary duties are based on stewardship theory under English law (Tricker, 1996) The trust concept of stewardship theory is opposed to the checks and balances concept by “monitoring and control” of agency theory.

Hawley and Williams (1996) highlight stewardship theory in relation to the board structure as, “the logical extension in either towards an executive-dominated board or towards no board at all”. McGregor (1967: 145) states, “With a group, leader, or course, he is in effect saying that the goals and values associated with that cause have become his own. He then self-consciously directs his efforts towards those goals.” Managers identify themselves by gaining intrinsic satisfaction through their achievement. Therefore, a positive view of control and monitoring among owners and managers under stewardship theory has developed, whereby the relationship between shareholders and managers is not in conflict. Rather, managers actively pursue business challenges in order to meet shareholders expectations. This contrasts with

shareholder agency theory, which advocates goal conflicts by the control structure of the separation of ownership and management. Burton (2000) distinguishes the difference between stewardship theory and shareholder theory by stressing that the former focuses on trust rather than monitoring; involvement rather than control and intrinsic non-financial motives rather than extrinsic motivations generally understood to be of a financial nature. Therefore, external control mechanisms are not necessary in order to impact upon the interest of owners (Argyris, 1990). Dulewicz and Herbert (2004) argue that management arrives at the required scope and latitude to implement effective control by allowing the required levels of co-ordination to be achieved.

However, criticisms of stewardship theory are unavoidable. Tricker (1994: 56) states it “ignores the dynamics of boards, inter-personal perceptions of roles and the effect of board leadership”. Tricker focuses on the lack of knowledge or causal explanation regarding to organisational life, for example the interplay of power, conflict and ideology. Clarke (2005) doubts the efficacy of stewardship theory, given it was exemplified in Enron’s demise.

Resource Dependency Theory

Pettigrew (1992) argues that both sociology and management doctrines are derived, in order to form the concept of resource dependence theory. This theory is based on the concept of cooptation, focusing in particular on the attempts by BoDs to create the appropriate linkage with the environment for the expansion of the enterprise. Pfeffer and Salancik (1978) add that, “when an organisation appoints an individual to a board, it expects the individual will come to support the organisation, will concern himself with its problems, will favourably present it to others, and will try to aid it”. The BoD is deemed to hold the key role of being co-operative mechanisms for the organisation to link the environment to access important resources and to buffer organisations against adverse environmental change (Pfeffer and Salancik, 1978; Pearce and Zahra, 1991; Goodstein *et al.*, 1994).

Ingley and Van der Walt (2001) state the nature of resource means the connection to a nation’s elite, industrial intelligence and competitors, market or capital. Further, inter-organisational linkage such as the appointment of outside directors and boardroom interlocutors can also be used to manage environmental contingencies (Muth and

Donaldson 1998). Price (1963) and Zald (1967) state that the board is viewed as the helper to the organisation by influencing their other constituencies on behalf of the focal organisation. The professions and communities of the directors can provide the resources within organisations. Overall, resources linkage by means of boards is aimed to maximise its performance (Zald, 1969; Pfeffer, 1972; Pfeffer and Salancik, 1978).

From such linkages, four types of organisational benefits are defined by Bazerman and Schoorman (1983):

- (a) Building reputation – Useem (1984) asserts that the BoD can affect the organisation's reputation and the organisation is seen to be linked.
- (b) Expertise Accessing – Mizruchi and Stearns (1988); Stearns and Mizruchi (1993) state that directors are likely to possess skills that could be beneficial to the focal organisation in terms of financial, technological or prior work experience with competitors. The background of the directors among external directors is expected to support resource dependence theory (Van der Walt and Ingley, 2003).
- (c) Horizontal co-ordination – a level of environmental awareness not readily available to management is achieved by exchanging information on topics of concern, providing opportunities of communication among directors and management (Bazerman and Schoorman, 1983).
- (d) Vertical co-ordination – in order to reduce the uncertainty about the availability of resources and even perhaps secure favourable treatment for the organisation, vertical linkage to its suppliers is vitally beneficial to the organisation (Bazerman and Schoorman (1983).

Criticisms about resource dependence theory have been raised: for example, the role of boards in potentially obtaining resources rather than being involved in exploiting them (Finkelstein and Hambrick, 1996; Hung, 1998). Therefore, it is suggested that boards serve as a “strategic consultant to top managers rather than (or in addition to) exercising independent control” (Carpenter and Westphal, 2001). Overall, the shortcomings of resource dependence theory centre upon several activities of the boards: namely, providing advice (Lorsch and dMaclver 1989; Westphal 1999);

monitoring (Fama, 1980; Bainbridge, 1993; Johnson, Daily *et al.*, 1996); and strategizing (Lorsch and MacIver, 1989; Kesner and Johnson, 1990).

3.1.4 The Reasons of Research Theories Applied in this Thesis

Stiles and Taylor (2001) point out that no single perspective adequately explains this strategy role though managerial, stewardship, agency and resource dependence theories provide insight into the strategy role. They summarise that: “The view that one theory by itself does not illuminate the whole spectrum of board endeavour receives strong support from examination of their shortcomings”. “It is not a matter of agency theory or stewardship theory or resource dependence theory. Rather each theory has a contribution to make to governance debate” (Kiel and Nicholson, 2003).

The two principal theories relied upon in this thesis are Shareholder and Stakeholder theories.

Shareholder Theory

Shareholder theory implies a need for supervisory functions, as managers cannot be trusted to act in the interests of shareholders. Since 2002, China has allowed a voluntary choice for listed companies to establish the British or the American system of ACs. Wang (2005) argues that the AC’s CG system in the US and UK is categorised as shareholder agency theory. The proxy (shareholder) theory is key in the research of CG. In particular, the importance of ACs’ functions is highlighted by the assumptions of proxy theory. This research is based on the shareholders’ agency theory, as a foundation with which to understand the effectiveness and operations of the ACs in China. It is also hoped to consolidate this shareholders’ agency theory through this research.

Stakeholder Theory

Wang (2005) believes that the SB’s CG system in Germany and Japan is considered within stakeholder theory. This theory suggests the company’s supervisory function should be enhanced: in order to expand to related stakeholders on top of taking care of shareholders. Since the beginning of 1993, the internal supervisory mechanism of CG in China has adopted the German and the Japanese system of SBs. This research will be applied to stakeholder theory, so as to explore the existence of an internal

supervisory mechanism of CG in China, with the purpose of gaining benefits for all stakeholders: not merely the major shareholders.

Shareholders and stakeholders are identified as the key links in the reliability of financial reporting quality, internal control³ and auditing. Most of all, they expect the SBs and ACs to supervise the tendency to manipulate the monitoring process of financial reporting, internal control and auditing. From the theoretical perspective of applying stakeholder and shareholder (proxy) theories, shareholders and stakeholders expect effective monitoring by the internal supervisory mechanism. They also expect the existing system of the SB in China to be adequate as a monitoring agency. Hence, the impact of the AC on the interaction with SBs of internal supervisory mechanism in China needs to be analysed and an assessment made of its effectiveness in practice, since a gap exists between the regulations and standards and actual practice (Spira and Page, 2003).

Other Approaches:

Managerial Hegemony Theory

Managerial hegemony theory asserted that the BoD is really a legal fiction and is dominated by professional management in the organisation (Mace, 1971; Vance, 1983; Lorsch and MacIver, 1989). This thesis aims to understand whether SBs and ACs can develop their supervisory functions with effectiveness in China. In this thesis, managerial hegemony theory is viewed as a fair basis with which to examine whether SBs and ACs in China only provide a rubber stamp function; or whether they can fulfil their defined “control” function of effectiveness.

³ The definition of Internal Control by the COSO Report (COSO 1992): “Internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: 1. Effectiveness and efficiency of operations. 2. Reliability of financial reporting. 3. Compliance with applicable laws and regulations.”

Political Model Theory

Political model theory is “based on politics rather than finance” and introduces the significant impact of the political environment by influencing the policy. It is probably best viewed in terms of complementing stakeholder theory, by controlling the relative power of each group. In this thesis, by applying the Anglo-American ACs system and German SBs in China, their effectiveness in China may be found to be different from what might be expected. Therefore, the macro framework of the political background of China will be explored, to understand and explain her unique circumstances and structures.

Institutional Ownership Theory

Shareholder ownership status is more centralised in China than the US and UK. Yet, developing countries seem more driven by the Anglo-American model. Concentrated shareholding may impact upon the effectiveness of supervisory functions if developing countries successfully adopt the Anglo-American model. Institutional ownership theory enables this thesis to reveal concentrated shareholding status as a basis with which to study the impact and effectiveness of ACs and SBs in China.

Stewardship Theory

Stewardship theory stresses that managers are driven by self-motivation, opposed to that taken by shareholders and stakeholders theories. Donaldson and Davis (1994) summarise the main features of the stewardship theory as asserting that “Managers are principally motivated by achievement and responsibility needs” and “given the needs of managers for responsible, self-directed work, organisations may be better served to free managers from subservience to non-executive director dominated boards”. This thesis is focused on the monitoring function, which is not the idea behind stewardship theory.

Resources Dependence Theory

The resources dependence theory suggests that boards serve as a “strategic consultant to top managers rather than (or in addition to) exercising independent control” (Carpenter and Westphal, 2001). It is hard to refute the expectations of the members

of ACs and SBs to bring benefits to their organisations, for it is an invisible asset, which may raise the enterprises' reputation, expertise, co-ordination and connection, in order to earn more resources. But this thesis questions the role of the AC played in China. The AC is one of the sub-committees in BoDs. Resource dependency theory highlights that the role of boards expands the outward-looking boundary, in order to enhance a business. This theory will be applied, in order to assess whether the AC's contribution in China can bring added value or provide extra service to the company, in addition to executing independent control.

3.1.5 A Summary of Research Theories Applied in this Thesis

The shareholder and stakeholder theories are the principal theories relied upon in this thesis while the other approaches of managerial hegemony, political, institutional and resources dependence theory have been included to provide background perspective on the approaches applied in the literature. This thesis aims to explore whether ACs are underpinned by a separation of ownership and control: the origin of agency theory. Fama (1980) comments that separation of ownership and control can be explained because of efficient forms of economic organisation. Furthermore, this thesis concentrates on the structure of the SB system, within which stakeholder theory is considered to take care of the interest of not only shareholders but stakeholders too. In turn, this will guide the thesis to study employee impact relative to the effectiveness of SBs and the co-ordination between SBs and ACs in China. Managerial hegemony theory forms the concept with which to study the effectiveness of supervisory functions, so it can be evaluated whether SBs and ACs in China merely act as rubber stamps. Political model theory and institutional ownership theory both lead this study to introduce the political and shareholding background for supporting the aforementioned and applied theories, in order to understand and explain the research findings. Resources dependence theory is used, to assess whether the contribution of ACs in China is limited in exercising independent control only; or whether ACs can verify resources dependence theory, by acting as consultant or providing extra services in China.

Table 10. A Summary of Research Theories Applied in this Thesis
(Source: Author, as supported by reference contained within)

| Item | Research Theory | The Reasons Applied in This Thesis |
|--|-----------------------------|--|
| Principal theories: shareholder and stakeholder theories | | |
| 1 | Shareholder / Agency | The AC is deemed to play a monitoring and control function in safeguarding the interest of shareholders because manager is assumed to act opportunistically to further their own interest before that of shareholders (Jensen and Meckling 1976) In this thesis, this theory forms the basis for introducing ACs into China, acting as the monitoring role to enhance the existing SBs with high expectation for AC's performance in effectiveness. |
| 2 | Stakeholder | Freeman (1984, page 31) defines "A stakeholder in an organisation is any group or individual who can affect or is affected by the achievement of the organisation's objective" Porter (1992, page 17) suggested to "nominate significant owners, customers, suppliers, employees, and community representatives to the BoD". Wang (2005) analyses that the SB's CG system in Germany and Japan is considered as stakeholder theory. In this thesis, this theory provides the basis for reasoning the SB serves as the key role of supervisory functions in China since 1993 though AC has been introduced since 2002. |
| The other approaches: managerial hegemony, political, institutional and resources dependence theory in this thesis | | |
| 3 | Managerial hegemony | The BoD is only a legal fiction and is dominated by professional management in the organisation (Mace 1971; Vance 1983; Lorsch and MacIver 1989). Hung (1998) adds that the governing board of a company serves simply as a "rubber stamp". In this thesis, this theory is founded as the basis for studying the effectiveness of SBs and ACs in China. |
| 4 | Political model | "..Governance based on politics rather than finance will provide a means of oversight" (Pound 1992). Therefore, "an understanding of the political marketplace is essential to appreciate the role that capital-market mechanism can play in CG" (Gundfest 1993). In this thesis, this theory provides the basis to introduce the background especially related to the internal supervisory mechanism of CG in China. |
| 5 | Institutional ownership | Institutional Ownership theory mainly defines the institutional shareholdings are so large that it is difficult to switch their invested capital from one firm to another. As a result, they play an important role in the decision-making processes of the firms in which they have invested (Changati and Damanpour, 1991). In this thesis, this theory uses this basis as part of the political model theory to enhance the understanding of the background relating to the shareholding structure in China. |
| 6 | Resources Dependence Theory | The resources dependence theory suggested that boards serve as a "strategic consultant to top managers rather than (or in addition to) exercising independent control" (Carpenter and Westphal 2001). It is used to assess whether the contribution of role-play of ACs in China is limited in exercising independent control. |

3.2 Literature Review

3.2.1 Introduction

In order to find the evidence for answering the research questions identified in the previous chapter, the literature reviews and related regulations on ACs will now be looked at.

The literature review presented here will start with the definition of the AC, followed by an exploration of the composition of ACs, which will focus on their independence, expertise and responsibility. The scope of these aspects of the composition of ACs and their impact on its effectiveness will be further explored through a review of related academic works and related regulations.

Western research findings published in the literature are referenced, in order to apply the proper attributes to the study of the effectiveness and the operations of the Chinese internal supervisory mechanism. Furthermore, there are areas in which further work is needed, and in which current regulation is in contradiction to the findings of the research. Based on the review of the regulations and research in these areas, the possible factors of dependent and independent variables for evaluation of the effectiveness, operations and co-ordination of the Chinese internal supervisory mechanism are therefore identified.

3.2.2 Definition of the Audit Committee

It seems there is no universally accepted definition of ACs that may be found in regulations, reports, surveys and research studies. Instead, different definitions are presented, such as Section 404 of SOX (2002), Klein (2002), Collier (1992), Marrian (1988), Peat Marwick McLintock (1987) and Braiotta (1981). Some examples of these definitions are quoted below:

“The term ”Audit Committee” means – a committee (or equivalent body) established by and amongst the BoD of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer” (US Securities Exchange Act of 1934 #3 (a)(58); SOX Section 404, 2002)

“Each member of the Audit Committee of the issuer shall be a member of the BoD of the issuer, and shall otherwise be independent.” (See US Securities Exchange Act of 1934 #10 (m)(3); SOX Section 404, 2002)

“Each issuer must have, and certify that it has and will continue to have, an Audit Committee of at least three members, each of whom must: (i) be independent as defined under Rule 4200(a)(15); (ii) meet the criteria for independent set forth in Rule 10A-3(b)(1) under the Act (subject to the exemptions provided in Rule 10A-3(c); (iii) not have participated in the preparation of the financial statements of the company or any current subsidiary of the company at any time during the past three years...” (See Final NYSE CG Rules, Section 303A(7)(a))

“A committee of the board normally comprises three to five directors with no operating responsibility in the financial management. Its primary tasks are to review the financial statements, the effectiveness of the company’s accounting and internal control system, and the findings of the auditors, and to make recommendations on the appointment and remuneration of the external auditor.” (Marian, 1988)

“An Audit Committee is a committee of the board of the directors established to give additional assurance regarding the quality and reliability of financial information used by the board. An Audit Committee of a company may be broadly defined as a committee of the board, composed wholly or predominantly of non-executive directors, set up to oversee, review and monitor the financial reporting process and the audit activities.” (Peat Marwick McLintock, 1987)

“An Audit Committee should be organised as a standing committee of the board composed mainly of non officer directors.” (Braiotta, 1981)

Summary

These definitions state that the AC is a sub-committee of the BoD; and confine the definition mainly to the composition and the key responsibilities of ACs. These definitions emphasise the composition of the AC by the participation of independent directors with the professional abilities to perform the key responsibilities of financial reporting, audit and internal control. In summary, all definitions of the AC tend to

emphasise two attributes of its composition, namely independence and financial expertise, as well as its responsibility or operations.

3.2.3 Composition

Since the AC's independence and financial expertise of competence are the key factors that determine its performances (Beasley, 1996), any serious regulatory attempt should have specific requirements related to these factors, and different levels of regulatory requirements may result in different levels of supervisory performance. Hence the need for a comparison on the requirements on the charters of the AC across the American, British and Chinese systems: the findings presented in the table below.

Table 11. Comparison on the Requirements on the Charter of the AC across the American, British and Chinese Systems
(Source: Author, as supported by reference CSRC (2001), CSRC and SETC (2002), FRC (2008), FRC (2010), and SOX (2002))

| Country | US | UK | China |
|---|---|--|---|
| Requirements related to the independent directors | All members: It should have at least three members, who should all be independent directors. | All members: It shall have at least three members, or two in the case of smaller companies, who should all be independent non-executive directors. "C.3.1 The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman"(FRC, 2010) | At Least half of the members: It shall be chaired by an independent director, and independent directors shall constitute the majority of the committees. |
| Requirements on the level of expertise | The firm is mandated to disclose in its filings whether the AC has a financial expert, and if not to explain why. | At least one member of the AC has recent and relevant financial experience. "C. 3.1 The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience"(FRC, 2010) | At least one independent director from the AC should be a professional accountant. |

As shown in this table, the Anglo-American model requires all members of the AC to be independent directors, while the Chinese model asks for only half of the members

to be independent directors. On the other hand, in the Chinese model, at least one of the members has to be a professional accountant, while the corresponding requirement in the Anglo-American model only asks for financial expertise or experience.

The key attributes of independence and expertise are described respectively in the following sections.

3.2.4 Independence

Definition of the Independence of ACs

Independence is highlighted as the one of the key compositions of ACs by the latter's definitions. The independence of members of a supervisory governance structure from executive management has been widely regarded as a necessary precondition for its effectiveness and supervisory quality. For example, in the UK, the Code of Best Practice issued by the Cadbury Commission (1992) contains the following statement:

“An independent director is independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholding. Their fees should relate to their working time.”

The UK Corporate Governance Code (FRC, 2010, June): on B 1.1 stipulates it to be independent from management, business, and relationships materially interfering with their independent judgments, apart from their fees and shareholdings. Their fees should relate to their working time.

“B.1.1 The board should identify in the annual report each non-executive director it considers to be independent. The board should determine whether the director is independent in character and judgement and whether there are relationships or circumstances which are likely to affect, or could appear to affect, the director's judgement. The board should state its reasons if it determines that a director is independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination, including if the director: has been an employee of the company or group within the last five years; has, or has had within the last three years, a material business relationship with the company

either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company; has received or receives additional remuneration from the company apart from a director's fee, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme; has close family ties with any of the company's advisers, directors or senior employees; holds cross-directorships or has significant links with other directors through involvement in other companies or bodies; represents a significant shareholder; or has served on the board for more than nine years from the date of their first election."

Similarly, in the USA, the Sarbanes-Oxley Act regards independent directors as those having no "significant relation" with the company. This means they are [1] not former directors, [2] not occupationally related with the company, [3] not the clients or the suppliers of the company, [4] not recommended or appointed on the basis of personal relations, [5] have no close relation to any executive director, and [6] do not have a significant share or represent major shareholders. Section 301 of the Sarbanes-Oxley Act also stresses the independence of the AC, stating that it must be formed by independent directors, who must not receive consultation fees or reward, and must not take part in any related transactions with the company or its subsidiaries.

Related to the regulations of the independence of ACs, besides SOX act, the NYSE and NASDAQ also mention that any of the following will be deemed to constitute lack of independence:

1. Directly or indirectly receive the remunerations or rewards of providing consulting or advising services (SOX act 、NYSE 、NASDAQ – three regulators all stipulate this point at the same time.)
2. The affiliates of the holding company or subsidiary company of the listed company (SOX Act, NYSE, NASDAQ – again, all three regulators stipulate this point at the same time)
3. Who participates in making the financial reports of the holding company or subsidiary company of the listed company in the past three years (NASDAQ)

4. The directors or the family members⁴ were ever hired as the executive managers (or management level) in the holding company or subsidiary company of the listed company in the recent three years (NYSE, NASDAQ)
5. The directors or the family members receive rewards over the limit, except the rewards of being directors in the recent three years (NYSE regulates 100,000 US; NASDAQ regulates 60,000 US)
6. The directors or the family members are the executive managers in other companies, or the executive managers of this listed company have been the members of the remuneration committee in the recent three years. (NYSE, NASDAQ)
7. Whoever acted as the members of the CPA firm hired by this listed company:
 - NYSE regulates: The directors or his/her most closest family members as experts or consultants directly or indirectly were hired to be the current or the prior internal auditors or external auditors in the recent three years.
 - NASDAQ regulates: The directors or his/her most closest family members are the current partners had ever been the partners or employees of the independent audit firm in the recent three years.
8. Whoever had been the partners (excluding the limited company's partners), control shareholders or executive managers, and this company receive the funds from the listed company over the limit.
 - NYSE regulates: Total operation revenue 2% or US\$ 1 million (based on the higher one)
 - NASDAQ regulates: Total operation revenue 5% or US\$ 200,000 (based on the higher one).

The regulations in the US and UK require that ACs should be comprised of independent directors. This means it is not allowed for independent directors to

⁴ "Family Member": means a person's spouse, parents, children and siblings, whether by blood, marriage or adoption, or anyone residing in such person's home." (NASDAQ, 2010: Rule 4200(a)(14))

conform to any of the aforementioned eight conditions. But in China, it is only required that the majority of the committees members fit in with the requirement of independence according to the Guidelines for Listed Companies on the Establishment of the Institution of Directors, effective since 21 August 2001. These state that:

The Independent Directors must be independent, and the following persons cannot be appointed as the Independent Directors:

- (1) People who work for the listed company or its subsidiaries, their direct family line or their immediate family members;
- (2) People, or their direct family, who either hold directly or indirectly 1% or more of the shares of the listed company, or are among the top ten natural person shareholders of the listed company;
- (3) People, or their direct family, who work for the institution that either holds directly 5% or more of the shares of the listed company or among the top five shareholding institutions;
- (4) People who have been included in the previous three categories in the previous year;
- (5) People who offer consultancy services on finance or law to the listed company or its subsidiaries;
- (6) Other people specified in the constitutions of the listed company;
- (7) Other people specified by the China Securities Regulatory Commission.

Summary

The Blue Ribbon Committee (BRC) (1999: 22) noted that “several recent studies have produced a correlation between AC independence and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud.” This statement indicates that more independent ACs could exercise better oversight of the quality of financial reporting. Looking at the UK, US and China’s regulations, the strictest standard is applied: the independent directors must not receive fees regarding

consultation or reward; must not have share holding; must not have any affiliations of having “significant relation” with the company by taking part in any related transactions with the company or its subsidiaries; must not work for the company or its subsidiaries in the current year or ever act as the “identified title or function” such as being the partner, executive or the maker of financial statements in the past three years.

Academic Works on the Independence of Audit Committees

These related studies support the contention that the independence of ACs can increase the company’s value and strengthen the quality of financial reporting and the effects of the earnings management (Beasley, 1996; Abbott *et al.*, 2002; Klein, 2002a; Klein, 2002b; Carcello and Neal, 2003; Xie *et al.*, 2003; Abbott *et al.*, 2004; Bedard *et al.*, 2004; Chiang, 2006; Tsai, 2009; Kao, 2009).

Beasley (1996)

Beasley researched the relationship among independent directors of ACs and concurrent financial manipulation, finding that those companies with a higher percentage of independent directors and those which had established ACs to have lower percentages of financial manipulation; whereas the companies which had not set up ACs had a higher.

Abbott et al. (2002)

Abbott *et al.* researched according to the proposal of BRC (Blue Ribbon Committee), dividing their samples between ‘normal’ and ‘abnormal’ reporting companies, so as to explore the relationship with the ACs. The results indicated that the higher the independence and higher the frequency of supervising the company’s financial conditions, the smaller the possibility of financial manipulation. They report:

“We find that the independence of the audit committee and whether the committee meets at least four times per year exhibits a significant and negative association with the occurrence of financial reporting restatements. Our results underscore the importance of the BRC’s first two recommendations, both of which concern audit committee independence.”

Abbott et al. (2003)

Abbott *et al.* (2003) explores the relations between the characteristics of ACs and the audit fee, by researching the independence, expertise and meeting times associated with the aforementioned fees. They use a review of the literature to assume that audit fee increase will increase the audit quality, and that ACs have the responsibilities of supervising the financial reports, management levels, and external auditors. They report:

“Audit committees comprised solely of independent directors that meet at least four times annually are significantly, positively associated with audit fees. This evidence is consistent with audit committee members taking actions within their span of control to ensure a higher level of audit coverage, as well as facilitating auditor independence.”

Klein (2002a)

Klein (2002a) explored whether the AC and the characteristics of BoD relate to the earnings management of the company. SEC, NYSE and NASDAQ assert the positive relationship between the earnings management and a weak CG mechanism; but Klein revealed a negative relationship. Decreasing independence of the BoD and ACs increases abnormal accrual numbers. This has the most obvious impact when the BoD and ACs are composed with a minority of the external independent directors. This research suggested that the more the structure of the BoD is independent from the CEO, the more effective it is in supervising the process of financial reports.

Klein (2002b)

Klein (2002b)'s purpose is to explore the factors affecting the independence of ACs. S&P's 500 listed companies between 1991 and 1993 provide the research samples. The findings reveal that the independence of ACs increase in tandem with enlarging the size of BoD, but decrease together with opportunities for growth if the shareholding by external directors who are also the member of ACs is over 5%. The AC has higher independence when the company has the bigger size of the BoD: the higher percentage of the external directors divided by the total director numbers of

BoD. Yet no relationship exists between the AC and the creditor's demand for accounting information.

Carcello and Neal (2003)

Carcello and Neal (2003) explored the independence of ACs in cases of a CPA report doubting a going concern qualification of the company. Their results reveal those companies with more independent AC members to have a lower shareholding. AC members have the expertise to prevent from the CPA firm from being dismissed after releasing the report. The findings expressed that those members with the characteristics of independence and governance expertise will be more effective in developing the supervisory role.

Bedard, Chtourou, and Courteau (2004)

Bedard, Chtourou, and Courteau (2004) study the influence of the independence, expertise and activities of ACs on the quality of the financial reports: focusing in particular on relations between the aforementioned characteristics and earnings management. They use two groups of samples in 1996 covering 100 US companies, finding a negative relationship between aggressive earnings management and the independence of ACs.

Chang (2006)

Chang (2006) explores the deviation rate between controlling rights of the control shareholders and cash flow; and the relationship between the independence and expertise of ACs and retained earnings. He uses as his research sample 150 listed companies in each of Hong Kong, Singapore and Malaysia respectively. He used the research design of Fan and Wong (2002) to discover no positive influence between the deviation rate between the controlling rights of the control shareholders and cash flow. He also finds that companies with a higher independence of ACs gain more trust of investors on financial reports; have a positive influence on earnings information; and control the negative influence of over high controlling rights on information contexts. His research reveals that companies with high cash flow have the most positive relationship between higher independence of ACs and the earnings information context.

Tsai (2009)

This study examines whether AC expertise and independence are related to earnings management by the firms in question. It finds that earnings management (discretionary accruals) is negatively associated with the of independent directors on AC. Tsai reports that the higher of independent directors divided by the total number of BoD leads to lower earnings management. This reveals that higher levels of independence can lead to more effective supervisory functions.

Kao (2009)

In this study, the quality of accounting information is divided into conservative accounting, stability, timeliness and continuity, in order to have set up in 2008 either the AC, or an AC of listed prospective cabinets. The result showed that the independence of the AC and conservative accounting information quality led to a smooth and continuous positive relationship in terms of timeliness. This study's results show that the independent directors of the AC can improve the CG environment, and effective assistance and supervision of the company's financial reporting process.

The Size of the AC

The SEC (1999) mandated that ACs consist of a minimum of three directors. Encouraged by the BRC and the accounting profession (IIA, 1991):

A survey by Price Waterhouse (1993) reports that 57% of firms have ACs with three or four directors, and three to six directors seems to be the optimum number for an AC. Yermak (1996) and Eisenberg *et al.* (1998) provide the evidence on the association between the number of directors on boards and the quality of financial reporting, generally suggesting a negative association, although this effect may begin only after an optimum number is reached. Xie *et al.* (2003) fail to find a significant association between the number of directors on the AC and annual earnings management.

Summary

A notable body of research has investigated the independence of ACs. Klein (2002), analysing data for over 800 US listed companies from 1991 to 1993, reported a reduction in earnings management in the presence of large outside directors on ACs and suggested that the independence of ACs is negatively associated with earnings management. Abbott *et al.* (2002) find that AC independence exhibits a significant and negative association with the occurrence of financial reporting restatements.

Two attributes that may reflect the independence of a supervisory body are the membership of outside directors and levels of members' stock ownership. In the US, Beasley (1996) reported that the likelihood of fraud is higher when the percentage of AC members who are outside directors is low. Carcello and Neal (2003) suggest that the presence of affiliated directors on an AC is positively associated with auditor dismissals following a going concern qualification, i.e. that ACs with greater independence can better protect the auditors from dismissal in potential disputes with management.

With respect to shareholding, the Cadbury Committee (1992) asserted that share option schemes for outside directors can reduce their independence. Bédard *et al.* (2004) examined the association between share option schemes for non-related outside committee members, which could reduce their independence, and the likelihood of aggressive earnings management. Yang *et al.* (2005) find that both independent and non-independent AC directors' stock ownership are positively associated with earnings management. These research results are consistent with Carcello and Neal (2003) and Bédard *et al.* (2004), who conclude that compensation by stock options may undermine an internal supervisory mechanism's independence.

The findings of all these related studies provide empirical support for a positive association between the AC's independence and its effectiveness in executing supervisory functions. Those ACs with higher levels of independence can prevent more earnings management. All studies conclude that higher levels of independence will increase the shareholders and stakeholders' trust in corporate governance.

3.2.5 Expertise

Section 301 of the Sarbanes-Oxley Act stipulates the responsibilities of ACs including hiring and paying for the CPA firm and supervising its auditing work, and resolving disagreements between the management and the auditors. It can be seen that the responsibility of ACs is related to financial, auditing and internal control. Members of ACs should be equipped with financial experience or education; otherwise, it is hard to expect them to develop the required supervisory functions.

Definition of “Financial Expertise”

SEC Definition

According to SEC’s Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act (2002),

(a) The members of ACs should be equipped with the following experience:

“The final rules define an Audit Committee financial expert as a person who has the following attributes: An understanding of generally accepted accounting principles and financial statements; The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves; Experience preparing, auditing, analyzing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of accounting issues that can reasonably be expected to be raised by the registrant’s financial statements, or experience actively supervising one or more persons engaged in such activities; An understanding of internal controls and procedures for financial reporting; and an understanding of Audit Committee functions.” (ibid.)

(b) The members of ACs need to develop financial experience through the following ways:

“Under the final rules, a person must have acquired such attributes through any one or more of the following:

- (1) *Education and experience as a principal financial officer, principal accounting officer, public accountant or auditor or experience in one or more positions that involve the performance of similar functions;*
- (2) *Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions;*
- (3) *Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or*
- (4) *Other relevant experience.” (ibid.)*

NYSE definition

According to NYSE (2003), Section 303A(7)(a) Commentary,

“Each member of the Audit Committee must be financially literate, as such qualification is interpreted by the company’s board in its business judgment, or must become financially literate within a reasonable period of time after his or her appointment to the Audit Committee. In addition, at least one member of the Audit Committee must have accounting or related financial management expertise, as the company’s board interprets such qualification in its business judgment While the Exchange does not require that a listed company’s Audit Committee include a person who satisfies the definition of Audit Committee financial expert set out in Item 401(e) of Regulation S-K, a board may presume that such a person has accounting or related financial management expertise.”

NASDAQ definition

According to NASDAQ (2010), Rule 4350(d)(2)(A),

“Each issuer must have, and certify that it has and will continue to have, an Audit Committee of at least three members, each of whom must...(iv) be able to read and understand fundamental financial statements, including a company’s balance sheet, income statement, and cash flow statement. Additionally, each issuer must certify that it has, and will continue to have, at least one member of the Audit

Committee who has past employment experience in finance or accounting, requisite professional certification in accounting, or any other comparable experience or background which results in the individual's financial sophistication, including being or having been a chief executive officer, chief financial officer or other senior officer with financial oversight responsibilities."

Summary

A second major attribute considered necessary for effective supervision and maintaining investor confidence is the professional or technical expertise of members of the supervisory structures (Sweeney and Vallario, 2002). For example, in the US, the BRC stated that the "effectiveness of the Audit Committee is affected, first and foremost, by the expertise of members of Audit Committees in the areas of accounting and financial reporting, internal controls and auditing" (BRC, 1999). Commonly, particularly in requirements for ACs, expertise is expressed through the attribute of financial literacy. For example, SOX mandates that the firm discloses in its filings whether the AC has a financial expert, defined as someone with experience in preparing or auditing financial statements and the firm's internal controls, and if not, explains why. Thus, firms must disclose whether the financial expertise in the AC is independent of management (SEC, 2002; SEC, 2003a).

In US, UK and China, the requirements state that every AC appoints at least one person with financial expertise. Initially the definition of financial expertise included prior work experience in accounting, for example, or that (s)he is a CPA, former CFO, corporate treasurer or controller. However, that definition has expanded to include senior officers from other companies – investment bankers and venture capitalists amongst them – with the capability to read and understand fundamental financial statements.

Academic Works on the Expert with Financial Background

Appointing a financial expert could only improve financial reporting when accompanied by complimentary governance provisions (Blue Ribbon Committee, 1999; DeFond *et al.*, 2005; Dhaliwal *et al.*, 2006). Firms with strong CG may exert stronger control over the firm's financial reporting decisions, irrespective of the activities of the AC, thereby reducing the impact of AC financial expertise on the

firm's reporting quality (Carcello *et al.*, 2008; Bryan *et al.*, 2007). DeFond *et al.* (2005) suggest that AC's responsibilities often require significant accounting sophistication: in that they involve assessing the reasonableness of complex financial matters such as the company's accounting reserves, and management's handling of proposed audit adjustments suggested by the external auditors. AC members with a financial background can decrease the possibility of earnings management and the errors in financial reporting; and increase the quality of financial reports. (DeZoort and Salterio, 2001; Abbotte *et al.*, 2002; Abbotte *et al.*, 2003; Xie *et al.*, 2003; Abbott, Parker, and Peters, 2004; Bedard *et al.*, 2004; Defond *et al.*, 2004; Defond *et al.*, 2005; Tsai, 2009; Kao, 2009)

DeZoort and Salterio (2001)

Their research purpose is to explore whether the experience of CG, financial reporting and auditing knowledge impact upon the judgement of ACs. 68 representatives selected from 340 AC members in Canada were given tests of arguable cases related to accounting policy; as well as knowledge of accounting and auditing, to explore whether they influenced the judgement of ACs members. They report;

“The results provide justification for calls that audit committees be composed completely of independent directors. The results also support auditor concerns that varying knowledge levels lead to systematic differences in audit committee member judgments in disputes between auditors and management.”

Abbott et al. (2002)

The purpose of this work was to divide the research samples into two groups of companies with normal and abnormal (not real) reports. The results indicate a lack of a professional background among AC members leads to a higher possibility of abnormal (not real) financial reports. They report:

“We also document a significant positive association between an audit committee that lacks a member with financial expertise and the occurrence of financial reporting restatements. Our results also highlight the need for financial expertise as a means of strengthening the monitoring and oversight role that the audit committee plays in the financial reporting process.”

Xie et al. (2003)

Xie *et al.* (2003)'s study takes 500 S&P listed companies from 1992 to 1993, excluding 48 no-data-provided companies but retaining a total of 282 companies as research samples. The purpose is to explore the relations between the composition of the BoD, ACs, executive committees and earnings management. It finds that the higher percentage of directors with experience as managers or with financial backgrounds, the lower the level of earnings management will be. This result proves that the US SEC was correct to stipulate the necessity for AC members to be equipped with a financial background. They report:

“We conclude that board and audit committee activity and their members' financial sophistication may be important factors in constraining the propensity of managers to engage in earnings management.”

Bedard et al. (2004)

Bedard *et al.* (2004) studies the impact of expertise, independence and related activities upon aggressive earnings management. They indicate that aggressive earnings management may mislead the investors and influence the quality of financial reports. The ACs are responsible for the supervision and insurance of the quality of financial reports. Their results indicate that the financial background of AC members and the experience of CG can be effective in preventing earnings management.

Defond et al. (2004)

The purpose here was to test whether recruiting financial experts the AC will have a positive and good response on the market. They separate two groups of ACs – those with and without accounting experts – to test market responses to the information announcements made by ACs. In 702 research samples, external directors were assigned as the members of the AC based on three-day accumulated extraordinary returns, to test market response to the announcement of information. The findings conclude that recruiting financial expertise onto ACs will have a positive market response; whereas non-accounting or non-financial expertise leads to no market response. It reports that experts with financial knowledge and background will enhance the performance of ACs: so ensuring the quality of financial reports.

Defond et al. (2005)

Defond *et al.* (2005) study the correlation between AC expertise and stock price. They discover that AC members with a professional accounting background have positive effect on stock price, whereas AC members without professional accounting background get no positive market response. Their research suggests that AC members with a professional accounting background are equipped with enough professional knowledge to ensure they have the capability to produce financial reports, so to have the better impact upon stock price.

Qin (2006)

Qin (2006) researches the influence levels of professional members of ACs, relative to earnings quality. Qin defined the professional background of accounting according to the SEC rule. The findings discover a positive relationship between the ACs with a higher percentage of accounting background and expertise, and to have a higher quality of earnings performance.

Tsai (2009)

This study examines whether AC expertise and independence are related to earnings management by the firm. It finds that earnings management (discretionary accruals) is negatively associated with the percentage of financial and accounting expertise on ACs. Tsai reports that AC's members from higher financial profession are more able to prevent earnings management.

Kao (2009)

In this study, the quality of accounting information is divided into conservative accounting, stability, timeliness and continuity, in order to have set up in 2008 either the AC, or an AC of listed prospective cabinet. The result showed that the professionalism of the AC and conservative accounting information quality resulted in a smooth and continuous positive relationship. This study's results show that professionals on an AC can improve the CG environment, and effective assistance and supervision of the company's financial reporting process.

Summary

The AC's financial expertise has also been linked to more informative earnings. A number of studies have examined the governance outcomes associated with varying levels of financial expertise. For example, Abbott *et al.* (2002) contend that there are greater incidents of earnings restatements and fraud in companies where the AC lacks financial literacy. Carcello and Neal (2003) find no association between the existence of a financial expert and the likelihood that the auditor will be dismissed following a going concern qualified opinion. Carcello *et al.* (2006) find a significant relationship between the presence on the AC of a financial expert with prior work experience in accounting and lower levels of earnings management. In contrast, they find no significant relationship between earnings management and the SEC's expanded definitions of financial expertise. More specifically, prior studies provide evidence of higher earnings response coefficients for firms having at least one financial expert on their AC (Bryan *et al.* 2007; Qin 2007) than firms without a financial expert. These results suggest that accounting expertise is associated with investor perceptions that earnings are persistent (Collins and Kothari 1989), and therefore of high financial reporting quality.

Other studies, such as DeFond *et al.* (2005), and Carver (2005), have examined the contextual role of various AC characteristics – notably including financial expertise – on aspects of financial reporting. Cohen *et al.*, (2005) and Klein, (2002a) document the effects that SOX and market regulations have had on earnings management. Agrawal and Chadha (2005) provide evidence concerning fraud and earnings restatements, Felo *et al.*, (2003) investigated financial reporting quality and Xie *et al.*, (2003), earnings management. There are also documented associations between financial expertise and incidents of accounting irregularities. Prior studies suggest that firms with at least one general financial expert disclose fewer accounting restatements (Agrawal and Chadha 2005; Abbotte *et al.* 2004). The results of this body of research provide empirical support for focusing on financial expertise as a significant governance attribute in this study of supervisory mechanisms in China.

DeFond *et al.* (2005) also provide evidence of a positive stock market reaction for firms that appoint a financial expert to their AC, with one interpretation being that accounting skills enhance the ability of the AC to oversee high quality financial

reporting. In addition, DeFond *et al.* (2005) find that firms that appoint a non-accounting financial expert do not experience abnormal returns surrounding the appointment, which implies the premium on financial expertise is naturally limited to individuals with financial expertise backgrounds. In addition, Zhang *et al.* (2007) and Bedard *et al.* (2007) find that firms with a larger of financial experts (both accounting and non-accounting) are less likely to report an internal control weakness over financial reporting. These results support the idea that financial experts are associated with stronger supervisory mechanisms.

The emphasis on AC members' expertise in regulation together with the research results from academic studies provide empirical support for a positive association between AC financial expertise and its effectiveness in executing its supervisory function. They support the view that higher levels of financial expertise lead to greater capability to prevent earnings management; and higher levels of professional expertise increase the trust of shareholders and stakeholders, reflected in, for example, a positive stock market reaction.

3.2.6 Responsibilities

Definitions of the Responsibilities of Audit Committees

The AC plays a central role in the monitoring mechanism of a firm. AC members maintain responsibility for oversight over accounting policies and judgments, as well as the quality of the overall financial statement (BRC, 1999; Bill, 2006). Furthermore, the AC is typically responsible for selecting outside auditors, and meeting with financial managers to gauge whether they are acting in the firm's best interest (Klein, 2002).

National Commission on Fraudulent Financial Reporting (Treadway Commission)⁵

COSO (1987) of the US reported on “The Good Practice Guidelines for ACs” to formulate the concrete compositions and functions of ACs. This regulation has been applied broadly and this guideline has been the standard for evaluating the effectiveness of ACs. Its context is listed as the following:

- (1) The Treadway report was the first formal documentation of setting standards based on best practices about AC responsibilities (Beans, 1999). This report identified CG principles that would significantly reduce the potential for fraudulent financial reporting.
- (2) Management and AC should guarantee internal auditors properly participate in the audit process of financial report, and communicate with the independent auditors;
- (3) Authorise AC
 - Funding to retain outside legal counsel without approval from management.
 - Funding to retain an independent accounting firm if a second opinion is called for.
 - Ready access to all books, records and employees of the corporation.
 - Power to conduct any investigation appropriate to fulfilling its responsibility
- (4) Appraisal and oversight the independence of the certified accountant;
- (5) Verify the planning of the management and consulting plan to engage the certified accountant
- (6) The management should listen to the opinions of the AC in the treatment of the major accounting issue.

⁵ The Treadway Commission was formed by the common association of AICPA (American Institution of Certificate Public Accounting), AAA (American Accounting Association), IIA (Internal Audit Association) and FEA (Financial Executive Association) and MAA (Management Accounting Association) in 1998 is a national independent committee related to fraud of financial reports.

(7) Oversee the internal control activities of the company and assess the effectiveness of a corporation's internal control structure and detail the attributes of an effective control system.

This COSO report emphasised the AC's role in establishing the tone at the top: explicit moral guidelines about right and wrong and the obligation to communicate ethical values to all employees. According to COSO (1987), the framework defines internal control as a process, enacted by an entity's BoD, management and other personnel, designed to provide reasonable assurance regarding the achievement of **objectives** in the following categories:

- Effectiveness and efficiency of **operation**
- Reliability of **financial reporting**
- **Compliance** with applicable laws and regulations.
- In 2004, COSO published Enterprise Risk Management – Integrated Framework, expanding the initial COSO framework with eight components of Enterprise Risk Management (COSO, 2004).

A. USA / COSO (1987) defined the responsibility of ACs:

The basic responsibilities of ACs are to achieve three objectives: the accuracy of financial reports, maintaining the self-discipline of the enterprises, and perfecting internal control:

1. Supervising financial reports: The purpose is to reflect the financial condition of the company, operation amount and long term strategy and plan. In order to achieve this goal properly, the ACs need to have the following rights and responsibilities:
 - (1) Recommendation for the certificate public accounting (CPA) firm.
 - (2) Supervising the process of auditing.
 - (3) Understanding the accounting principles and their significant impacts to the companies and reviewing the changes of the accounting policies.
 - (4) Inquiring about the significant forecasts, the judgemental issues and the other items that are easy to be neglected.
 - (5) Supervising financial reports and audit results.

- (6) Ensuring the independence of the CPA firm.
 - (7) Requiring the legal consultant to understand if there is any lawsuit pending for resolving or dispute cases related to tax payment.
 - (8) Maintaining the self-discipline of the enterprise: the purpose is to ensure properly that the company complies with the regulations, the commercial conducts meet to moral guideline, and controls the fraud of the employee or the conflict to the benefit of the company. In order to ensure the company can achieve this goal, the ACs need to have the following rights and responsibilities:
 - a) Review the regulations of the company
 - b) Review the internal audit significant findings, and yearly audit scopes and context
 - c) Review the misconduct or fraud events by the employee.
 - d) Review the lawsuit or the cases under investigation by the judiciary.
 - e) Review the expense process of allowance for entertainment and review the compliance of the management level including the usage of assets.
 - f) Represent the BoD to investigate the special case.
2. Perfecting the internal control: the purpose is to understand the critical risk and the internal control framework through the monitoring by the internal audit. In order to achieve this goal, the ACs need to have the following rights and responsibilities:
- (1) Supervising the charter of the internal audit to ensure the proper responsibility and the independence.
 - (2) Supervising the dismissal and transferral of the head of the internal audit department.
 - (3) Supervising the audit plan and budget to ensure the adequacy of the auditing.
 - (4) Supervising the audit progress and audit reports.
 - (5) Requesting the auditors for project investigation at any time, and supervising the audit context and result.

- (6) Requesting the audit department to perform the peer review periodically for ensuring the audit quality.
- (7) Supervising the internal control of internal audit, the control and security and reliability of the system information.
- (8) Supervising the statement of internal control by the management level.

In order to achieve the aforementioned responsibilities, the AC needs to have the following authorisations (rights):

- (1) Supervising the financial and business information and data of the company at any time,
- (2) Requesting the special project investigation according to the necessity.
- (3) Requesting the BoD and management level to provide sufficient resources such as requesting help from the outsourcing accountants, lawyers, and administrators.
- (4) Requesting the management level, internal auditors and independent auditors (certified accountants) to have the obligation to notify the ACs in case it is needed.

B. USA / POB (1993; 1995) defined the responsibility of the AC:

The POB report dated March 5, 1993 affirmed that “the integrity and reliability of audited financial statements are critical to the well-being of the American economy” and went on to recommend steps to regain public confidence in the accounting profession.

This public watch function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust.

The central suggestion of the 1995 report was that the independent auditor's engagement letter should specify that the client is the AC, making it clear that the auditor is not beholden to management; and the independent auditors should deliver forthright and candid reports in a timely manner in terms of both quality and acceptability.

Its more detailed recommendations included:

- (1) Review the company's annual financial report;
- (2) Communicate with the management and independent auditors to discuss the auditing regarding the annual financial report;
- (3) Evaluate the completeness of the financial statement and the consistency of the information.

Independent accountants were encouraged in the public interest to help ACs understand their responsibilities and make recommendations to the committees to help them improve the internal controls of the corporations whose shareholders they represent—in other words, to go further than the minimum requirements of an audit by issuing a “management letter.”

- (4) To communicate with independent accountants to assure the relevant information in compliance with the auditing standard (GAAS);
- (5) To ensure the financial report is in compliance with the accounting standard (GAAP).

C. USA / BRC (1999) defined the responsibility of the AC:

The 10 recommendations of the Blue Ribbon Committee on improving the effectiveness of corporate ACs (NYSE and NASD, 1999: Recommendations 1-10):

Mr. Arthur Levitt, the previous US Securities and Exchange Commission Chairperson, proposed to strengthen the supervision of the financial reporting process by the BoD. In 1998, the Blue Ribbon Committee on Improving the Effectiveness of Corporate AC, supported by the common association of the SEC National Association of Securities Dealers (NASD) and the New York Stock Exchange, put together a report on improving the functions of ACs and related issues. This committee reported the following year, and as well as confirming the problems regarding financial reporting disclosure, set out recommendations for enhancing the quality of financial reports and consolidating the importance of ACs. The 10 recommendations are summarised in the following three points:

- (1) To review the financial reports and other financial information provided by the corporation to any governmental body or the public; and review the corporation's auditing, accounting and financial reporting processes generally.
- (2) To oversee the work of the other actors in the financial reporting process – and require management, including the internal auditor and outside auditors to endorse the processes and safeguards employed by each.
- (3) To review the Corporation's systems of internal controls regarding finance, accounting, legal compliance and ethics that management and the Board have established. In particular, the AC should encourage procedures that promote accountability among these players, ensuring that management properly develops and adheres to a sound system of internal control, that the internal auditor objectively assesses management's accounting practices and internal controls, and that the outside auditors, through their own review, assess management and the internal auditor's practices.

The US Securities and Exchange Commission issued related rules in 1999 (SEC 2003b) to request every company to disclose the functions of ACs including the charter regulating the responsibility of ACs, the independence of the AC members and related financial reporting information of the discussion between the BoD and the certified accountants.

The American Institute of Certified Public Accountants (AICPA) issued in February 2000 and revised in March 2004, the Practice Alert 2000-2 "Guidance for Communication with ACs Regarding Alternative Treatments of Financial Information within Generally Accepted Accounting Principles", to request that certified accountants and the ACs discuss the quality of the applied accounting principles; not only its acceptability. The management also need to be involved in this discussion; for management should take the first responsibility for financial reports.

D. USA / SOX (2002) defined the responsibility of the AC:

"(1) The AC of each issuer, in its capacity as a committee of the BoD, shall be directly responsible for the appointment, compensation, and oversight of the work of any registered public accounting firm employed by that issuer (including resolution of

disagreements between management and the auditor regarding financial reporting) for the purpose of preparing or issuing an audit report or related work”, and

“(2) Each such registered public accounting firm shall report directly to the AC.

“A committee (or equivalent body) established by and amongst the BoD of an issuer, has the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer.”

“(3) Complaints

“— Each AC shall establish procedures for

“(A) the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters”;

“(B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.”

“(4) Authority to engage advisers

“— Each AC shall have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.”

E. UK / FRC (1992) and FRC (2010, June) defined the responsibility of the AC in terms of

- (1) Making recommendations to the board on the appointment or the external auditor, the audit fee, and any questions of resignation or dismissal;
- (2) Reviewing the half-year and annual financial statements before submission to the board;
- (3) Discussing with the external auditor the nature and scope of the audit, co-ordinating where more than one audit firm is involved, any problems or reservations arising from the audit, and any matters which the external auditor wishes to discuss, without executive board members present;

- (4) Reviewing the external auditor's management letter; and reviewing any significant findings of internal investigations.
- (5) Reviewing the company's statement on internal control systems prior to endorsement by the board.

The UK Corporate Governance Code (FRC (June 2010)) has more clearly defined the main role and responsibilities of the AC on C.3.2-3.7 as the following:

“C.3.2 The main role and responsibilities of the audit committee should be set out in written terms of reference 19 and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm, and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

C.3.3 The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available. A separate section of the annual report should describe the work of the committee in discharging those responsibilities.

C.3.4 The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.6 The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditor. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.7 The annual report should explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded."

F. PRC / SSE (2000) defined the responsibility of the ACs

“(1) Reviewing the Company's accounting and financial reporting policies and practices, financial status as well as a review of the process of financial report; checking the accounting policy, financial condition and financial reporting process;

(2) Discussing with the independent auditors (certified accountants) through the process of the independent auditors' review;

- (3) Recommendation and engagement of the independent auditors;
- (4) Reviewing the adequacy of the Company's internal controls and internal audit functions;
- (5) Reviewing the Company's policies with respect to legal compliance;
- (6) Reviewing and monitoring all types of the significant risks and exposures to the Company such as the financial risk and system security risk;
- (7) Reviewing and monitoring the company's ethical code of conduct;
- (8) The Committee will undertake such other duties as the BoD delegates to it."

G. PRC / CSRC and SETC (2002) defined the responsibility of the AC

- "(1) To recommend the engagement or replacement of the company's external auditing institutions;
- (2) To review the internal audit system and its execution;
 - (3) To oversee the interaction between the company's internal and external auditing institutions;
 - (4) To inspect the company's financial information and its disclosure;
 - (5) To monitor the company's internal control system."

Summary

The research on the responsibilities of the AC in American, British and Chinese models listed in the above regulations is summarised below:

- American documentary sources
 - The Report of the National Commission on Fraudulent Financial Reporting, ("The Treadway Report") (COSO, 1987)
 - In the Public Interest: A Special Report, ("The 1993 POB Report") (POB, 1993)

- Blue Ribbon Committee on Improving the Effectiveness of Corporate ACs: Report and Recommendations (BRC, 1999)
- The Public Company Accounting Reform and Investor Protection Act, (“The Sarbanes-Oxley Act”; “SOX”) (SOX, 2002)
- British documentary source
 - Financial Aspects of CG, (“The Cadbury Report”) (FRC, 1992)
 - The UK Corporate Governance Code (FRC, June 2010)
- Chinese documentary source
 - Code of CG for Listed Companies in China (CSRC and SETC, 2002)
 - Shanghai Stock Exchange Guidelines for CG of Listed Companies (SSE, 2000)

Despite the variations in the specifications of the functions of the AC in the Anglo-American and Chinese models, their common aim of serving the management targets of the BoD and the reality of their independent evaluation operation are upheld. From the required responsibilities of the AC, the functions and position of the AC in the company’s CG structure is summarised in the following three categories:

FUNCTION 1: Strengthening the oversight function of the BoD over the company’s financial reporting and disclosure:

Based on the regulation, the AC’s key responsibilities are auditing the company’s financial information and its reporting; examining accounting policies, financial conditions and financial reporting procedures of the company. In summary, it includes:

- a. Overseeing the auditing results by the external independent accountants;
- b. Examining all the accounting policies of the company, and reporting major changes and other dubious points;
- c. Previewing the interim and annual financial reports and the reports of the BoD;
- d. Organising special investigations on the company’s financial activities.

To enhance the truthfulness and reliability of the company’s financial reporting, it is the AC – being an important part of the company’s CG system formed mainly by independent directors-rather than the accounting firm selected by the management, that establishes an independent governance team in the BoD and evaluates the quality of the audits by the external accountants, thus avoiding the potential defects of having

the overseers controlled by the overseen. In other words, the implementation of the AC ensures the independence of the external audit and audit quality appraisal, and subsequently establishes the governance mechanism for the checks and balances of financial information that can promptly identify and correct inaccurate financial information, as well as improving the disclosure of the financial information of the listed company. In this manner, the control and oversight of the BoD over the management's financial reporting through ACs is strengthened.

FUNCTION 2: Strengthening the oversight function of the BoD over the company's Auditing

According to the regulation, it is required for AC to perform the following tasks: reviewing the internal auditing⁶ functions, supervising the company's internal auditing system and its operation; giving proposals on the recruiting or changing external auditory institutions; giving recommendations and hiring accounting firms; communicating with accounting firms following the auditing procedures; providing communication between the internal and external auditing bodies. In summary, these entail:

(a) Strengthening the functions of the internal auditors

Through the oversight function of the Internal Audit, overseeing key financial and management risks and internal control, examining the scope of the internal audit plans, appraising the skills of the internal auditors, and determining the financial budgets of the Internal Audit, etc.

⁶ "Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes. Internal auditing is a catalyst for improving an organization's effectiveness and efficiency by providing insight and recommendations based on analyses and assessments of data and business processes. With commitment to integrity and accountability, internal auditing provides value to governing bodies and senior management as an objective source of independent advice. Professionals called internal auditors are employed by organizations to perform the internal auditing activity." (Wikipedia, *Internal audit*, http://en.wikipedia.org/wiki/Internal_audit, as of July 2007)

(1) The oversight functions of ACs over internal auditors:

Both the AC and the internal auditors have the function of monitoring internal control and independent evaluation of the financial reporting. The AC holds a higher position in the organisational structure than the internal auditors and oversees the latter. According to the regulation and guidelines, the oversight of the AC over the internal auditors should consist of the following categories:

- (a) To review and approve the Internal Audit charter;
- (b) To review audit plans and of the changes in planned activities;
- (c) To review the organisational structure of the Internal Audit;
- (d) To review the quality and training of the Internal Audit staff;
- (e) To approve the appointment or removal of the Internal Audit managers;
- (f) To review the audit findings.

(2) The strengthening of the AC by the internal auditors:

The AC has a low profile role in day-to-day operations and cannot participate in the regular auditing tasks, and not all members of the AC are experts in accounting or finance or can perform the evaluation of the internal control system in person. Hence for the AC to fulfil its duty of oversight, it is imperative for it to utilise the superior resources of the internal auditors.

(b) Improving the independence of the external auditors

Presiding over the affairs of the external audit, selecting the independent accountants, discussing the scope, process and plan of external audit, evaluating the capabilities of the independent accountants; in order to give suggestions for the appointments and dismissal of the external auditing institutions, the AC should be confined to supporting the sound suggestions made by the chartered accountants and actively co-ordinate with the latter on major auditing matters, as well as co-ordinating the relations between the latter and the management to ensure the smooth operation of the auditing tasks.

Having the AC responsible for co-ordination with external auditors, the selection of the chartered accountants and the determination of their reward can ensure the

independence of the independent audit and improve the quality of the chartered accountants. Additionally, the AC has the power to appoint or remove the external auditing agencies. The external audit is an important channel of the AC's oversight over the management, but this channel could be rendered powerless if performed by an agency appointed by the management that is supposed to be overseen. This problem can only be avoided by reserving the power of appointing or removing the external audit agencies to the AC.

FUNCTION 3: Strengthening the oversight function of the companies' internal control and compliance

According to the regulations, the key responsibilities of ACs cover examining the company's observation of laws and regulations; examining and supervising the behaviours and regulations of the company; reviewing the internal control and its operation; examining the internal control of the company; examining and supervising all forms of risks, including financial risks and information systems security risks; other responsibilities given by the BoD. In summary, it includes:

- a. Overseeing the recommendations on internal control made by internal and external auditing.
- b. Overseeing the company's compliance with regulations and business ethics, keeping effective control in revealing conflict of interest and errors through reviewing reports of outstanding litigations, major conflict of interests, and various policies of the company.

It is anticipated that the establishment of the AC will strengthen the oversight of the management by the BoD. According to CSRC and SETC (2002), the implementation of the AC introduces oversight into the decision making process of the BoD. The purpose of having most positions on the AC taken by independent directors is to ensure the independence of the AC from the company's management, so that it can evaluate the performance of the management with a fair and detached stance. In other words, through evaluation of the management's awareness of the importance of internal control and risk management via an appraisal of the effectiveness of the company's internal control system, the evaluation of the management's planning of company activities can engage in production and operation according to the laws and

regulations. Equally, through an evaluation of the management's attention to standards of corporate conduct, the AC can appraise the management objectively and neutrally, and the level of oversight of the BoD over the management is strengthened as a result.

These functions include cooperating periodically with internal auditors and financial supervisors, utilizing qualified external accountants in effectively supervising the financial reporting process of the company, inspecting the internal audit procedure, discussing in detail the problems in auditing, collecting from the accountants the recommendations on audit management, evaluating the internal control system to ensure that the company's wealth is in line with the requirements of the laws and regulations, and all the company's accounting, finance and internal audit corresponding to the company's operating condition.

Academic Works on the Responsibilities of Audit Committees

(1) Annual Number of AC meetings:

McMullen and Raghunandan (1996) report that firms with financial reporting problems are less likely to have high frequency of the AC's meetings. Wright (1996) finds that the number of meetings held during the fiscal year is not related to analysts' disclosure ratings. Beasley (1996) reports no difference between fraud and no-fraud firms in the number of meetings held by ACs during the year preceding the fraud. Scarborough, Rama and Raghunandan (1998), in a survey of chief internal auditors of Canadian manufacturing companies, found that ACs comprised of outside directors met regularly with the chief internal auditor and reviewed the internal audit programme. Furthermore, Collier and Gregory (1999) studied the impact of insiders on the AC's activity level. They found that ACs which consisted primarily of insider members met less frequently. Abbott *et al.* (2000) and DeZoort *et al.* (2002) document that companies where the AC meets less than the minimum threshold are more likely to restate earnings. Abbott *et al.* (2002) also find a significant and negative association with the occurrence of financial reporting restatements when a committee does not meet at least four times a year. Xie *et al.* (2003) also report that:

“We conclude that board and audit committee activity and their members' financial sophistication may be important factors in constraining the propensity of managers to engage in earnings management.”

Abbott *et al.* (2000), DeZoort *et al.* (2002), Xie *et al.* (2003), Abbott *et al.* (2004) all support the contention that, when ACs meet at least four times a year, it improves the effectiveness of the supervisory function.

Xie, Davidson and DaDalt (2003)

This study explored the BoD, AC, and executive committees associated with the prevention from the earnings management. They find that the activities of BoD and ACs may help control or limit the managers' capacity to engage in earnings management.

Abbott, Parker and Peters (2002)

This study explored the characteristics and activities of the ACs, recording a negative association between the annual number of ACs' meetings and the restatement of financial reports. They report:

“We find that the independence of the audit committee and whether the committee meets at least four times per year exhibit a significant and negative association with the occurrence of financial reporting restatements.”

(2) The processes associated with the practical operation of ACs

It remains the case that the operating processes around ACs or other structures of supervisory governance in practice have been largely overlooked. Only a limited number of studies using in-depth fieldwork and interviews with significant actors in internal governance have addressed this issue (see, for example, Gendron *et al.*, 2004 and Turley and Zaman, 2007).

A number of authors have pointed out that research investigating the processes associated with the practical operation of governance structures in companies has been limited. For example, Gendron and Bedard (2006) argue that, “Actors' reflectivity especially is a neglected theme in the CG literature”, while Spira (2002)

notes that only a few studies have examined the perceptions of actors involved in ACs' processes. Turley and Zaman (2004) commented that, "there is very little evidence on the processes associated with the operation of ACs and the manner in which they influence organisation behaviour". There is only limited information available about what AC members actually do in meetings and whether, even in companies where the AC meets normative expectations regarding its composition, their behaviour satisfies external expectations about how they should execute their responsibilities (DeZoort *et al.*, 2002; Gendron *et al.*, 2004).

Summary

The Treadway Commission pointed out in "The Good Practice Guidelines for ACs" in 1987 that ACs should hold a minimum of three or four meetings a year and special meetings when necessary (IIA, 1991; Price Waterhouse, 1993). Meeting frequency has been noted as a measure of an AC's due diligence.

The AC plays a central role in the supervisory aspects of governance. In the Western literature, the annual number of meetings is often employed as an indicator of the due diligence of ACs and BoDs. Most such studies support the thesis that more meetings of the supervisory institutions can improve their effectiveness.

The research on the processes associated with the practical operations of governance institutions is limited, especially in terms of the empirical implementation of supervisory functions in China. Therefore, this thesis makes a contribution through providing an, presented in the chapter devoted to the operation of supervisory functions of SBs and ACs in China.

3.2.7 The Effectiveness of Supervisory Functions

Throughout the history of ACs, their effectiveness has been an issue of concern. A plethora of studies concerning AC effectiveness concentrate on the role played by mandated characteristics of the AC. These characteristics are independence, financial expertise and diligence. Previous studies have examined the impact of AC independence on financial report quality. Beasley (1996) compared firms experiencing financial statement fraud with non-fraud firms and found that the former had a lower of outside directors on their boards. In addition, McMullen and

Raghunandan (1996) found that majority companies with no financial reporting problems had ACs primarily composed of outside directors. Likewise, Abbot *et al.* (2000) found that firms with independent committee members who met at least twice a year were less likely to have fraudulent financial mis-statements. Klein (2002) conducted an archival study involving 692 publicly traded United States firms, and examined the relationship between abnormal accruals (unexpected accruals due to earnings management) and boardroom or AC independence, discovering a strong negative association between these two variables (independence and abnormal accruals).

Moreover, Carcello and Neal (2003b) reviewed the going concern discussions provided by companies in the notes, Management Discussion and Analysis (MD&A) sections of the financial statements. The results suggested that companies with a high of affiliated (non-independent) directors on their ACs exhibited greater optimism about the going concern issue. A study by Ho Young Lee (2003) revealed an association between the independence of AC members and lower accounting discretion by management. Carcello and Neal (2000) maintained that an independent AC would be more likely to support the external auditor in auditor-management disagreements involving going concern issues. Thus auditors of companies with independent ACs were more likely to issue going concern reports. Accordingly, companies with a high of affiliated directors on their ACs were less likely to receive a going concern report from the external auditor. In addition, Archambeault and DeZoort (2001) found that companies with suspicious auditor changes also had a lower number of independent AC members.

A second stream of research investigated the impact of financial expertise on AC effectiveness. A survey by McMullen and Raghunandan (1996) revealed that a majority of companies that reported no financial reporting problems had Certified Public Accountants (CPA) on their ACs. DeZoort (1998) found that AC members with auditing and internal control evaluation experience made judgements similar to experts (auditors), and the performance of experienced committee members was higher than their inexperienced counterparts in areas of judgement, self-insight, and consensus. McDaniel, Martin and Maines (2002) also compared the evaluations of financial reporting by financial experts and financially literate AC members. The results suggested that financial experts and financially literate AC members assessed

and identified certain reporting issues differently. For example, financially literate AC members concentrated more on non-recurring financial information; whereas the financial experts, based on the concept of relevance, selected more recurring activities for evaluation.

Other studies focused on the role of AC expertise in affecting the position members take during auditor-management disputes. DeZoort and Salterio (2001) found that independent AC members with audit-reporting knowledge supported the auditor in disputes involving the external auditor and management. In addition, Carcello and Neal (2003a) examined the relationship between AC characteristics (independence, governance knowledge, financial expertise) and dismissal of the auditor following a going concern report. They found that companies with independent ACs were less likely to dismiss the external auditor. The results also suggested that companies whose AC members had governance expertise retained the auditor after issuance of a going concern report. Similarly, Lee, Mande and Ortman (2004) found that the financial expertise of AC members was negatively associated with auditor resignation. Likewise, Krishnan and Ye (2005) found that the presence of a financial expert on the AC was positively associated with the committee seeking ratification of the external auditor with the board, which signified that the presence of the expert enhanced the monitoring activities of the AC.

Subsequent to the passage of the Sarbanes-Oxley Act, AC research continued to concentrate on examining the relationship between the three AC characteristics (independence, expertise, and diligence) and AC effectiveness. Abbot, Parker, Peters and Raghunandan (2003b) postulated that independent ACs would limit the non-audit services of the external auditor in order to enhance auditor independence. Results suggested that independent and diligent (meeting at least four times a year) ACs were negatively associated with the non-audit fees ratio, signifying the members' reluctance to approve non-audit services by the external auditor. In another study, Abbot, Parker, Peters and Raghunandan (2003a) investigated the relationship between AC characteristics (independence, financial expertise, diligence) and audit fees, which serve as a proxy for audit quality. After examining 492 proxy statements, they found a significant association between the two characteristics (independence and expertise) and high audit fees.

Bedard, Chtourou and Courteau (2004) discovered that independence and financial expertise of AC members were associated with lower aggressive earnings management, as measured by abnormal accruals (unexpected accruals due to earnings management). Additionally, Abbot, Parker, and Peters (2004) found that the independence, financial expertise and diligence of AC members were negatively associated with occurrences of financial statement restatements. Moreover, Krishnan (2005) investigated the relationship between AC characteristics (independence, expertise) and internal control problems. Since companies that changed auditors had to report the existence of internal control problems, he compared companies that changed auditors with companies that did not. The results suggested there to be a negative association between these characteristics and internal control problems. Mangena and Pike (2005) investigated the association of AC shareholding, financial expertise, and committee size with the level of disclosures in interim financial statements. They found a significant positive association between AC financial expertise and the extent of disclosure on interim reports.

The above discussion of prior literature on AC reveals a possible overemphasis on AC characteristics as measures of effectiveness. Although these studies provide credible attempts to examine the boundaries of AC effectiveness, there is a need to look beyond these boundaries for a number of reasons.

First, the performance of ACs in real life situations provides mixed signals about factors linked to effectiveness. Prior research confirms the need for financial experts on the AC. However, the performance of Enron's highly knowledgeable AC suggests that financial expertise may be a necessary but not sufficient attribute for AC effectiveness (Lublin, 2002). Additionally, even though the independence of the AC is highly laudable, there are numerous examples of companies that have exhibited impeccable financial reporting integrity despite having affiliated directors on their ACs (Sonnenfeld, 2002b). These examples suggest the presence of other factors, besides those most frequently investigated, may affect the decision-making quality of ACs. In addition, Paredes (2003) has stated that cognitive biases such as escalation of commitment and groupthink could affect board behaviour. Researchers, who have observed this gap in research on ACs, have called for "psychology-based experimental research involving AC member judgment and decision making" (DeZoort *et al.*, 2002: 69).

Independence, expertise and diligence are identified as the key attributes of the effectiveness of the supervisory functions in the literature and in regulations. This thesis will provide empirical evidence about the characteristics and effectiveness of two supervisory institutions in China.

Earnings Response Coefficients (PER)

If the governance institutions can implement effective supervisory functions well, it will increase investors' trust in the company's CG and its operations, reflecting positively on earnings. The ultimate test of earnings quality is the market's response to earnings (PER), which provides a measure of the extent to which new earnings information is capitalised in the stock price (Kim and Kross, 2005; Ryan and Zarowin, 2003).

Holthausen and Verrecchia (1988) documented a positive association between the magnitude of stock price responses and the precision of accounting information. Teoh and Wong (1993) and Balsam *et al.* (2003) suggested that investors' responses to an earnings surprise depend on the perceived quality and credibility of the earnings reported.

Specifically, Teoh and Wong (1993) hypothesised that that investors perceived Big 8 auditors as providing higher quality audits. Examples of this include the reaction of the stock market towards unanticipated income reports of Big 8 clients. Thus, by linking financial reporting results to the PERs, they provide evidence that the financial statements audited by Big 8 are of higher quality and utility. Kao (2002)'s research reveals a higher stock pledge of supervisors and directors to have the lower fluctuation of stock price. Huang (2002) researches the association between stock market price and the effectiveness of the company's operation: revealing a positive relationship between them.

Earnings management entails the selection of accounting procedures and estimates that may induce a deviation to achieve certain objectives. Earnings management has the potential to decrease the perceived quality of earnings (Schrand and Wong, 2003; Watkins *et al.*, 2004). Due to the fact that income management is expensive to detect, the agency theory forecasts that income management will rise when the benefit of manipulating earnings exceeds the relevant costs (Watts and Zimmerman, 1986). A

large number of studies have documented that business managers have great motivation to handle earnings. These incentives result from the explicit and implicit contracts that link the management's interest to accounting numbers (Anderson *et al.*, 2004; Bartov and Mohanram, 2004).

The literature on earnings management makes three general predictions about the use of discretion relevant to a particular benchmark (Healy, 1985; Abarbanell and Lehavy, 2003). First, if pre-managed earnings are well above a relevant benchmark, firms will make income-decreasing choices. Next, if pre-managed earnings are below a benchmark but reserves are available to meet it, firms will draw from accounting reserves to just edge past the benchmark. Finally, if pre-managed earnings and available reserves are insufficient to meet any benchmark, firms will engage in extreme, income-decreasing behaviour that will pay off in the future. Healy (1985), Das and Zhang (2003), and Dechow *et al.* (2003) all reported evidence from the US market that firms might undertake extreme, income-decreasing earnings management to maximise accounting reserves for future use.

Prior research also documents other incentives for earnings management. Watts and Zimmerman (1990) contended that larger firms would make income-decreasing accounting choices in an attempt to minimise political costs. Other empirical studies (Cahan, 1992; Han and Wang, 1998; Jones, 1991; Cahan *et al.*, 1997; Monem, 2003) also document that business managers use income-reducing discretionary accruals to minimise the political costs. Litigation concerns discourage firms from managing earnings upward because of the asymmetrical loss function on firms who exaggerate their earnings. Perry and Williams (1994) reported the evidence of downward earnings management in the year before the management buyouts in the US.

A large body of recent literature indicates that management has strong incentives to report earnings growth (e.g., Kothari, 2001). Studies by Hayn (1995), Burgstahler and Dichev (1997), and Degeorge *et al.* (1999) documented unusual patterns in the distribution of earnings levels, earnings changes, and earnings surprises. For instance, Burgstahler and Dichev (1997) reported that an unusually large number of firms report small profits and an unusually small number of firms report small losses. These patterns are widely interpreted as evidence of earnings management. These findings have spawned many studies to investigate various aspects of the management's

incentives to meet or beat earnings benchmarks, including Healy and Wahlen (1999), Dechow and Skinner (2000), Fields *et al.* (2001), Bartov *et al.* (2002) and Kasznik and McNichols (2002).

The survey evidence in Graham *et al.* (2005) indicates that reporting increases in quarterly earnings per share is an important goal for management, and may even be more important than either beating analyst forecasts or reporting profits. Meanwhile, Degeorge *et al.* (1999), provided evidence that the management's first objective was to report positive earnings, then to increase quarterly earnings, and then to beat analyst forecasts. Myers *et al.* (2005) demonstrated that many more firms reported long strings of consecutive increases in earnings per share than would be expected by chance. They interpreted this phenomenon as an evidence of earnings management and provided the evidence that business managers had incentives to maintain their firms' earnings trends.

Hence, in the US and other Western countries, as management is generally motivated to manipulate earnings upward, there are also incentives for them to manipulate earnings downward. However, incentives and behaviours of earnings management are different in China because the structures of ownership and motivation scheme of the Chinese listed firms are quite different from their counterparts in the Western world (Haw *et al.*, 2005).

Abarbanell and Lehavy (2003) suggest that firms with poor performance may not take an 'earnings bath' if they want to maintain good investor relations. Chinese listed firms usually have a highly concentrated ownership structure, which makes opaqueness gains possible for the controlling owners of the firms. In order to maintain opaqueness gains, the controlling shareholders may try hard to package the listed firms so as to avoid being monitored by outside shareholders. They are very unwilling to take an 'earnings bath' since such an action will badly damage the investor relations and very probably lead to much stricter surveillance by market regulators⁷.

⁷ In fact, Chinese listed firms took a market-wide big bath in 2001, as the listed firms are required to make provisions for eight items to follow more conservative accounting treatments. However, this action is initiated by the change of accounting standards but not by the management of listed firms.

Chinese listed firms are willing to take a “big bath”⁸ only if they are labelled as ST firms⁹ by the stock exchanges.

As Chinese listed firms are usually controlled by the government or parent state-owned enterprises (SOEs), they face much fewer political costs compared with their US counterparts. Threat of litigation is less likely to deter Chinese business managers from reporting optimistically when it is difficult to successfully sue them for doing so. In China, the legal system is not highly independent, often influenced by the government; and law enforcement is weak. In addition, class legal action is not allowed in China at present. As controlling shareholders are usually the government agencies or parent SOEs, it is very difficult for Chinese investors to effectively sue business managers (usually appointed by the controlling shareholders) and controlling shareholders. Management buyout is nearly impossible as business managers of Chinese listed firms are usually appointed by the government and they hold none or an insignificant amount of the firm’s shares. Kim *et al.* (2003) found that, in the US, share-decreasing firms have the intention of managing earnings downward; however, share-decreasing action is generally not allowed in China.

Considering the facts and arguments above, Chinese listed firms have few incentives to manage earnings downward. However, they do have strong incentives to manipulate earnings upward. In order to maintain opaqueness gains from a weak CG

⁸ “Big Bath in accounting is an earnings management technique whereby a one-time charge is taken against income in order to reduce assets, which results in lower expenses in the future. The write-off removes or reduces the asset from the financial books and results in lower net income for that year. The objective is to ‘take one big bath’ in a single year so future years will show increased net income. This technique is often employed in a year when sales are down from other external factors and the company would report a loss in any event. Corporations will often wait until a bad year to employ this ‘big bath’ technique to ‘clean up’ the balance sheet. Although the process is discouraged by auditors, it is still used. The objective is to take these loses all at once, so future periods can show positive net income.” (Wikipedia, *Big bath*, http://en.wikipedia.org/wiki/Big_bath, as of July 2007)

⁹ Special Treatment (ST) stock is designed for a listed company on the Shanghai or Shenzhen stock exchanges when it demonstrates an abnormal financial situation. The ST firms will be delisted if they suffer three consecutive years of loss, so they have the incentive to take big baths to avoid making a loss in the third year. The ST firms are not many (around 5% of all listed firms) and happen to fall outside of my sample.

mechanism, the controlling owners (through the management) are motivated to manipulate earnings upward to avoid stringent market surveillance and monitoring from public investors. For example, controlling owners have been actively involved in a lot of related party transactions to boost profit or decorate below-the-line items as operating income. Listed firms need to manipulate earnings upward to avoid being de-listed or being capped with ST status.

As business managers are usually appointed by the government or controlling SOEs, there are incentives for them to overstate earnings to please their superiors and maximise their own benefits. Business managers are also motivated to manipulate earnings upward to fulfil certain political agendas, in order to get promotion in their political career. In addition, the bonus system also motivates business managers to overstate earnings.

Hence, in China, listed firms have a much stronger intention to manage earnings upward than to manage them downward. The author conjectures that the earnings management in China is dominantly unidirectional. Haw *et al.* (2005) suggested that Chinese investors would make a distinction to the quality of income and not set as much value on the income assumed to be subject to a larger extent of manipulation. Their results imply that the Chinese investors, to some extent, can make rational adjustment for the quality of earnings.

The above discussion illustrates that many research studies have used an earnings based measure as a proxy variable. The market's response to earnings (PER) is likely to vary with the stockholders perceptions of the effectiveness of supervisory institutions. This thesis therefore applies the market's response to earnings (PER) as the dependent variable to evaluate the effectiveness of SBs and ACs in China.

3.2.8 The Relevant Attributes Applied in this Thesis

This research is focused on three objectives relating to the effectiveness of the supervisory institutions, operations of supervisory functions and the co-ordination between the governance institutions.

Objective 1: To understand the effectiveness of SBs and ACS in China

Currently, two groups of listed companies exist in China. Some choose to establish ACs in addition to SBs; some to have only SBs. It is expected that the companies with ACs have less confidence in their SBs, and so add an AC to improve the effectiveness of supervisory functions. The following two hypotheses are therefore formed, in order to answer key research questions 1 and 2:

Q1: Which system, with or without ACs, has more effective supervisory functions in China?

H1: Firms with SBs plus ACs (G2) are more likely to effectively engage in the supervisory functions than the firms without ACs (G1).

The Effectiveness of Supervisory Functions: $G2(WithAC) \geq G1(WithoutAC)$

The effectiveness of supervisory functions of the two groups of companies will be investigated by comparing the proxy variable and control variables for the effectiveness of the supervisory institutions.

The Proxy Variable of the Effectiveness of the Supervisory Institutions:

Holthausen and Verrecchia (1988) documented a positive association between the magnitude of stock price's market responses and the precision of accounting information. Kim and Kross (2005), Ryan and Zarowin (2003), Huang (2002) and Kao (2002) all support a positive relationship between stock market price and earnings. Stock price reflects the confidence of investors in the effectiveness of supervisory institutions; and their faith in the implementation by the CG. Therefore, this thesis applies the market response to earnings (PER) as a proxy variable for the effectiveness of supervisory institutions of SBs and ACs in China.

In addition, firm size, growth rate of assets, return on assets and decrease in debt ratio are taken as control variables of the effectiveness of the supervisory functions to prove which system of listed companies with or without ACs can have more effective supervisory functions. This approach is discussed further in the chapter on The Empirical Studies – Section A – The Effectiveness of the Supervisory Functions of SBs and ACs in China in this thesis.

Q2: Will the AC contribute to the effectiveness of the supervisory functions in China?

H2: In companies adopting an AC, the AC exhibits characteristics and responsibilities that are likely to contribute to the effectiveness of supervisory functions.

Firms with higher levels of independence, greater expertise among members, of a larger size and with more active meetings, lower centralised shareholding structure and separation between executive and oversight positions are more likely to enjoy effective supervisory functions when adding ACs. This hypothesis is tested through comparing the impact of variables for independence, expertise and diligence on the the proxy variable for effectiveness of the supervisory institutions between two groups of listed companies.

Independent Variables:

As discussed above, the composition of the ACs, independence and expertise, and the frequency of meeting have shown a positive association with effectiveness of supervisory institutions

Independence

This thesis will apply four indicators of independence:

- (1) The percentage independent directors: The Anglo-American model requires that all directors should be independent. On the other hand, the Chinese model only stipulates that those independent directors shall constitute the majority on the committees among listed companies. Hence, the requirements in these systems differ in the required percentage of independent directors. The number of independent directors as a percentage of the total number of BoD is used as an independent variable for evaluating the independence of composition of supervisory institutions.
- (2) The SB's shareholding: the shareholdings of SBs as a proportion of the total shareholdings is used as a second variable for evaluating the independence of supervisory institutions.

(3) & (4) SBs and independent directors receiving remunerations:

On the basis that remuneration, fees or reward could affect the independence with which independent directors execute their roles, further variables reflecting whether SBs and independent directors receive remuneration are included to test for the independence of supervisory functions.

Expertise

Four indicators of expertise are included as independent variables:

According to the regulations in China, at least one expert with financial or accounting background and legal background is required. Both financial or accounting and legal backgrounds are included as independent variables in this research. In addition, another two variables representing internal audit literacy and the presence of party member employees are included. The party member employee without financial or legal background was incorporated as a supervisor when SBs were first formed in China (see discussion in the chapter on the Background of the Supervisory Mechanism).

Internal audit literacy is defined as possessing internal auditing skill and experience in the audit process. Experience of external auditing and a background of financial or accounting expertise will be counted as evidence of financial and accounting expertise, as supervisors with an internal auditing background may not have the education or experience relating to a financial, accounting or legal background.

Diligence

(1) The frequency of meetings: Four meetings of ACs in one year are required by the regulations in the Anglo-American system but only one meeting of SBs annually is required by Chinese regulations. The due diligence by supervisory institutions is assumed to impact on the effectiveness of their supervisory functions. This study uses the number of meetings of supervisory institutions as independent variables for their operational diligence in carrying out their supervisory functions.

(2) The size of supervisory institutions:

The number of members of SBs and BoD are also treated as variables reflecting the level of diligence, which can impact on the effectiveness of the supervisory functions in China.

Other variables

- (1) The shareholding structure in Chinese listed companies: US regulations state that independent directors must not have a significant shareholding or represent major shareholders, but in China, the shareholding structure is different. Therefore, shareholdings of 50% or more by the largest three shareholders in Chinese companies are also included as a possible influence on the effectiveness of supervisory institutions.
- (2) CEO dual positions: BRC (1999) suggested that the position of CEO should be separate from the president of BoD to prevent a loss of supervisory functions. Abbott *et al.* (2000) showed that if the CEO holds a concurrent position of President of BoD, it would increase the risk of fraud or negligence in financial reporting. Liu and Lu (2002) also proved that dual positions held by the CEO would lead to less independence, so increasing levels of earnings management. Lin (2005) used a dummy variable, and assumed that if the CEO holds the concurrent post of President, the company would have less willingness to establish ACs. My thesis also applies capture whether the President of the BoD serves concurrently as the CEO.

Objective 2: To understand how the operations of SBs and ACs improve the effectiveness of supervisory governance functions in China.

Key Question: What are the operational processes, problems and difficulties faced in the implementation of the supervisory functions by SBs and ACs in practice in China?

Sub-questions:

Sub-Question 2.1: What is the role played by the AC in China?

Sub-Question 2.2: What are the overlaps and omitted items in terms of functions between the SBs and the ACs?

The above literature review reveals a limited basis for understanding the processes associated with the operation of ACs and SBs in China. It also suggests that problems and difficulties in applying the dual structures of SBs and ACs at the same time are likely. Therefore, this study endeavours to explore the implementation of supervisory functions including the operational processes and the problems and difficulties faced in China.

The role of the ACs as defined by the regulations provides a basis with which to understand the intended role to be played by ACs in practice in China. This will be explored, in order to establish whether the AC not only executes basic functions of supervision, but also provides added value of consulting and training services.

The AC's responsibility is rooted in the three key functions of financial reporting, auditing and internal control. This thesis therefore focuses on these three key functions to better understand the overlapping status between the two supervisory institutions of SBs and ACs in China.

Objective 3: To understand the co-ordination between SBs and ACs as governance organisations.

Question 3.1: How will the systems with and without ACs exist in the future according to framework of legislation and government management?

Question 3.2: What is the preferred linkage of interactions between the SBs and the ACs in terms of organisation in China?

In order to investigate how to solve possible problems of overlapping supervisory functions given the coexistence of SBs and ACs, this study will research co-ordination between the SBs and ACs as dual supervisory institutions in China from the viewpoints of legislation and government management. This investigation will be rooted in the political model theory as well as the empirical practice of listed companies in China, and explore the preferred linkage of interactions between these two supervisory institutions as a basis for future development.

Chapter 4 The Background – The Development of Supervisory Mechanisms of Corporate Governance in the West and China

4.1 Introduction

Shareholder theory forms the basis for introducing ACs into China, acting as monitors enhancing existing SBs with a high expectation for AC performance in effectiveness and operations. Meanwhile, stakeholder theory provides the basis for establishing whether the SB has played the key role of supervisory functions in China since 1993, even though ACs were introduced in 2002. In addition, managerial hegemony theory is used as the basis with which to study the effectiveness of SBs and ACs in China.

This thesis applies political model theory and institutional ownership theory to enhance understanding of the background relating to the shareholding structure in China. Both theories lead this thesis to provide an overview of the political environment and shareholding background in this chapter.

The structure of this chapter is based on an understanding of four features of four CG models, revealing peculiar problems they face in the supervisory mechanism. Meanwhile, the features of three models in the West are referenced, in order to provide a comparison. The existing model of China's CG is then revealed. Furthermore, an overview of how China's political environment influences the development of supervisory mechanisms of CG, and the relationship between the shareholding structure and internal supervisory mechanisms in China are introduced.

The objective of the chapter is to emphasise the contextual nature of what will be effective in governance structures, the particularity of what China has done in combining alternative approaches from other systems, and the need for research to investigate the effectiveness, operations and co-ordination of this combination.

4.2 The Definition of Corporate Governance

It has been generally argued that the 21st Century is that of global CG. CG structures have been in place in countries such as the United States and the United Kingdom for many decades, but their adoption in Asia gathered momentum in the aftermath of the regional financial crisis of 1997.

CG covers a large number of distinct economic phenomena and affects the legality and effectiveness of a company's powers worldwide, so a universally agreed definition or scope is yet to be established. However, as a starting point for the discussion in this chapter, the following definition from the OECD provides a useful reference:

Corporate Governance is the system by which business corporations are directed and controlled. The Corporate Governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance. (OECD, 1999; OECD, 2004a)

The promotion of global governance is illustrated by the World Bank's efforts to encourage countries to voluntarily comply with formal and informal systems of rules and arrangements. The concept of CG refers essentially to the mechanisms of governance and supervision. With respect to CG, it seeks to establish a mechanism to maximise the corporate value of promoting what is beneficial, such as pursuing maximum return for stakeholders, shareholders, creditors and employees. With respect to supervision, CG strives to minimise the chance of the occurrence of events or incidents harmful to the company, such as the potential for wrongdoing and fraudulent practices.

Separation of ownership and control has presented a challenge to the profit maximisation of cooperation. As one of the main purposes of CG is to facilitate maximisation of shareholders' value, and to increase the stock price of the enterprise,

it needs to establish both an effective strategic management for making decisions on corporate affairs to maximise corporate value, and an effective supervisory mechanism to minimise the potential risk to the corporation, in which managers are accountable to the shareholders, to align and to protect the interests of both shareholders and managers. Hence, it has become an extremely important task to design and execute both an effective strategic management and an effective supervisory mechanism.

Yeh *et al.* (2002) defined that one of the functions of CG is to “strengthen a company’s competitiveness and management effects”. Olivier *et al.* (2008) analysed 26 years of strategic management research, and provided an overview of the development of strategic management, in order to understand future strategic management research. They proposed that the integration of corporate and competitive strategies should be related to future research of strategic management. Hence the promotion of the competitiveness of a company has become the key common purpose of implementing both CG and strategic management.

Moreover, globalization provides motivation in both fields as well. Pol (2005) researched the need for new dominant designs of strategic management in the future, and identified that globalization increasingly determines that the capability of firms to innovate is essential to their competing successfully. Yet the research on strategic management by Ikujiro and Ryoko (2007) described an entity pursuing universal ideals and a particular reality at the same time, rather than merely profit. They concluded that an entity has to build up the standard of “ideal” for making judgements in particular situations when building and practicing a strategy. However, “transitional economies” are necessary to create new research and expand entrepreneurial challenges in the field of strategic management (John, 2007).

CG in China is characterised by weaknesses of strong insider power, highly concentrated ownership of the state, and a weak legal system for shareholder protection (Udo *et al.*, 2005). These weaknesses affect China’s strategic management. Moreover, Chinese company law stipulates that both the CEO and the SB have to be elected by the shareholders’ meeting: the controlling shareholder is responsible for the appointment of these positions.

The ownership of CG may affect levels of control of the management. Guy and Pei (2005) concluded that class of shareholdings does matter in terms of company performance. Their study revealed that, as the controlling shareholder of public corporations, indirect state control of wholly industrial companies with focused business is the least inefficient shareholding class among eight different ranked classes. Their finding suggests that supervisory mechanism of CG control over the management could be further enhanced, especially through CG reform under a transition economy in China.

The supervisory mechanism of CG in China is peculiar in terms of establishing AC in the board and SB simultaneously. China adopted two tier boards, with SB based on the German CG model in 1993, and China adopted AC based on the Anglo-American CG model in 2002. China therefore combined two models' supervisory mechanisms of CG at the same time. Zhezong *et al.*, (2004) studied the role of the SB in China, and revealed a "two tier board is also fraught with problems". Meanwhile, no evidence exists to show that SB performs effective monitoring functions over the management. The only function seems to be the allocation of the "right" people in strategically important positions, regardless of their level of, or lack of, economic expertise (Zhezong *et al.*, 2004).

From 1995 to 2000, about 15% of listed companies received modified audit opinions (MAOs) on their annual reports every year. Xijia *et al.* (2005) identified weak CG as one of the contributory reasons for the large number of MAOs in China. The Chinese government required both the BoD and SB to take responsibility for monitoring the quality of financial reporting, especially when a MAO is involved. Xijia *et al.* (2005) found that neither board performs an effective monitoring function.

4.3 The Development of Supervisory Mechanisms of Corporate Governance

Shareholders and creditors who invest their assets in a company may suffer losses if the company fails (Spira and Page, 2003) and seek to safeguard their interests by setting up mechanisms of CG. Hence, international organisations and various

countries' CG criteria generally require or propose some *external* and *internal* supervisory mechanisms to be established.

The external supervisory mechanism: Environmental factors such as policies and systems included in established legal frameworks for firms impose discipline and demand accountability of the firm's directors and management (Yeh *et al.*, 2002). These factors provide the foundation for the external supervisory mechanism, which includes administrative regulations as well as accounting and auditing criteria. This involves a combination of various professional groups, such as accountants, lawyers, investment banks, financial and economics media, investment consultants and research institutions and personnel analysing CG.

The internal supervisory mechanism: A narrow focus for CG is that of relations between shareholders and management layers within the company (Yuan, 2005). The core of CG lies in the BoD, are accountable to shareholders and creditors as well as the whole company. Here, the focal point of CG lies in designing a set of systems to enable the external shareholders to supervise the company's management. Hence, a company's internal supervision mechanism constitutes a critical part of CG in constraining the controlling management from looking after only their own interests, taking advantage of their position and power, at the expense of the interests of the stockholders.

In general, the supervisory mechanism, the company's management and the BoD constitute three important mainstays for a stable governance framework, and the reliability of control and financial information. The inclusion of an AC in the process of supervision is intended to offer a more holistic view of CG and ensure the co-ordination of external and internal responsibilities, by enhancing the integration of CG, business management, the audit functions and internal controls.

Hansmann and Kraakman (2001) asserted that the CG model used in both the US and the UK, focusing on shareholders' benefit, is most effective, and referred to this Anglo-American model as the standard CG one. The findings of the Governance Metrics International (GMI), an international management appraisal organisation that evaluated companies in 38 countries, seem to confirm this viewpoint. Several countries with similar CG models, such as the UK, the US, Canada, Australia and

New Zealand, have been consistently highly ranked on the GMI rankings, and occupied the top six places in the 2007 ranking (GMI, 2007).

To appreciate the merits of this model, it is useful to review the historical development of supervisory mechanisms of CG in both countries. Tables 14 and 15 list chronologically the major events and their impacts on the development of the supervisory mechanisms of CG in the UK and the US.

When reviewing the history of CG, we find that each stage of development was often a reaction to an economic crisis or corporate failure. For example, the South Sea Bubble of 1720 in the UK, Asian Financial Crisis of 1997, Enron scandal of 2001 and WorldCom scandal of 2002 in US all triggered public demand for reform of the CG system. These scandals also persuaded both enterprises and authorities to re-emphasise the importance of strengthening the supervisory mechanism of CG in response to the rapidly changing economic environment and the manipulative behaviour of elements of management.

A survey of the historical development of CG also illustrates the risks associated with failure to improve its supervisory mechanism. Without some form of supervisory mechanism, discipline and order in the capital market would be difficult to maintain, investors' interests would be encroached upon, and the structure of CG would be mere decoration. Therefore, criteria for effective quality in the supervisory mechanism continually increase; and for this reason, requirements for supervisory bodies in various countries have become stricter over time.

4.4 Corporate Governance Models and Principles of Supervision

4.4.1 The Supervisory Mechanism in Models of Corporate Governance

What then is the ultimate goal of Corporate Governance? Is it to maximise the shareholders' interests, the managers' interests, or the company's interests as a whole? According to Jensen and Meckling (1976) CG should devote itself to solving problems in the relations between the owner and the management. Fama and Jensen (1983) further pointed out that the central issue of CG is how to reduce agency costs. Shleifer and Vishny (1997) provided a comprehensive survey of this issue by

reviewing the literature of Corporate Governance. They concluded that the core objective of CG is to guarantee the interests of the suppliers of capital. Yeh *et al.* (2002), Tian and Feng (2004) and Yuan (2005) have all undertaken comparative studies of governance structures internationally. All concluded that, since no perfect system of CG can be found anywhere in the world, each system should draw lessons from the strength and weaknesses of others, in order to develop a system befitting the specific considerations of the country of interest.

Thus, the goal of CG is closely related to the CG model. Countries at different stages of economic development have gradually established their own unique CG model. Solomon and Solomon (2004) pointed out that the ownership structure of the company is a key factor for a government, when determining the CG model. Thompson (1999) found differences between externally and internally driven systems, and this, he asserted, has become a general criterion used for categorising CG models. La Porta *et al.* (2000) have not only identified two kinds of thoroughly different CG models in the world – namely the dispersed ownership model and the concentrated ownership model – but also suggested that the legal system is the key variable for explaining the existence of these two kinds of models. They further stressed that providing legal protection for investors, especially for minority stockholders, is the most fundamental goal of Corporate Governance.

Other scholars have attempted to search for an ideal type of CG model in the world. For instance, Hansmann and Kraakman (2001) observed that, though there are different types of models, the general trend of the development of CG is moving increasingly toward convergence worldwide. Coffee (2001) analysed the problem of convergence of CG models within various countries in the present era of globalisation, and pointed out that the ongoing transitional development of the ownership structure worldwide is a continuing process and is clearly moving towards the US and the UK models, characterised by advanced legal rules. Coffee noted that this trend is especially apparent among the various developing countries of the world.

While Bedchuk and Roe (1999) recognised that differences among the various CG models have diminished, they nevertheless noted the fact that these differences still linger. Branson (2001) concluded that, although a convergence of the various CG models may have taken place in some specific areas – such as financial accounting

principles and information disclosure standards – the scope of convergence thus far has been regional rather than global. Branson, however, disapproved of the notion of global convergence, because he viewed it as a limited phenomenon: arguing that the crux of the problem lies in cultural diversities among nations. He therefore proposed studying the impact of Confucian culture on the emergence of clan capitalism in China and overseas Chinese communities.

In this regard, it can be said that East Asia has developed its own governance model, by mixing the Anglo-American model and the German and Japanese ones. In the aftermath of the 1997 Asian financial crisis, several scholars including Li (2007), Feng (2005), Huang (2005) and others focused on analysing how East Asia countries have endeavoured to reform their CG systems, and characterised the East Asian model as family controlled, because most of the ownership is concentrated in the hands of family clans.

The relevant studies of Buchanan (2007), Hu *et al.*, (2000), Huang (2005), Shi (2006), Strikwerda (2003), Tan *et al.* (2007), Tian and Feng (2004), Ye (2001), and Yuan (2005) have identified the following four influencing factors as the main cause of differences between systems internationally:

Governance culture: Cultural background shapes people's behaviour and their way of thinking, which in turn influences the formation of their CG models.

Legal environments: The law is a factor in shaping people's behaviour. Normally people tend to observe legal provisions, which in turn influence the establishment of their CG models.

Ownership structure: This dictates the ratio of shares owned by the small and big shareholders, which affects the influence these shareholders can have over the corporation. This in turn influences governance structure.

Governance structure: Whether established on a single- or double-pronged board, the governance structure influences the construction of the supervisory mechanism.

Despite these differences in the establishment of a supervisory mechanism, it is still possible to identify the following three major models of CG in the world:

- The Anglo-American ownership-oriented externally driven model;
- The German and the Japanese organisation-oriented internally driven model, and
- The East Asian family-oriented clanship driven model.

These three major models of corporate governance can be analysed and compared with one another based on the aforementioned determining factors in order to identify their respective supervisory mechanisms, as well as specific problems with the system and measures taken for reform, according to the relevant studies of Bhasa (2005), Blair and Maclaury (1995), Branson (2001), Buchanan (2007), Buchanan and Deakin (2007), Coffee (2001), Fama and Jenson (1983a), Gulinello (2004), Hu *et al.* (2000), Huang (2005), Li (2007), Nakamura (2007), Shi (2006), Shleifer and Vishny (1997), Singh and Zammit (2006), Solomon and Solomon (2004), Strikwerda (2003), Tan and Wang (2007), Tan *et al.* (2007), Thompson (1999), Tian and Feng (2004), Ye (2001), Yeh *et al.* (2002), Yuan (2005).

The Anglo-American Ownership-Oriented Externally Driven Model

Governance Culture

There are several characteristics that underpin the underlying capitalist system. The ownership is separated from the management. There is a large-scale circulation of capital. The stock market is well developed. Shareholders' equity that concentrated in the pension fund and specialised management fund is managed by institutional investors. Proper governance is crucial to corporations as managerial under performance may lead to the failure of the corporation.

Legal Environment

Under a free market economy, there are strong legal provisions, through the company law and securities law, etc., to make the CG structures provide a stronger check and balance role, management's duty is clearly defined, and the rights and interests of the employees, creditors and shareholders, especially the minority shareholders, are upheld.

Ownership Structure

Shares and associated rights are highly distributed and frequently exchanged amongst numerous small investors. In other words, the direct influence of individual investors over the corporation is relatively small compared with that of the management, but shares can be easily exchanged, which can lead to fluctuation of the stock price. This needs to be taken into consideration when making managerial decisions, and thus provides a mechanism of aligning the interests of the management to those of the ownership.

Governance Structure

To prevent the erosion of the right of the ownership, a unitary BoD, also known as the independent directors' system, is established at the top of the managerial hierarchy of the company, to represent the shareholders' interest and directly report to the shareholders' meetings. The board may establish several committees such as the AC, the remuneration committee and the nomination committee.

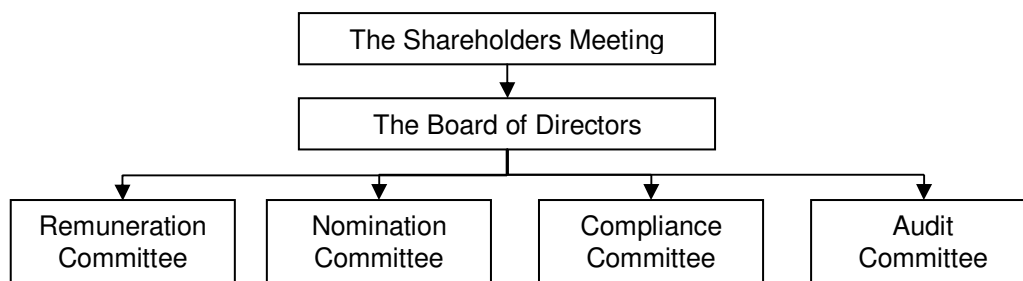


Figure 2. The Anglo-American Single-Pronged Governance Structure
(Source: Author, referenced to the named studies)

Supervisory Mechanism

The AC, formed by the independent directors, is the core of the internal supervisory mechanism. The AC is appointed by the BoD, but has no authority over the management. It is not guaranteed that the performance of the AC will meet the shareholders' expectation.

Peculiar Problems

The power of individual shareholder is weakened by the large number of minority shareholders. This makes it difficult to safeguard their interests against the relatively strong power of the management.

Reform Measures

The interests of shareholders are safeguarded by minimising information asymmetry with measures such as information transparency and the prohibition of insider transactions, to ensure the proper functioning of the supervisory mechanism.

German and Japanese Organisation-Oriented Internally Driven Model

Governance Culture

In this model, enterprises are hugely influenced by the government, the organisational structures, the unions and the banks. The stock market is less active, and circulation of capital is of a lesser scale. It is more difficult for mergers, acquisitions or takeovers to take place. This makes the banks the main source of the enterprises' financing, and gives financial creditors greater power over the shareholders.

Legal Environment

Because of the indirect manipulation of the market economy by the government, the regulations that protect shareholders' equity are weaker compared with those in the Anglo-American model. There is an emphasis on the interests of various stakeholders, and there are stricter regulations restricting the stock market, so the influence of market forces on the enterprises is reduced. There is less restriction on majority shareholders such as the banks. Hence, executives are selected and appointed by the majority shareholders. This further strengthens the majority shareholders' influence on the enterprise.

Ownership Structure

The stock is relatively concentrated and less frequently exchanged. The company's shares are mainly held by the corporation and the banks. Enterprises rely more on loans from creditors rather than on capitals from shares sold on the stock markets.

Hence, financial institutions such as the banks play a major role in the enterprises, which in turn pay more attention to protecting the interests of the major shareholders than those of the minority stockholders. As a result, the stock market is less developed as there is less incentive to do so.

Governance Structure

The governance structure is based on a two-tier board. These are the SB and the Management Committee in Germany, or the Board of Auditors and the BoD in Japan.

In the Japanese model, the shareholders' meeting holds the supreme power within the enterprise, and appoints the auditors. In the German model, the general meeting holds the supreme power within the enterprise and appoints the members of the SB, which is responsible for appointing the members of the Management Board. There are employee representatives on the SB who directly report to the general meeting. Hence, the shareholders, the banks and the managers all play significant roles in the governance structure.

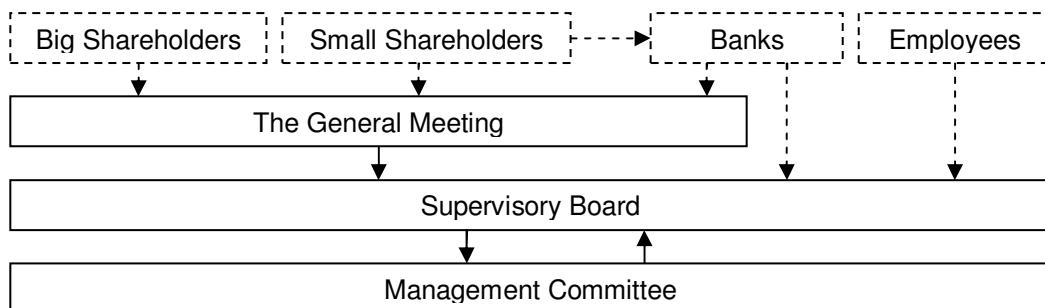


Figure 3. The German Two-Tier Governance Structure
(Source: Author, referenced to the named studies)

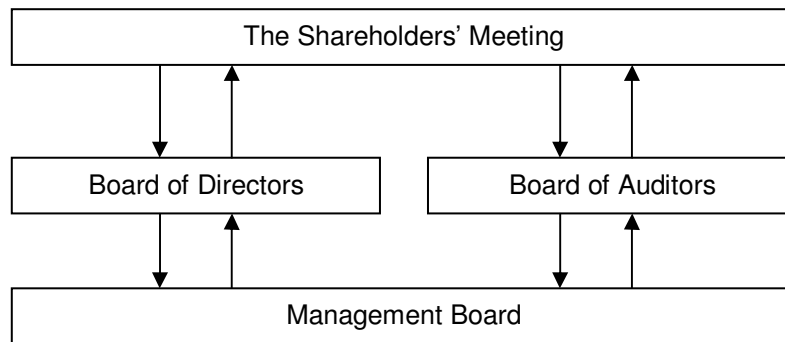


Figure 4. The Japanese Dual Governance Structure
(Source: Author, referenced to the named studies)

Supervisory Mechanism

The key role in the supervisory mechanism of CG is played by the SB in Germany and the legally assigned auditors in Japan. There are reservations on the extent to which these boards can function and doubt over the independence of the Board of Auditors in the Japanese model.

Peculiar Problems

The minority shareholders do not usually participate in the general meeting, so the banks naturally become the representatives of the shareholders, and have enjoyed an increase in their power. Consequently, only the interests of the banks and the corporation are safeguarded.

Reform Measures

Attempts have been made to protect the interests of minority shareholders, such as strengthening the external supervisory mechanism on the capital market, as well as improving information transparency in the functioning of the SB.

East Asian Family-Oriented Clanship Model

Governance Culture

Tian and Feng (2004) state that the East Asian family-oriented clanship system has been built on the following three factors: the influence of the Confucian tradition, the

economic role and support of the government, and the unhealthy market system. Family members will do their best to operate the company with a long-term objective, but the need to raise large amounts of capital will cause the CG structure to change.

Legal Environment

The economy is guided by the government, the management style is determined by the family, and this leads to a synthesis of a traditional paternalistic managerial style and modern organisational form. Ownership and management are not totally separated, and there is an overlap between the organisational and clan structures. Hence, operations can be accomplished by means of these alternative structures, and actions do not necessarily comply with organisational rules or laws. In this situation, family ethics becomes the only form of restraint on behaviour of the management.

Ownership Structure

Stock rights are heavily concentrated in the hands of members of a few families, who are also the owners and employees of the company. This means, generally, the interests of shareholders and management are naturally aligned, so there is less need for additional incentives or control. Capital comes primarily from funds provided or controlled by the family or the government, and secondarily, from bank loans.

Governance Structure

As ownership and management are usually inseparable, the principal families generally participate in both the management and the investment decisions of the company. The parental style is adopted in decision making, the relations amongst the kindred are influential on the management style, and the succession of power naturally follows the succession system of the principal family.

Supervisory Mechanism

A clanship system has the holding family as the core of its supervisory mechanism of Corporate Governance. External control is weak, with minimal engagement between the bank and the company. The lack of effective market restraints leads to criticism that the supervisory mechanism is merely symbolic.

Peculiar Problems

Such a company tends to exhibit patriarchal behaviour and arbitrary and subjective policy making. Overlapping between the ownership and the management means the members of the holding family have unreasonably strong power over the company and can easily encroach on the interests of the shareholders who are not the members of the family, and have little protection in this model.

Reform Measures

Attempts have been made to curtail the power of the primary family by encouraging or forcing it to open its shares to the market so that market forces can be used to protect the interests of the minority shareholders. Alternatively, regulations could be used to encourage or enforce organisational reform to separate the ownership and the management.

4.4.2 The Principles of Corporate Governance

The origin of the principles of CG illustrates some of the important problems in the operation of CG. Non-mandatory CG principles have an imperceptible function in the formation of a kind of benign shareholder culture. CG principles are not actually intended to substitute the existing laws and regulations, but to offer principles for formulating concrete and effective regulations.

CG concerns itself with the soundness of enterprise operations as well as the stability of the global financial system. For this reason, many international organisations such as the Organisation for Economic Cooperation and Development (OECD), the World Bank and others have given considerable attention to the development of CG around the world.

The OECD-initiated Principles of Corporate Governance, first published in 1999, have been widely adopted as a benchmark amongst OECD countries and beyond. In April 2004, the 30 member-states of OECD approved the revised version of the OECD's Principles of Corporate Governance. Veronique Ingram, chairperson of the OECD Steering Group on Corporate Governance, said:

“The revised Principles emphasise the importance of a regulatory framework in Corporate Governance that promotes efficient markets, facilitates effective enforcement and clearly defines the responsibilities between different supervisory, regulatory and enforcement authorities. They also emphasise the need to ensure transparent lines of management responsibility within companies so as to make boards and management truly accountable.” (OECD 2004b)

The OECD Principles of Corporate Governance, adopted in 2004, highlighted the following six main aspects of concern:

Ensuring the Basis for an Effective Construction of CG Framework

The CG framework should promote transparent and efficient markets, be consistent with the rule of law, and clearly define the division of responsibilities among different supervisory, regulatory and enforcement authorities.

The Rights of Shareholders and Key Ownership Functions

The CG framework should protect and facilitate the exercise of shareholders’ rights.

The Equitable Treatment of Shareholders

The CG framework should ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have equal opportunity to obtain effective redress for violation of their rights.

The Role of Stakeholders in CG

The CG framework should recognise the rights of stakeholders prescribed by law or through mutual agreements, and encourage active co-operation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises.

Disclosure and Transparency

The CG framework should ensure that timely and accurate disclosure is made on all documents regarding the corporation, including its financial situation, performance, ownership, and governance of the company.

The Responsibilities of the Board

The CG framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders.

Other issues addressed by the revised Principles include matters pertaining to:

Institutional Investors

Institutions should disclose their CG policies, how they decide the use of their voting rights and how they manage conflicts of interest that may compromise their voting. Restrictions on consultations between shareholders about their voting intentions should be eased to reduce the cost of informed ownership.

Shareholder Rights

The rights of investors must be strengthened. Shareholders should have the right to remove poorly performing board members and to participate effectively in the nomination and election processes. They should also have the right to voice their views regarding executive and board remuneration policy and any equity component should be subject to their approval.

Conflicts of Interest and Auditor Responsibility

A new principle calls for rating agencies and analysts to avoid conflicts of interest, which could compromise their advisory role.

The duties of the auditor must be strengthened and include accountability to shareholders, and a duty to the company to exercise due professional care when conducting an audit.

Auditors should be wholly independent and not compromised by other relations with the company.

Stakeholder Rights and Whistle-Blower Protection

The Principles refer to the rights of stakeholders, whether established by law or through mutual agreements.

A new principle advocates protection for whistleblowers, including institutions through which their complaints or allegations can be addressed, and provides for confidential access to a board member.

Board Responsibilities

The duties and responsibilities of the board have been defined as fiduciary in nature; this is particularly important where company groups are concerned.

The principle covering board independence and objectivity has been extended to avoid conflicts of interest and cover situations characterised by block and controlling shareholders, as well as the board's responsibility for oversight of internal control systems covering financial reporting.

4.4.3 Summary

At present, there is no single ideal CG model in the world because of the diversity of cultural, social and economic settings, different historical traditions and levels of development. Considering economic globalisation and the interaction among the aforementioned three CG models, it is apparent that each of these three models has its unique characteristics and problems, prompting them to seek to converge with each other, and absorb the strong points of other models in order to remedy shortcomings. Though existing CG models are essentially different from each other, nevertheless some common principles do exist which could further improve the effect of the CG in each of three models.

Common CG principles can be highlighted in the following four areas: [1] Accountability and Responsibility: by strengthening the function and obligations of the BoD; [2] Fairness: by strengthening the framework of Corporate Governance; [3]

Transparency: by strengthening the disclosure of information; and [4] Contestability: by strengthening the distribution of surplus value. The common feature of the principles is equal treatment of stakeholders' interests.

Meanwhile, the two new principles adopted in 2004 were intended to strengthen audit duties and insure the protection of whistleblowers, representing a significant departure from the past. Strengthening effective supervisory mechanisms has become the priority. No matter which CG model is in place, the function of a supervisory mechanism of governance has been given greater emphasis, in order to promote its development.

4.5 The Existing Model of China's Corporate Governance

The works by Yu (2002), Shi (2006), Huang (2005), Feng (2005), Li (2007), Yeh *et al.* (2002), Zhia (2004), Wu and Li (2006), Wu *et al.* (2006), and Yang *et al.* (2007) all suggested that China should develop a comprehensive CG model, suiting its actual and unique conditions, by looking at the strengths and weaknesses of the existing three world models. The paragraphs that follow offer a brief synthesis of the existing model of China's CG system with respect to its governance culture, legal environment, ownership structure, supervisory mechanism, peculiar problems and reform measures.

4.5.1 Governance Culture

China's economy is a planned economy, transitioning to a market based one. This transitional period tends to assume a core of neo-liberalism, characterised by privatisation, mercerisation and liberalisation. Its culture is one of trial, constraints on issues being fully debated, full of uncertainty, and the system is struggling to find its new orientation.

4.5.2 Legal Environment

China's legal environment has left much to be desired while going through the process of transition. There are many aspects for improvement, especially the serious lack of norms covering the supervisory mechanism.

4.5.3 Ownership Structure

In the reform process towards privatisation, ownership structure is leased to workers and managers, etc. This structure is concentrated in the hands of insiders consisting of state-owned stocks and limited workers; and manager-owned stocks, which affects the mobility of the stock market.

4.5.4 Governance Structure

Large-scale state-owned enterprises are in need of reform, but there is a total lack of any legal norm. Thus, the company's decision-making power is concentrated on the management layer. Additionally, the external environment of stock market competitiveness is not perfect. Overall, governance structure has a typical 'insider control' tendency.

4.5.5 Supervisory Mechanism

The control of state run enterprises aside, both the external and internal supervisory mechanisms are still under construction. Externally, there is a lack of any real market environment supervision, such as stockholders participating in Corporate Governance. Internally, there is a lack of management supervision: such as the functional integration of the SB, AC, Internal Audit and independent directors.

4.5.6 Peculiar Problems

The legislation is still not robust enough to accelerate the transition of the economic environment. There is a lack of a supervisory mechanism, and a high concentration of ownership of the state-owned enterprise, banks and major enterprises in the hands of a few.

4.5.7 Reform Measures

Reforms are needed to revise and improve the law and regulations, optimise the market environment, and review bank and enterprise relations, to improve the external environment and the conditions of minority owned companies.

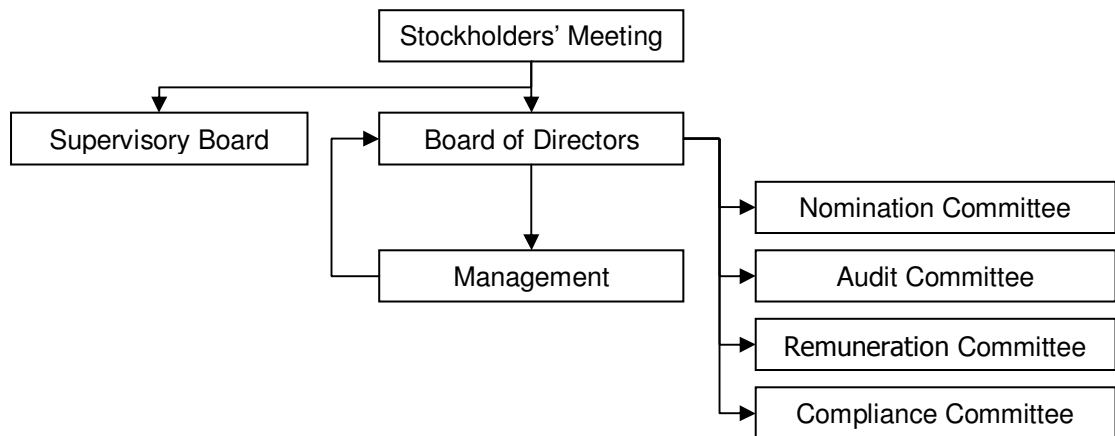


Figure 5. The Chinese Duality Governance Structure
(Source: Author, referenced to the named studies)

Summary

Such are the aforementioned characteristics of the CG model in China, it is imperative to probe their causes, summarised from the relevant studies by Li and Li (2007), Li (2004), Chang and Yan (2004), Jiang (2004), Yu (2002), Shi (2006), Huang (2005), Feng (2005), Li (2007), and Yeh *et al.* (2002) in terms of governance culture, legal environment, ownership structure and governance structure as follows:

Governance culture

One of the typical defects of the outmoded governance culture in China is that the directors of the company, supervisors and general manager are mainly appointed directly by state owned shareholders or the large shareholders. There is little effective supervision by the BoD or the SB. This kind of traditional governance concept is inadequate for modern enterprises, because of the need to emphasise not only the interests of the big shareholders, but also to give consideration to the interests of all shareholders and stakeholders, in order to facilitate the enterprises' long-term development.

Legal environment

Stronger legislation is needed in order to prevent a few shareholders from operating maliciously, and to prevent power from being excessively concentrated in the hands of the BoD or the company's President. China is still in the process of dispersing the ownership structure of large-scale state owned enterprises, and releasing state owned

stocks. Therefore, China should endeavour to set strict standards governing property relations for state owned holding companies and listed companies in the following two aspects:

- (1) Strengthening the supervision dynamics to the management by using the force of the law to safeguard all investors' rights and interests by investigating and punishing management who abuse their powers;
- (2) Strengthening the supervision of financial managers by using the force of the law to ensure that financial managers produce true and accurate accounting reports.

Ownership structure

Ownership is excessively centralised, and the circulation of the stocks of listed companies is proportionately very low. As resolutions are passed by majority votes in shareholders' meetings, middle and small shareholders in China are powerless and have little influence in the Board of Director's meetings. It is very difficult to form effective and independent CG structures under such conditions.

Governance structure

The shape of the governance structure is imbalanced because of the centralised ownership. Most of the directors of state owned holding companies and the individual proprietorships are appointed by large shareholders, so directors representing medium and small shareholders and workers' directors become disadvantaged.

Presently, the external structure of CG in China still needs to be strengthened. The ownership structure of a company in China has remained highly centralised, the stock market is still underdeveloped, and the legal system is yet to be improved. Under these circumstances, the internal supervisory mechanism relies on the effectiveness of the CG structure to avoid the risk caused by weak internal control. As such, the development of an internal supervisory mechanism of CG should be the top priority in China's development of CG.

The work of the internal supervisory mechanism is difficult to establish due to the lack of clear stipulations in the relevant laws regarding the functions and powers of the supervisory mechanism. The status of the internal supervisory mechanism does

not allow it to apply supervisory pressure on the BoD, which possesses real powers and is seldom supervised effectively. Rather, the BoD is controlled by large shareholders.

4.6 An Overview of the China's Political Environment on Impacting to the Development of Supervisory Mechanisms of Corporate Governance

Shortly after the founding of the People's Republic of China in 1949, the supervisory profession in China disappeared almost completely. Independent monitoring was virtually non-existent under the planned economy before the 1980s, when the State both owned and ran enterprises. The re-emergence of independent supervision was a result of mushrooming Sino-foreign joint ventures, conveyed by China's open door policy, adopted in the early 1980s. Due to non-state owned interests in the joint ventures, demand emerged for the verification of capital contributions and audits of annual financial statements and income tax returns by registered non-government-employed Chinese certified public accountants (Xiao *et al.*, 2000). The progress of full-scale economic reforms, with the separation of ownership and management of enterprises, led to agency problems in business firms. Independent monitoring is thus called for, in order to alleviate these problems.

The Chinese Institute of Certified Public Accountants (CICPA) was established in the early 1980s. At the turn of the 1990s, the rapid development of shareholding companies (stock companies) in China led to a sharp increase in the demand for supervisory mechanisms. The China Securities Regulatory Commission (CSRC) requires that all listed firms have their annual reports audited by certified public accountants (CPAs). The monitoring of both public and private enterprises by independent auditors has been employed by the government as an important supervisory mechanism in transforming the Chinese economy from the one directed by the "visible hand" of centralised set up and schedule towards the one directed by the "invisible hand" of market forces.

Meanwhile, in legislation passed in December 1993, Chinese Company Law specified for the first time that every listed company establish a SB to supervise the company's

financial activities and the conduct of directors. Subsequently, additional regulations involving the appointment of independent directors were introduced. Initially, starting in 1997, this was optional, but it became compulsory for listed companies from 2005 (see Table 1: "Timeline of the Development of the System of Independent Directors in China" for the main stages in this development).

In 1997, as China celebrated the historic return of Hong Kong to its rule, the occasion was suddenly dampened by the unexpected outbreak of the Asian financial crisis. This crisis was triggered after the Thai government decided to abandon the practice of thirteen years (1984-1997) of pegging the Thai Baht to the US dollar. As a result, the exchange rate of the Baht against the US dollar fell nearly 20%. Other Southeast Asian currencies soon plunged, and the financial storm quickly swept across the entire region. Ten years later, as Asia has once again become a crucial market that attracts international capital and the pressure of an international financial imbalance increases, there is great concern whether the Asian financial crisis of 1997 will happen again.

The International Monetary Fund and the World Bank, while providing assistance to the crisis ridden and cash-strapped Asian economies, urged them to supervise their listed companies effectively by setting up CG systems. Since the 1997 crisis, the establishment of CG in the region has come to be regarded as one of the critical priorities for government. Subsequently, various Asian administrations initiated serious efforts to develop CG, in order to improve their international competitiveness. A survey by McKinsey (2000), which examined 188 companies in India, South Korea, Malaysia, Mexico, Taiwan and Turkey, in order to test the link between market valuation and CG practices, found that, "institutional investors in companies based in emerging markets claim to be willing to pay as much as 30 percent more for shares in companies that are well-governed." Similar findings were reported in the 2002 survey by McKinsey.

China applied to join the World Trade Organisation (WTO) in September 2001 and eventually was admitted in November of the same year. After accession to the WTO, China has strengthened its supervision of domestic listed companies in order to align itself with the international market, gradually move towards an export-oriented economy and eventually implement an open economic system. In recent years, for example, the shareholding structure of wholly state owned commercial banks such as

the Construction Bank, the Bank of China, and the Industrial and Commercial Bank have been reformed significantly. These three banks have been reconstructed into joint stock companies and have been listed in Hong Kong and various inland stock markets. The changes in their roles and functions have opened a new chapter in China's history of financial reform. Presently, while China has left no stone unturned in luring foreign capital into the country, it has also encouraged local enterprises to focus on the global market and to be competitive internationally. To ensure success in both directions, the next milestone for China's ongoing reform will be to actively promote the implementation of CG systems as the international trend dictates.

In 2002, China announced the regulation of the Code of CG for Listed Companies in China (CSRC and SETC, 2002: Section 52), encouraging listed companies to set up an AC voluntarily, though its installation is not mandatory. This introduction of ACs is an attempt to compensate for the deficiencies of SBs. China expects that the implementation of the AC will improve the internal supervisory mechanism of CG, and also effectively oversee the internal directors as well as protect the interests of the investors, the functions of ACs are similar to those of SBs. Nevertheless, it expects to encounter problems or difficulties in trying to transplant the AC from the unary control system to the binary control system with the SB. In recent years, many listed companies in China have started establishing ACs alongside the existing SBs to form their own structure of internal supervisory mechanisms, combining the Anglo-American and German-Japanese systems in one.

China has experienced a period of unprecedented social and economic transformation since it embarked on a policy of reform and opening up to the outside world, initiated by Deng Xiaoping in 1978. Over the past three decades, business operation in China has become more complex, a process characterised by innovation and trial and error. With a view to exploring foreign practices that may be applicable to China's unique internal supervisory mechanisms of CG model and context, it is necessary to consider how to enhance the governance mechanisms in its listed companies in order to develop China's capital market; and also how to learn from the best reform practices of domestic and overseas CG, to improve China's internal supervisory mechanism. The SB has been established in China since 1993, and its effective experience over the past 15 years can serve as a benchmark in launching the ACs successfully, as well

as in enhancing its smooth interaction with other institutions of the internal supervisory mechanism in the country.

China's response to the global trend for promotion of CG is illustrated in Table 16. The history of the development of the CG in China is rather short. China not only has had to learn from the experience of other countries, but also to take into account different national conditions such as economic systems and the stage of development of the capital market, etc. Singh and Zammit (2006) assessed the comparative merits of the US corporate model and traditional Asian model, from the perspective of developing countries. Their research provided little evidence to support the argument that the fundamental causes of the 1997 Asian crisis lay in weak CG and poor competitive environments in these emerging economies. On the contrary, they suggested that "a reformed Asian model that encompasses labour and other social groups, and promotes the cooperation between business and government would much more likely be conducive to economic development and broad-based social welfare than the speculative and conflicting US corporate model."

Tan and Wang (2007) undertook a study to construct a suitable model of CG for those listed companies in China that were formerly state owned enterprises. They concluded that both 'outsider' and 'insider' systems of CG are not suitable for application in China, because of its unique problems as a transitional economy. They suggested that China needs a system that is uniquely its own, shaped by the 'socialist market economy with Chinese characteristics'.

Summary

China has entered a period of unprecedented transformation, within which business operation has become more complex and complicated. It is a process of innovation as well as trial and error. The relevant studies of Li and Wang (2007), Du and Tang (2006), Li and Chen (2006), Li and Liu (2005), Li (2003), and Chang (2001), all suggest that China must enhance governance mechanisms in its listed companies and the development of the capital market by refining the basic principles of "Corporate Law", "Securities Law" and the "Rules for Listed Companies Governance" as well as by learning from the best reform practices of domestic and overseas Corporate Governance.

China's internal supervisory mechanisms consist of the SB and the AC. This combination of structures is unique and different from the British, American, German and Japanese models. The functions and interaction between these two governance elements represent important subjects for research, to establish the impact of the Chinese approach; and the effectiveness and the co-ordination of combining both mechanisms within it.

The Supervisory Board

According to Article 126 in China's Corporate Law, the SB in a Chinese company is the internal supervisory unit responsible for supervising the directors and managers' behaviour. Corporate Law also stipulates the system of the SB and guides it on behalf of the shareholders to supervise the organisation of internal power, exercised by the BoD and the layers of management of the company. In practice, however, the SB does not have real power, and it only has limited authority to supervise. The SB in Germany has three major powers: to appoint and remove the Executive Committee members, sanction the company's key decisions, and supervise the Executive Committee. In contrast, if the SB in China finds the behaviour of the directors and managers harmful to the interests of company, they can only suggest holding an Interim Shareholders' Meeting, and if the directors and managers ignore this, the SB is rendered powerless.

Obviously, China's Corporate Law needs to be revised in order to give the SB concrete and real power, for example to be able to hold the Shareholders' Meeting directly. At the same time, the law should be revised to demand that the SB fulfils its legal obligation. Compensation should also be made should the SB not fulfil its duties to improve the supervision of company managers. Efforts are still needed in China to prevent the SB from being a mere formality and failing to execute its supervision function.

The Audit Committee

According to Section 52 of the Code of CG for Listed Companies in China, the BoD of a listed company may establish an AC. China's "Rules for Listed Companies Governance" set out five main duties of CG for the AC:

1. Provide suggestions for engaging or changing the external audit firm (CPA);
2. Supervising the Internal Audit system and its implementation;
3. Be responsible for the internal and external auditing communication;
4. Verify and reveal the financial information of the company;
5. Check the internal control system.

The duties of the AC and the SB as stipulated in Corporate Law are essentially similar, involving supervising financial affairs and the directors and managers controlling the activities of the company. Both the SB and AC have responsibilities for supervising the company's financial problems, internal accounting information and employment of the external certified accountant. However, organisationally they are not affiliated to each other, as the AC is under the jurisdiction of the BoD, while the SB is parallel to the BoD. This can cause confusion in their respective responsibilities if there is lack of clarification or co-ordination, and it may appear that many institutions are supervising but no unit actually performing that function. Clarification or co-ordination includes defining the duties, functions and position of the AC in the organisation, and establishing a legal standard for the AC, but such clarification measures are still outstanding.

4.7 An Overview of the Relationship between the Shareholding Structure and Internal Supervisory Mechanism in China

Presently there are several company types in China. State Owned Enterprises (SOEs), which are industrial enterprises where the assets or income are owned by the state; Collectively Owned Enterprises (COEs), which are industrial enterprises where the assets are owned collectively, including urban and rural (township and village enterprises) (TVEs); Private and Individual Owned Enterprises (IOEs), which are small private businesses; and Other Ownership Types (Others), which includes Shareholding Companies (or joint-stock, joint-share companies), which are Chinese companies converted into shareholding or limited liability companies, and Joint venture Wholly Foreign Owned Enterprises (WFOES) (Clarke and Du, 1998).

A listed firm in China usually has a controlling owner, being usually the government or a parent SOE. The controlling owner can exercise absolute control over the listed

firm. Four share types in China in the current security market are illustrated in the table below. An SOE share can be further divided into four types: shares owned by central or local governments; employees; individuals; and institutions. Normally governments are the controlling owners or parent SOEs that owned shares that are not tradable. B share is available for foreign investors; H share listed on the Hong Kong Stock Exchange; N share listed on the New York Stock Exchange. SOE (A) shares occupied the share market of over 91% in China between 2003 and 2009, as illustrated in Table 13. B shares of listed companies represent less than 10% in the Chinese security market at present. Therefore, the preceding discussion suggests that whether a firm introduces an AC to serve a CG function is controversial, depending on the potential costs and benefits to the controlling owner.

Table 12. Share Types in China
(Source: Author, as supported by CSRC and SETC (2002))

| Share Types | Description | Liquidity | |
|-------------|--|--|---|
| A-share | SOEs' shares which can be further divided into 4 types | Shares owned by the central or local governments | Non-tradable |
| | | Share owned by employees | Tradable after holding for 6 to 12 months |
| | | Shares owned by individuals | Tradable |
| | | Shares owned by institutions | Tradable |
| B-share | Available for foreign investors only | Tradable | |
| H-share | Shares listed on the Hong Kong Stock Exchange | Tradable | |
| N-share | Shares listed on the New York Stock Exchange | Tradable | |

Table 13. The Numbers of Listed Companies Owned By A (SOEs) and B Shares
(Source: Author, as supported by CSRC and SETC (2002))

| Year | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|--------|--------|--------|--------|--------|--------|--------|
| Number of Listed Companies in Mainland China including A and B Shares | 1287 | 1377 | 1381 | 1434 | 1550 | 1625 | 1718 |
| Number of Companies of B Shares | 111 | 110 | 109 | 109 | 109 | 109 | 108 |
| Number of Companies of A Shares | 1176 | 1267 | 1272 | 1325 | 1441 | 1516 | 1610 |
| % of B Shares | 8.62% | 7.99% | 7.89% | 7.60% | 7.03% | 6.71% | 6.29% |
| % of A Shares | 91.38% | 92.01% | 92.11% | 92.40% | 92.97% | 93.29% | 93.71% |

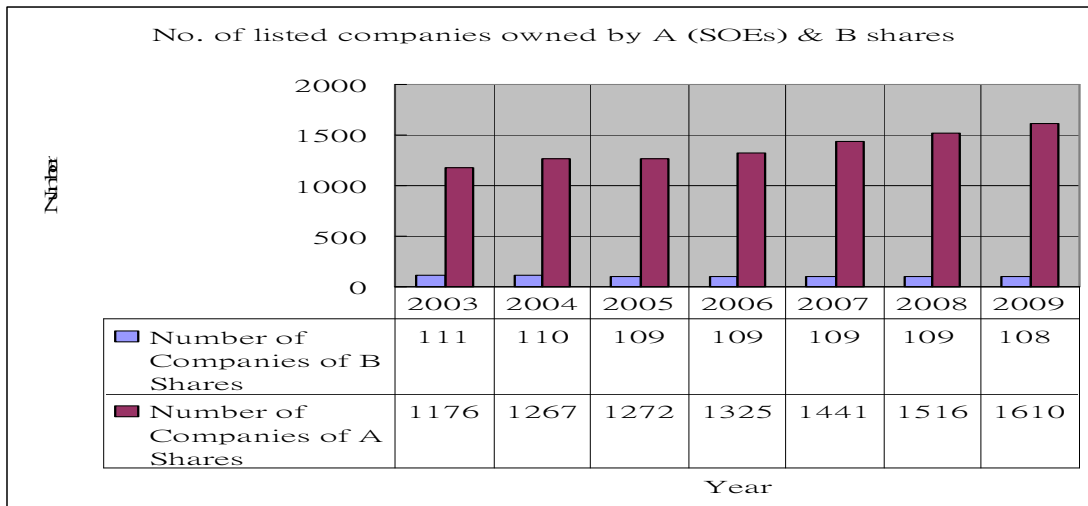


Figure 6. The Numbers of Listed Companies Owned By A (SOEs) and B Shares (Source: Author, as supported by CSRC (2010))

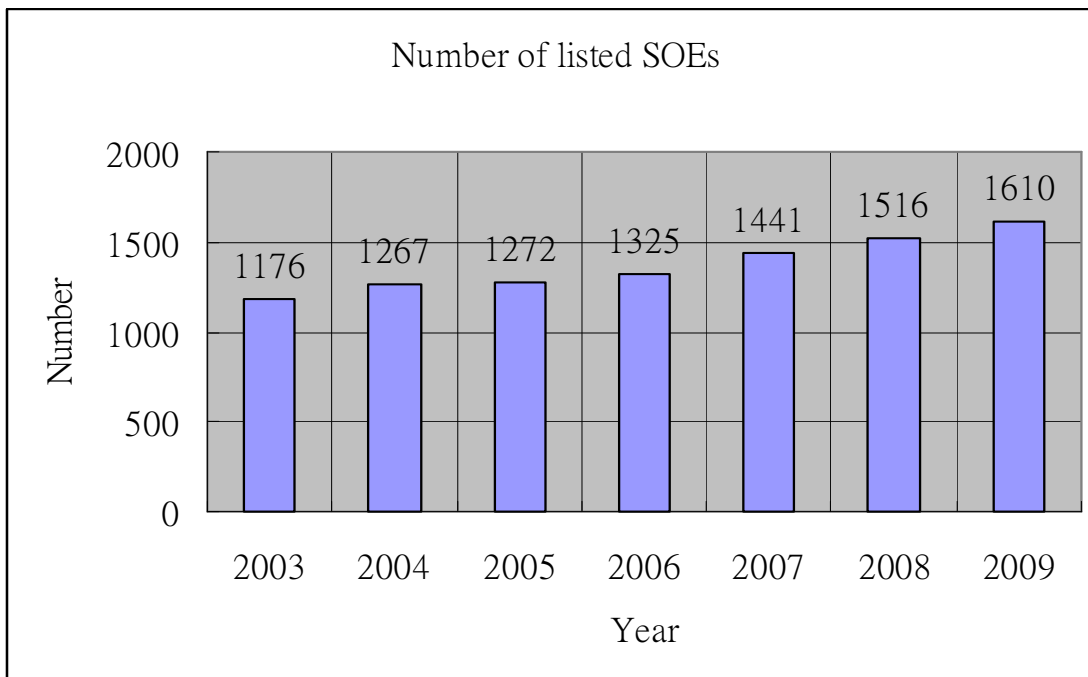


Figure 7. The Number of Listed SOEs in China (Sources: Author as supported by CSRC (2010))

State shares and legal entity shares are not tradable at present, so there is no motivation for controlling large shareholders to care about changes in value or share price of the listed firms in the market. In fact, the controlling shareholders of many listed firms, mainly government agencies or parent SOEs, are keen only on raising funds from the stock market (Xiang, 1998). For Chinese listed firms, the main benefit of introducing an AC is that firms may be able to raise funds in the capital market at a lower cost, or sell shares at a higher price, as the market may perceive that high

quality supervision will lead to better quality of information disclosure. And the costs will be the diminution of the opaqueness gains: the controlling owner may be inhibited in their ability to maximise self-interest through benefit transfer because of high standard monitoring by the AC.

Basically, the controlling shareholders benefit from a lack of transparency: they engage in rent-seeking activities, at the cost of other shareholders (Leuz *et al.*, 2001). In China, controlling shareholders have frequently intervened in the operations of listed firms to benefit parent companies, using the listed firms to guarantee loans for related entities, and exposing them to unnecessary financial and operating risks. They are frequently engaged in benefit transfer through misappropriation of funds or related party transactions, to expropriate the listed firms and infringe upon the interests of other shareholders, public investors in particular.

In such a market, the benefits of lowering capital raising costs are insignificant: Chinese listed firms have little intention or possibility of offering new equity to the public; IPO (Initial Public Offering – meaning a new offer of shares from a company which was previously unlisted) firms can sell their shares with no difficulty, but are unable to offer new equity in the near future after listing. Therefore, opaqueness gains are supposed to outweigh the benefits of lowering the costs of raising capital. Hence, lower quality monitoring will be preferred by listed firms, especially those with weaker internal supervisory mechanisms, because they have relatively more opaqueness gains to protect (Beasley *et al.*, 2000; Carcello and Neal, 2000; Felo *et al.*, 2001).

The internal supervisory mechanism within a firm consists of various types of organisational arrangements or procedures to balance the power and responsibilities among the firm's shareholders, directors, management and employees. Among them, the ownership structure, the BoD, SB, and the duality of the BoD chairman and CEO are of great importance in determining the effectiveness of internal supervisory mechanism, especially for listed firms in China (Liu and Sun, 2005). There are many multifaceted traditions that affect the value of the corporation as well as the CG because of ownership structures. Daniels and Iacobucci (1999) argue that more narrowly controlled firms may face greater agency costs because the controlling

shareholders would have a dominant influence on corporate affairs, and it is easier for them to bypass the monitoring of other shareholders.

La Porta *et al.* (1998, 1999) showed that in emerging transitional economies, controlling shareholders might expropriate the minority shareholders through aggressive benefit transferring behaviours. They further argue that “the central agency problem in large corporations around the world is that of restricting expropriation of minority shareholders by controlling shareholders” (La Porta *et al.* 1999). This is particularly true for Chinese listed firms, where controlling shareholders, on average, hold a very large portion of the equity.

There are two primary patterns of board structure: the unitary board system or Anglo-American system, and the two board system or German-Japanese system. Under the unitary board system, a company has only one board, comprised of the executive directors and the independent directors. The executive directors are in charge of the company’s business operation, while the independent directors act as supervisors of the management. Under the two-board system, a firm has two boards – the BoD and the SB. The SB functions as the special monitoring organ and may have the same mandates as the BoD or even higher status than the BoD. Pursuant to Chinese Company Law, listed firms adopt the typical two-board system, thus having both the BoD and SB.

The Code of CG for Listed Companies in China issued by the CSRC and State Economic and Trade Commission (2001) further requires that members of SB should have professional knowledge or work experience in such areas as business law and accounting. The SB shall ensure its capability to independently and effectively conduct its supervision over the activities carried out by the directors and management, as well as monitor or examine the financial affairs of the firm. The BoD is expected to perform in ways that guarantees shareholders that their interests are protected. The BoD is responsible for the execution of the resolutions passed in the shareholders’ meetings; appointing, removing and remunerating the general managers and other senior managers. On the other hand, there are quite a number of directors who, at the same time, hold the title of CEO or are considered as the firms top executives. Most of these top executives are naturally less likely to be detached in administering, appraising and assessing the management’s performance. For the BoD

to effectively perform a monitoring function, the separation of the positions of CEO and BoD chairman is essential in respect of an effective internal supervisory mechanism (La Porta *et al.*, 1999).

Extracting private control benefits, if detected, is likely to invite external intervention by minority shareholders, analysts, stock exchanges, or market regulators (Haw *et al.* 2004). The desire to maximise self-interest through benefit transfer may drive listed firms to avoid being monitored. In general, the more concentrated the ownership structure, the weaker the internal supervisory mechanism; hence, there will be more opaqueness gains for the controlling shareholders (Chau and Leung, 2006). Therefore firms with larger controlling owners are more eager to choose a pliable auditor or supervisor, so they can easily benefit from tunnelling behaviours of benefit transferring under a lower level of monitoring.

In addition, controlling shareholders enjoy a monopolistic position and influence, so they can easily control or dominate the nomination and appointment of directors and senior management officers, and virtually preclude other shareholders from participation in making operating decisions, including hiring of auditors or supervisors or members of ACs. Hence a larger controlling shareholder is more likely to maintain a low quality internal supervisory mechanism in order to realise and sustain opaqueness gains.

4.8 Summary

The structure of this chapter is based on understanding four CG models' features of governance culture, legal environment, ownership structure, and governance structure, in order to reveal the peculiar problems faced by the supervisory mechanism in each model respectively. These four features were identified by studying the relevant literature on the supervisory mechanism of Corporate Governance. Meanwhile, the four features of the three international models respectively are used in order to study the supervisory mechanisms in China.

This chapter begins by studying the historical development of the 'standard' CG model of the UK and the US, so as to illustrate the development of the supervisory mechanism. The next section contrasts different CG models, to illustrate how each

model's supervisory mechanism reflects particular problems, and discusses the principles of CG regarding supervision from internationally, to review China's internal supervisory mechanism.

At present, there is no single set ideal CG model in the world because of diversity in cultural, social and economic settings, and different historical traditions and levels of development. Considering economic globalisation and the interaction among the aforementioned CG models, it is apparent that each of these models has its unique characteristics and problems, prompting them to seek to converge with each other, and absorb the strong points of other models in order to remedy shortcomings.

Though existing CG models are essentially different from each other, nevertheless some common principles do exist which could further improve the effect of the CG in each of the three models.

In addition, shareholder, stakeholder and managerial hegemony theories are applied as ground theories for evaluating the studies of operations and effectiveness of the supervisory functions of SBs and ACs in China. This thesis also applies political model theory and institutional ownership theory, leading it to provide an overview of the political environment and shareholding background in this chapter. Political model theory provides the basis to introduce the political background, especially related to setting the policy of the internal supervisory mechanism of CG in China. The above section in this chapter presents "An Overview of the China's unique political environment on impacting to the development of supervisory mechanism of CG in China" because "Governance based on politics rather than finance will provide a means of oversight" (Pound, 1992). Therefore "an understanding of the political marketplace is essential to appreciate the role that capital market mechanism can... play in corporate governance" (Gundfest, 1993).

This above section in this chapter also introduces "an overview of the relationship between shareholding structure and internal supervisory mechanism in China", to respond to the key meaning of Institutional Ownership theory. This theory states that as institutional shareholdings are so large, it is difficult to switch their invested capital from one firm to another. As a result, they play an important role in the decision-making processes of the firms in which they have invested (Changati and Damanpour,

1991). Institutional Ownership theory provides the basis as part of political model theory to enhance the understanding of the background relating to the shareholding structure in China.

The main purpose of the analysis is to probe the supervisory mechanism of CG in the West and China: by providing an overview of both the international environment and China's peculiar background, so as to understand the problems and potential causes of these problems. In essence, the objective of the chapter is to emphasise what China has done in combining alternative approaches from other systems; as well as the need for research to investigate the effectiveness, the operations and the co-ordination of this combination under China's governance structures.

The Chinese approach to an internal supervisory mechanism has combined British, American and German models while at the same time absorbing the characteristics of the East Asian model. Under the Chinese internal supervisory mechanism, the SB and AC were not introduced at the same point in China's economic and business development. China's internal supervisory structure involves a unique interaction between two mechanisms of ACs and SBs, and the functions and interaction between these two governance elements represent important subjects for research.

1. The SB may be considered to have failed to fulfil its function in actual practice. Listed companies expect to have better effectiveness of supervisory functions after adding in ACs. Which system is more effective in China: SBs alone or SBs with ACs? This research question is then studied in the following empirical chapter.

2. It is expected that the AC should provide the orientation for the supervisory mechanism in managing China's listed companies. Yet ACs are still at an early stage of evolution. The improvement in the operation of supervisory functions also seems to be a goal of the reform and development of China's securities market. So understanding "The operations of supervisory functions of SBs and ACs in China" provides a basis for suggesting improvements for the effectiveness in the future.

3. It is a process of innovation as well as trial and error. In order to explore other practices that are suitable to the unique CG setting and model in China, the research may be required to understand the interaction between these two institutions of internal supervisory mechanism on how to enhance governance mechanisms in listed

companies for the development of the capital market. Therefore, the co-ordination between SBs and ACs of internal supervisory mechanism after adoption of ACs is designed as another phase of empirical studies in this thesis.

The following three empirical studies will find the evidence for answering these three research objectives with five key questions respectively.

Table 14. The Development of the Supervisory Mechanism of CG in the United Kingdom
(Source: Author, as supported by reference cited within)

| <i>Year</i> | <i>Subject, Major Impact and Major Result</i> |
|---------------------|--|
| 1711 – 1720 | |
| <i>Subject</i> | The South Sea Bubble ¹⁰ |
| <i>Major Impact</i> | Investors suffered heavy losses that seriously undermined the then developing economy of UK. This became the basic factor that subsequently generated the first company laws in Britain. |
| <i>Major Result</i> | Britain subsequently organised 13 people's special committees to investigate the bankruptcy of the South Sea Company, and ordered licensed public accountants to audit the account of the South Sea Company, in order to expose frauds involving this company. |
| 1844 | |
| <i>Subject</i> | Having clearly defined the duty of the BoD, shareholders' meeting and CPA in the company law. ¹¹ |
| <i>Major Impact</i> | The BoD should announce the final financial statement to the shareholders' meeting The shareholders' meeting appointed CPA and one or more shareholders to serve as supervisors for examining the financial statement. |
| <i>Major Result</i> | The designated CPA should report the audit result to the shareholders. The first time it was differentiated between partnership and shareholders in a company. Investors strengthen the supervisory mechanism of the shareholders; A joint stock company could gain legitimacy simply through the official register. It was a necessary procedure when applying to register via the designated CPA which check its accounting stipulations; Emphasised that the making of an "overall and just" balance sheet must be referred to each shareholders' meeting; The accounts and financial statement of the company must be examined by the supervisors who were elected by the shareholders, and who appointed one or several supervisors elected by shareholder to serve as the auditor based on agreement signed by shareholders. |

10 The South Sea Bubble episode created a big shock not only in Britain but the whole world as well. The entire episode has been documented intact and is kept in the Historical Museum of Central Bank of London.

11 Ever since the Joint Stock Company Act of 1844, statutory company law has been amended and consolidated on a number of occasions, most recently in the Company Act of 2006.

| <i>Year</i> | <i>Subject, Major Impact and Major Result</i> |
|-------------|---|
| 1845 | <p><i>Subject</i> Revision of the company law (Kuo 2004: vol.2, pp.196-199)</p> <p><i>Major Impact</i> It further emphasised the importance of the supervisory mechanism in CG in providing protection to investors.</p> <p><i>Major Result</i> A special chapter stipulated the company's audits structure, made the company auditing concrete, and enabled it to carry out auditing with effectiveness; Stipulated clearly that the supervisor of a company has the right to engage the accountant and other relevant personnel to help in auditing and stipulating that the auditor must write 'audit report' and refer the report to shareholder's meeting before disbursing bonus. The auditor read out the accounts as well as the audit report approved by the auditors during the bonus-sharing meeting. Regulations pertaining to accounting compiling and assembling were systematised, emphasising integrity and authenticity of the content of accounts, and adopted stricter rules for compiling, assembling and disclosure.</p> |
| 1862 | <p><i>Subject</i> Revision on the company law (Kuo 2004: 202-204)</p> <p><i>Major Impact</i> Supervisor's duty is substituted by the designated CPA.</p> <p><i>Major Result</i> The shareholder's supervision to company's director is not conducted by the representatives of shareholders but is substituted by the designated CPA.</p> |
| 1948 | <p><i>Subject</i> Revising the company law</p> <p><i>Major Impact</i> Strengthening the supervision of the company as well as promoting the company's responsibility toward the community.</p> <p><i>Major Result</i> Strengthening the company's Internal Audit function and elaborated the outside audit function as designated by CPA; Guaranteed the authenticity, dependability and fairness and sound of the information disclosure.</p> |
| 1961 – 1975 | <p><i>Subject</i> Releasing a series of audit instructions (Tsai and Tang 2006: 3)</p> <p><i>Major Impact</i> The gap existed between regulatory instructions and practical construction.</p> <p><i>Major Result</i> The auditing quality of auditors was severely criticised by all circles.</p> |
| 1976 | <p><i>Subject</i> Establishing the Auditing Practice Committee (APC)</p> <p><i>Major Impact</i> Appointing professional members to promote research on the audit function.</p> <p><i>Major Result</i> Setting up the criterion for auditing</p> |
| 1980 | <p><i>Subject</i> Stipulating the audit criterion and guide</p> <p><i>Major Impact</i> Stipulating specialised criterion and guide for auditing</p> <p><i>Major Result</i> The released audit criterion and guide became Britain's first official document in recording development of the independent audit construction in UK. Since then Britain entered a new era in company's supervisory mechanism and auditing quality.</p> |
| 1992 – 1998 | <p><i>Subject</i> The peak period of study on CG in Britain (Hu <i>et al.</i> 2000)</p> <p><i>Major Impact</i> Cadbury (1992) Rutterman (1994) GreenBury (1995) Hampel (1998)</p> <p><i>Major Result</i> The Combined Code formulated in 1998 consolidated the principles and recommendations of Cadbury, Rutterman, Greenbury and Hampel reports, which contributed greatly in developing the comprehensive criterion of Corporate Governance.</p> |

| <i>Year</i> | <i>Subject, Major Impact and Major Result</i> |
|---------------------|---|
| 1998 | |
| <i>Subject</i> | The Combined Code |
| <i>Major Impact</i> | The London Stock Exchange Council approved the Combined Code |
| <i>Major Result</i> | British incorporated companies listed on the UK Stock Exchange (not Alternative Investment Market (AIM)) are subject to the Combined Code on Corporate Governance. The UK Combined Code had become the supplementary rules of the exchange regulations for the listed companies. The UK Combined Code operates on what is known as a 'Comply or Explain' basis. In other word, companies may choose not to comply with specific provisions, but in that case, they will have to provide a proper public explanation of their decision. |
| 2003 | |
| <i>Subject</i> | The revised Combined Code, published in July 2003 was a direct result of the recommendations of the Higgs report and the Smith review concerning ACs. |
| <i>Major Impact</i> | As with the 1998 Under the Combined Code, companies are required to report on their compliance on the Code and should also explain areas of non-compliance. The revised Combined Code is effective for companies with financial years starting on or after 1 November 2003. |
| <i>Major Result</i> | The new Code amounts to a significant revision of the 1998 Code. In particular the Code calls for: A separation of the roles of the Chairman and Chief Executive. The Chairman should satisfy the criteria for independence on appointment, but should not, thereafter, be considered independent when assessing the balance of board membership; A Board consisting of at least half independent Non-Executive Directors (NEDs). The Code defines independence as recommended by the Higgs Report; Candidates for Board selection are to be drawn from a wider pool; The Board, its committees and directors are subject to an annual performance evaluation; At least one member of the AC should have recent and relevant financial experience; and In contrast to the Higgs Report, the revised Code permits the Chairman to preside over the nominations committee, except where the committee is considering the appointment of the chairman's successor. |
| 2004 | |
| <i>Subject</i> | The British Company Act of 2004 (IT Governance 2010) |
| <i>Major Impact</i> | The UK's Company Act of 2004 pertaining to audit, investigations and community enterprise placed a statutory duty on officers and employees (including ex-employees) to provide auditors with information (other than legally privileged information) and explanations in respect of any issue related to their audit of the company's accounts. |
| <i>Major Result</i> | The directors are required to make a statement that they have disclosed (having taken appropriate steps to ascertain it) all relevant information to the auditors and that making a false statement is a criminal offence. The British Financial Reporting Review Panel (FRRP), which was originally set up in 1990 to look into instances of corporate accounting non-compliance with UK GAAP, gained new powers to require companies, directors and auditors to provide documents, information and explanations when there accounts of non-compliance with regard to reporting requirements. With the exception of small and medium enterprises, UK companies will be required to make detailed disclosure of non-audit services supplied by their auditors. |
| 2006 | |
| <i>Subject</i> | The British Company Act of 2006 |
| <i>Major Impact</i> | The British Company Act of 2006, which received royal assent at the end of 2006, will be fully in effect by October 2008. This Act replaces virtually all the previous UK companies' legislations. |
| <i>Major Result</i> | The first commencement order contained requirements on disclosure of company information, and made provisions for the use of e-communications because this Act affects every single UK company. |

| <i>Year</i> | <i>Subject, Major Impact and Major Result</i> |
|---------------------|--|
| 2007 | |
| <i>Subject</i> | A review of the implementation of the Combined Code |
| <i>Major Impact</i> | The Financial Reporting Council (FRC) conducted consultations on a small number of changes to the Code. The FRC is an independent British regulator responsible for overseeing the Combined Code. The FRC is also responsible for the statutory oversight and regulation of auditors, the professional accountancy, and actuarial bodies. |
| <i>Major Result</i> | The most recent (2003) version of the Code combines the Cadbury and the Greenbury reports on Corporate Governance, the Turnbull Report on Internal Control (revised and republished as the Turnbull Guidance in 2005), the Smith Guidance on ACs and elements of the Higgs Report. In 2006, the Combined Code was subject to a review. These changes were subsequently incorporated in the updated version of the Code published in June 2006. |

Table 15. The Development of the Supervisory Mechanism of CG in the United States (Source: Author, as supported by reference cited within)

| <i>Year</i> | <i>Subject, Major Impact and Major Result</i> |
|---------------------|--|
| 1929 – 1933 | |
| <i>Subject</i> | The Wall Street Crash of 1929, which led to economic crisis in the US in 1930 |
| <i>Major Impact</i> | The crash was one of the most devastating stock market downturns in US history. Accounting regulations were chaotic and accounting information quality has serious problems. The crisis awakens the people about the importance of creating unified accounting regulations. |
| <i>Major Result</i> | <p>The crash was also the starting point of implementing important financial reforms and trading regulations in the US In1930 the American CPA association criticised the chaotic accounting regulation at that time, and established a special committee for co-ordination securities trading;</p> <p>In 1932 the American CPA association sanctioned several companies based on six accounting principles that the special committee had drafted, and the augmented form, known as the approved accounting principles, subsequently became the foundation in. making accounting criterion in the US</p> <p>The 1933 Securities Law: This law was aimed to protect investors' rights and interests. It puts emphasis on the function of independent auditing, on the requirement that financial statements must be based on auditing by the committee's approved CPA, and on providing a certificate according to the result of auditing in order to confirm its authenticity.</p> <p>The 1934 Securities Exchanges Act: Set up the securities trading committee (SEC) in order to strengthen the management of the securities market. This committee was tasked to reform the American accounting and audit system and it has carried out various reform as well as provide guidance authoritatively and decisively;</p> <p>In 1936 the American CPA association published the modified version of "the checking of the financial statement" first published in 1929. From then on the approved accounting principles became the "generally acknowledged accounting principles," allowing the examining points to be transferred for purpose of obtaining credit financing, especially for the shareholders. This change reflected the fact that the CG has now placed the creditors and shareholders in the centre.</p> |

| <i>Year</i> | <i>Subject, Major Impact and Major Result</i> |
|---------------------|--|
| 1938 | |
| <i>Subject</i> | The outbreak of the Mekesson and Robbins bankruptcy case. (Kuo 2004: 446-447) |
| <i>Major Impact</i> | The result was the supreme stratum practices fraud, and made the appointed CPA fall seriously in auditing. |
| <i>Major Result</i> | It was not a perfect audit procedure, and the appointed CPA didn't use the procedure of confirmation; Robbins noted serious internal control problems in Corporate Governance, but he did not appraise or announce the status of this company's internal control. That could be the important reason to invalid audits and make management practice frauds and get away with it. This scandal became the main reason for promoting independent audit norms in the US |
| 1952, 1972 and 1978 | |
| <i>Subject</i> | 1952 issuing |
| 1972 and 1978 | Revising and unifying Commercial Code |
| <i>Major Impact</i> | Replaced the original single trader's code, and confirmed the three major principles of the contract legislation which included the free principle of contract, the principle of honesty, and the principle against swindle. |
| <i>Major Result</i> | This code has exerted a great influence on Corporate Governance, corporate accounting and auditing criterion. It subsequently also influenced the development of conceptual frameworks on financial accounting criterion in the US |
| 1988 | |
| <i>Subject</i> | Issuing SAS no. 53 and 54, replacing SAS no. 16 and 17 (SEC 2010; SOX 2010) |
| <i>Major Impact</i> | These two announcements regarded prevention of fraud audits as one of the main auditing goals. |
| <i>Major Result</i> | Auditor regarded shareholders as the primary stakeholders. This is an inevitable outcome of progress in Corporate Governance. |
| 1997 | |
| <i>Subject</i> | Issuing the SAS no. 82. |
| <i>Major Impact</i> | Issuing SAS no. 82: the audit financial statement alerted the concern regarding fraud practicing. In fact the outside CPA did not regard preventing fraud audit as its primary goal. |
| <i>Major Result</i> | Audit contract is signed by both sides of outside CPA and the company's executor. But the outside CPA bears no responsibility for the prevalence of fraud practices that the high management carry out by abusing its authorities. |
| 2001 | |
| <i>Subject</i> | The outbreak of the Enron Scandal |
| <i>Major Impact</i> | The Enron Scandal triggered stronger public concern for Corporate Governance |
| <i>Major Result</i> | The Sarbanes-Oxley Act: The listed US companies (amounting to more than 970 in 2001) with annual sales volume of over US\$ 1,200 million. Besides, CEO of CFO made vows and guaranteed that their accounting information is true and reliable, and they also pledged to strengthen the accounting responsibility of the layers of management. This law makes stricter demands on Corporate Governance, while also requiring the company to provide internal control report, which must be proved by the independent auditor. |

| <i>Year</i> | <i>Subject, Major Impact and Major Result</i> |
|---------------------|---|
| 2002 | |
| <i>Subject</i> | WorldCom (WCOM) was the second largest long distance phone company in the US, and this scandal becomes the biggest financial fraud case in US history (CyberTelecom 2003) |
| <i>Major Impact</i> | Issuing SAS no. 99: the name is the same as the SAS no. 82: the audit financial statement raised public concern about fraud practicing. The issuance of SAS no.99 was to strengthen the responsibility of finding fraud practices of the independent CPA as the outside auditors. |
| <i>Major Result</i> | Improving the audit effectiveness in preventing fraud practice and elevated the important status of the audit function in improving Corporate Governance. |

Table 16. The Development of the Supervisory Mechanism of CG in the People's Republic of China
(Source: Author, as supported by CSRC (2010))

| <i>Year</i> | <i>Key Promotion Issues of Corporate Governance</i> |
|-------------|---|
| 1978 | China undertook reform to transform its planned economic system into market economic system. Through the reform, economic control was channelled into the market mechanism, thus allow the collective or the private enterprise economic organisations to compete with the state-owned enterprises through the price competition. |
| 1984 | China's first Limited Company was formally established. |
| 1990 | The Shanghai Stock Exchange Commission was set up. |
| 1991 | The Shenzhen Stock Exchange Commission was inaugurated. |
| 1992 | China Securities Regulatory Commission which is tasked with overseeing the securities market in the country was established. |
| 1993 | This period marked a milestone in China's reforming of its socialist economic system when it implemented reform of ownership, by separating the power of management under the new enterprise system. In December of the same year, China issued the 'company law' which would also promote the concept of modern enterprise system. It was the first time for China to set up a solid legal foundation for establishing corporate management system. Subsequently, China set up the double layers systems of the BoD and board of supervisors under the shareholders' meeting, and both boards also reported to shareholders' meeting respectively. |
| 1997 | Reforming state owned big enterprises to comply with the company system, while maintaining control over large enterprises and relaxing control over small ones and enabling large number of small enterprises to survive. |
| 1998 | The "Securities Law" was adopted and went into effect in 1999. Since the listed company's ownership was structured by large state owned stocks, which was unable to set up effective CG structure, further reform was necessary. |
| 1999 | Established the check and balance relation between ownership and management of the company, and requiring the state-owned enterprises to reorganise and set up the regulated CG system. |
| 2001 | Issued the Provisional Regulations on Reducing State Shares and Raising Social Security Funds. Required all companies' directors to at least appoint two independent directors and one independent supervisor before June of 2002, and before June of 2003, the BoD at least must consist of more than 1/3 of the independent directors. |
| 2002 | Issued the "Code of CG for Listed Companies in China". It standardised the operation of listed companies and became the first important document standardising the behaviour of listed companies in an all-round and systematically way in China. |
| 2003 | The establishment of the State-owned Asset Supervision and Management Board under the State Council. |
| 2005 | Issued the temporary provisions for state-owned enterprises transfer to management authorities, and the reform and management rule for dispersing ownership of listed companies. |
| 2006 | The "Company Law" and the "Securities Law" were revised and adopted on the same day, went into effect beginning January 1, 2006. |

Chapter 5 Research Design and Methodology

5.1 Introduction

The research steps of this thesis are illustrated by way of a flowchart in Figure 8 as follows. The research questions, theories, literature review and background introduction have been explained in detail before this chapter, and are also explained in the “introduction” chapter of this thesis. This chapter aims to design the research methods with which to find the evidence for answering the research questions, so to structure this chapter by the order of research questions in Table 17 as follows. The flow chart of research steps of this thesis is presented in Figure 8; and the research objectives, questions and methods are consolidated and presented in Table 17 as the roadmap to guide the empirical studies of the next chapter in this thesis.

This research endeavours to understand the effectiveness, operations and co-ordination of the two institutions of internal supervisory mechanism in China by employing both quantitative and qualitative methods. The data is collected from the CCER statistical database and financial statements, interview, survey and archival studies. The rationale in adopting both quantitative and qualitative methods is to focus on both scope and depth.

If based on only a few pre-determined constructs, large sample studies could serve as a generalisable set of findings, but for a limited number of people and cases, in-depth studies such as field research can produce much more detailed information (Patton 1990). This study will select both research methods, and more often than not involves a trade-off between generalisability and understandability. Considering the limited availability of resources on measurable features of ACs, as well as the scarcity of knowledge about concrete practices of ACs, the qualitative research method will therefore focus on better understanding. In depth methods such as interviews are particularly relevant when this study is sought to better understand the perspectives, impacts and phenomena in their naturally occurring settings (Patton, 1990).

The quantitative research method will be designed to focus on generalisability. The data response volume for the quantitative method is over 50 for each question in this

thesis, and according to the assumption of Joseph *et al.*, (2006), "Small samples, usually characterised as having fewer than 30 observations, are appropriate for analysis only by simple regression with a single independent variable." Hence, it can be said that the collected data has met the requirements for using a quantitative method approach. However, it is expected that both research methods will compliment one another. Meanwhile, social science researchers such as Onwuegbuzie and Leech (2005: 375) encourage all graduate students to learn to utilise both quantitative and qualitative research in order to be pragmatic researchers. They also emphasised that the inclusion of qualitative data can help explain relationships discovered through quantitative data.

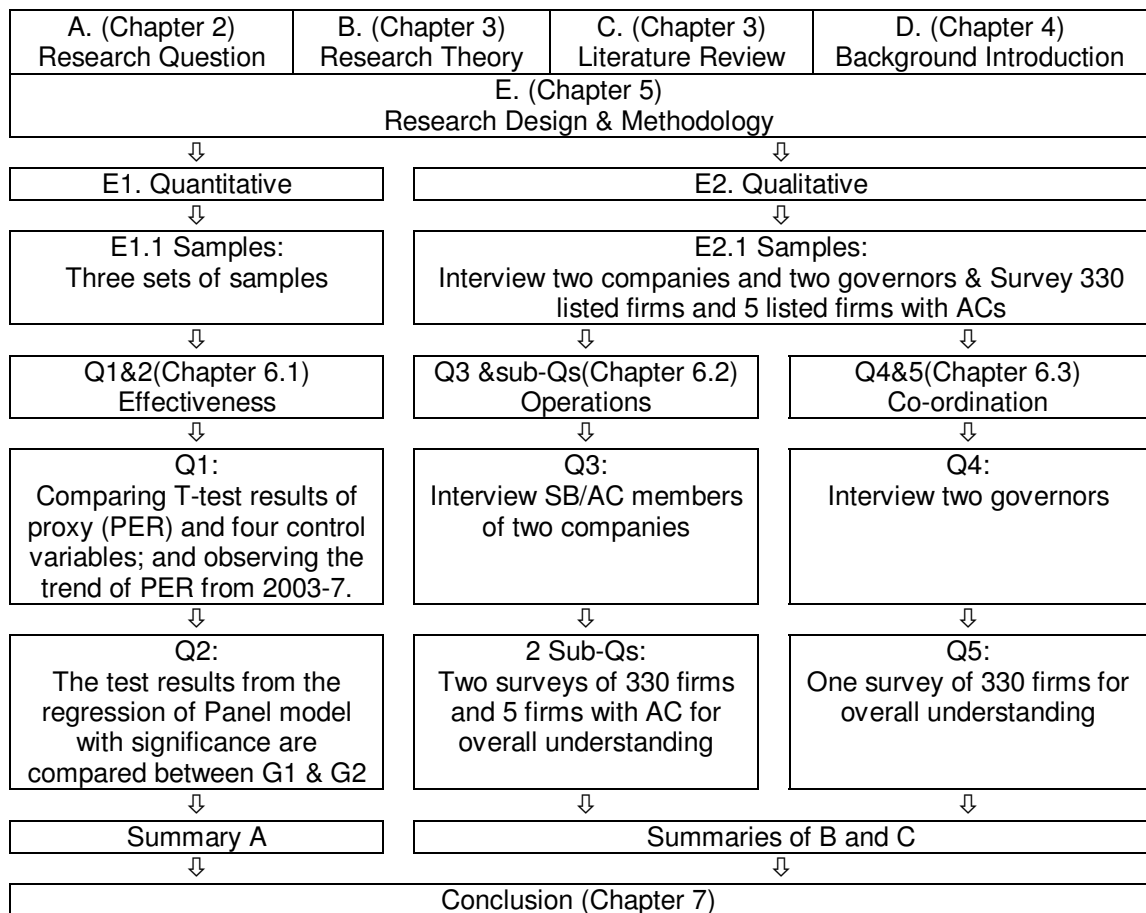


Figure 8. Flow Chart of Research Steps
(Source: Author)

Table 17. Research Objectives, Questions and Methods
(Source: Author)

| |
|---|
| <i>Objective 1: To understand the effectiveness of SBs and ACs in China</i> |
|---|

| | | |
|---|---|--|
| <i>Hypothesis</i> | H1: Firms with SBs plus ACs are more likely to effectively engage in the supervisory functions than the firms without ACs. The Effectiveness of Supervisory Functions: $G2(WithAC) \geq G1(WithoutAC)$ | H2: The AC is assumed to contribute to the effectiveness of supervisory functions by the characteristics and responsibility of the AC. It is assumed that firms after adding in ACs have better coefficients in comparing the independence, expertise, diligence (size and annual number of meeting times), decentralising the shareholding structure and decreasing the dual positions of CEO and the president of the BoD with the firms without ACs. |
| <i>Questions</i> (1&2) | 1.1 Which system with or without ACs has more effective supervisory functions in China? | 1.2 Will the AC contribute to the effectiveness of the supervisory functions in China? |
| <i>Methods</i> | 1.1 By comparing two stages/groups of the listed companies having SBs alone (without ACs) and SBs with ACs (with ACs): market response to earnings (PER), firm size, growth rate of assets, return on assets and decrease the debt ratio as the proxy variable (PER) and four control variables of the effectiveness of supervisory functions. Meanwhile, the trend of PER from 2003-2007 is observed. | 1.2 The evidence is collected from the regression test results of Panel model. The test results with significance are compared between two systems of SBs alone and SBs plus ACs in China: the better system being supplied with a better impact with significance after the comparison. |
| <i>Objective 2:</i> To understand how the operations of SBs and ACs improve the effectiveness of supervisory governance functions in China. | | |
| <i>Question 3:</i> | What are the operation processes, problems and difficulties faced in the implementation of supervisory functions by SBs and ACs in empirical practice in China? | |
| <i>Method 2:</i> | The findings for the operation processes, problems and difficulties faced in implementing the effectiveness of SBs and ACs in China are identified by interviewing the members of two supervisory institutions of two cases studies/firms. | |
| <i>Sub-Questions</i> (1&2) | 2.1 What is role of the AC played in China? | 2.2 What are the overlapping and missing items and percentages between the SBs and the ACs in terms of functions? |
| <i>Methods</i> | 2.1 The evidence is collected from the telephone survey of 330 listed companies with ACs, the finding is analysed through the statistics of the roles defined by the regulated main functions of the AC in a listed company is calculated and then compared to the stipulated functions. | 2.2 The operations items are defined through the studies of the related regulations and charters; and the overlap items and percentages between two supervisory bodies is researched through survey of five listed companies with having experience in implementing the ACs. |
| <i>Objective 3:</i> To understand the co-ordination between SBs and ACs in terms of organisation in China | | |

| | | |
|-----------------------------|--|--|
| <i>Questions</i> (4 & 5) | 3.1 How will the two systems with or without ACs exist in the future according to framework of legislation and management of government? | 3.2 What is the preferred linkage of interactions between the SBs and the ACs in terms of organisation? |
| <i>Methods</i> | 3.1 The two systems with or without ACs exist in the future according to the understanding two governors' assertions and opinions on the framework of legislation and management of government. | 3.2 The preferred co-ordination is collected from telephone survey of 330 listed companies for improving the interactions between the SB and the AC in organisations. |

5.2 Research Method Designed For Answering Questions

5.2.1 Quantitative Method

Objective 1: The Effectiveness

Goodwin and Seow asserted that "Further investigation into the effectiveness of AC is needed" (Goodwin and Seow, 2002: 220). Collier concluded that evidence of their effectiveness was very limited and certainly insufficient to support their rapid increase in popularity, describing this as a 'curious phenomenon' (Collier, 1996). So how is an AC's effectiveness in performing its functions measured? For this and other reasons, further research into CG regarding AC effectiveness is called for. This study will evaluate the effectiveness of the alternative systems of SBs alone and SBs plus ACs, via the quantitative method. This phase is designed to achieve objective one: to understand the effectiveness of SBs and ACs in China.

The variables, research models and samples designed for evaluating Research Question One and Two are summarised as follows:

Variables

The importance of ACs functions is highlighted by the assumptions of proxy theory. Therefore stakeholders generally rely on the effectiveness of the AC to be manageable to a significant extent through regulatory or self-regulatory approaches (Gendron and Bedard, 2006). The AC's performance on effectiveness is expected to meet the stakeholder's expectation, and the AC is expected to carry out its monitoring function.

Owing to the concerns of the U.S. Securities and Exchange Commission's (SEC), the

Blue Ribbon Committee (BRC) sponsored by the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD), announced ten recommendations to strengthen the functions of ACs. The regulators highlighted their requirements regarding the characteristics and activities of AC such as independence, financial expertise, meeting frequency, size and so on.

AC Characteristics and Activities (diligence)

Regulations in the US and UK required that AC be comprised of independent directors. The BRC Report (1999) also raised the importance of financial literacy. Qualification rules for AC members are aimed at strengthening corporate governance, enhancing company accountability and maintaining investor confidence (Sweeney and Vallario 2002). Meanwhile, AC should hold a minimum of three or four meetings a year and special meetings when necessary (IIA, 1991; Price Waterhouse, 1993). DeZoort *et al.* (2002) express meeting frequency as a measure of the AC's due diligence.

The U.S. SEC and stock exchanges require that listed companies maintain AC members with at least three directors at the beginning of December 1999. Yet there is no threshold in China's Code of CG, which merely mentions that "independent directors shall constitute the majority of the committees." The variables of the characteristics and activities of supervisory functions affect the investors' key concern of market response to earnings (PER). Meanwhile, special characteristics relating to Chinese political and economic environment, such as the shareholding structure and party-member employee will be considered to evaluate the effectiveness of supervisory functions in China. The research model and each variable's hypothesis responses to the dependent variable will be listed in the chapter of empirical study, especially in the section of Phase I on effectiveness.

The market provides a positive or negative reflection when a company announces its accounting's earnings information, and reflects the trust and accountability of the shareholders to the listed companies. The market response to earnings (PER) is used as the dependent variable to evaluate the market reflections for performance of effectiveness indicators. This has been explained in the chapter on the literature review.

Ordinary Least Squares and Panel Data Regression Model

This thesis will apply quantitative research by the linear regression of ordinary least squares (OLS) to examine the mean value of the proxy variables of effectiveness, and the Panel Data Regression Model to examine the independent variables representing the characteristics and activities of supervisory functions to the dependent variable of market response to earnings (PER). If the test result shows that the estimated coefficients and p value are positive and statistically significant across the sample years, this would suggest that investors positively recognise AC effectiveness in developing the monitoring function to the company. The more effective system will emerge following comparison between the two groups and two stages of the sample targets, in order to find the answers proving H1 and H2.

Sample Target

The research sample will focus on China. In October 2002, China enacted the Practical Regulations for CG for Listed and Over-the-Counter Companies. So this thesis will select the sample firms from listed Chinese firms by the same groups in two stages, and also the current listed companies with and without ACs in two groups. The first group consists of companies without ACs and the second group consists of companies with ACs. Three samples are designed:

Sample 1: These samples compares two sets of data of four consecutive years (2000-2003 and 2004-2007) of the same companies before and after the ACs were introduced in the year 2004.

Sample 2: This thesis uses the comparisons between two groups of all of the listed companies with and without setting up ACs as of 2007, the year in which the research ends. There are two systems of oversight included in the text, namely the one with SBs alone and the one with both SBs and ACs.

Sample 3: The expertise data of the supervisory institutions is not available in the CCER database. Accordingly, the expertise data is designed to retrieve from the financial statements of 100 listed companies, three years from 2005 to 2007 for each sampled company respectively. So, sample 3 is aimed to test the expertise of the SBs

by comparing two systems, in order to reveal the contribution of ACs in improving the expertise and enhancing the effectiveness of supervisory functions in China.

Question 1.1: Which system with or without ACs has more effective supervisory functions?

Hypothesis 1: Firms with SBs plus ACs are more likely to effectively engage in the supervisory functions than the firms without ACs.

The Effectiveness of Supervisory Functions: $G2(\text{With AC}) \geq G1(\text{Without AC})$

The research method is designed by comparing two stages(sample 1)/groups (sample 2) of the listed companies having SBs alone (without ACs) and SBs with ACs (with ACs): market response to earnings (PER), firm size, growth rate of assets, return on assets and decrease in debt ratio as the proxy (PER) and four control variables of effectiveness of supervisory functions. The average (mean) of each proxy variable is used to test for two samples: Sample 1 and 2, and compare two stages/groups of two samples test results by t statistics and p value to evaluate whether p-value is less than 10%, 5% and 1% (*,**,*** significant).

Sample 1 uses t test with the model of The Difference of Average (Mean Value) Test by Pairs of Populations. Sample 1's size is selected from the same companies with two different periods of years. Sample 2 uses t test by the model of The Difference of Average (Mean Value) Test by two populations. Assuming the variants are unequal for sample 2 in terms of size, it has different companies and numbers of groups by differentiating all of the companies into those with and without ACs.

Furthermore, the trend of the average (mean) Market Response to Earnings (PER) from year 2003-2007 will be reviewed, in order to understand the increasing or decreasing tendency to forecast the two groups' performances for the future as a base with which to evaluate the tendency to apply ACs in China in the future. Additionally, average growth trend of market response to earnings (PER) will be used to evaluate the performance of the supervisory functions by the two groups under consideration.

Question 1.2: Will the AC contribute to the effectiveness of supervisory functions in China?

It is intended to establish whether the listed companies, after adding in ACs, contribute to improving the independence, expertise, diligence (size and annual number of meeting times), decentralise the shareholding structure and decrease the dual positions of CEO and the president of the BoD.

Hypothesis 2: The AC is assumed to contribute to the effectiveness of supervisory functions by the characteristics and responsibility of the AC.

Firms with higher levels of independence, greater expertise among members, of a larger size and with more regular meetings, lower centralised shareholding structure and lower dual CEO positions are more likely to provide effective supervisory functions when adding in ACs.

The research data for proving H2 covers cross sections and timing sequences for the period 2005 to 2007. In order to resolve the possible problems related to correlation in analyzing timing series, the Panel data model has been chosen: which can analyse the data with cross-sections and time-series at the same time, decreasing the likelihood of problems of auto-correlation of the variables, as well as possible problems of heteroscedasticity of the samples in cross sections. Panel data is particularly good at catching more information and improving the efficiency of the estimated value.

There are two types of fix and random effect models.

(A) Fix effect model is also called least-square dummy variable model (LSDV) for the dummy variable may be put in the model. The different sample has a different intercept item, and the fix effect model can evaluate the impact of the unobserved variables to the model in order to understand the variation between the samples and decrease the common correlation coefficient of the model.

(B) Random effect model is also called error component model. This model highlights the whole relation of the data. Its intercept is generated randomly but will not be changed by timing.

Mundlak (1978) pointed out that if the correlation of the variables exists, it would have a deviation in using the random effect model; if no correlation between the

variables exists, this model should be selected. Hausman (1978) proposed the Hausman test as the standard with which to check whether the test result of random effect model could be accepted; if the overall result is rejected, the fix effect model should be chosen. Breusch and Pagan (1980) proposed LM (Lagrange multiplier) to check if its p value of random effect model is not significant, it means the fix effect model is the correct model and the random model is not selected.

This research will first base itself on Mundlak's (1978) study to check if the correlation coefficient exists over 0.8 by definition of the Pearson correlation coefficient. If so, the fix effect model will be selected. If not, this research will be based on both studies of Hausman (1978) and Breusch and Pagan (1980)'s proposed LM (Lagrange multiplier), for both studies direct to test the random effect model as the priority. If the result of p value is acceptable, random effect model will be chosen; if not, fix effect model will be selected.

Comparative Data Analysis

This thesis will process three layers of comparative data analysis for the two systems applied (with or without the AC):

The data analysis will be based on the collected evidence of the quantitative research results, to perform the data comparison between the two systems. The evidence is collected from the regression test results of Panel model. The test results with significance are compared between two systems of SBs alone and SBs plus ACs in China: the better system being supplied with a better impact with significance after the comparison. Finally, the conclusions with findings will be generated to respond to the Research Questions 1.1 and 1.2; and also summarise the demands for further research in the future.

5.2.2 Qualitative Method of Cases Studies and Interviews

Objective 2 & 3: The Operations and Co-ordination

This phase uses the qualitative method, for only very few field-based studies on AC processes have been done. Until very recently, "There is very little evidence on the processes associated with the operation of ACs and the manner in which they

influence organisation behaviour” (Turley and Zaman, 2004: 305). Gendron *et al.* (2004) suggested that this could be due to the fact that field studies of CG processes have encountered some serious difficulties, such as a demand for confidentiality and practitioners' time pressures, among others. They further suggested studying the judgemental processes of AC members to create opportunities in future researches.

The research on the supervisory function's aspects of operations and co-ordination – particularly the role played in China and the functional overlapping status of two supervisory institutions and analysis of the dynamic relationships between ACs and SBs in organisation – is necessary, but has not been clearly defined. Objectives 2 and 3 are designed to achieve the understanding of the operations of supervisory functions and the co-ordination of supervisory organisations by SBs and ACs in China.

This thesis will mainly reference the study of “Getting Inside the Black Box: A Field Study of Practices in “Effective” ACs” co-authored by Yves Gendron, Jean Bedard and Maurice Gosselin (2004), in order to interview two case studies. Scapens R. W. (1990) described the relations between a field study and a case study, suggesting that “fieldwork is usually taken to mean studies of social practices, such as accounting practices, in the field of activity in which they take place. This could be a study of a single company, or a number of companies. A case study, however, usually implies a single unit of analysis (Scapens, 1990: 264). Their research focuses on field study and in-depth interviews in the hope of enriching the knowledge of concrete practices of ACs, as field study is applied to better understand phenomena in their naturally occurring settings (Gendron *et al.*, 2004).

Interviewing may also be part of other research strategies such as case studies (Cassell and Symon 2004). Furthermore, they analysed the interview transcripts for the chosen three cases individually via grounded theory procedures (Gendron *et al.*, 2004: 157). During the process of data analysis, they formed three conceptual matrices to summarise the main themes, examining the relationships and further ensuring the validity, to prepare the outline for their paper.

Miles and Huberman (1994: 173) contended that “one aim of studying multiple cases is to increase generalisability, reassuring yourself that the events and processes in one well-described setting and are not wholly idiosyncratic. At a deeper level, the aim is

to see processes and outcomes across many cases, to understand how they are qualified by local conditions, and thus to develop more sophisticated descriptions and more powerful explanations”.

This thesis applies two case studies and interviews to gain insights into the practices in the implementation of ACs and SBs in China. Specifically, this thesis sought to find answers from interviews of the members of two companies and two governors to the following two questions:

Question 3: **What are the operation processes, problems and difficulties faced in the implementation of the supervisory functions by SBs and ACs in empirical practice in China?**

Question 4 (3.1): **How will the two systems with or without ACs exist in the future according to framework of legislation and management of government?**

To answer the Research Question 3 and 4 (3.1), the qualitative methodology is applied by referring to the work of Gendron, Bedard, Turley and Zaman, Spira and others. However, since they performed only limited research on internal processes, they have called for more research on it. Thus the qualitative methodology is used in response to calls by the relevant researchers to unravel the black box of the monitoring system by studying their process, as it cannot otherwise be achieved through the quantitative method.

Generally, the qualitative method will be applied to two cases' based examinations of companies, to discover the process from both sides of SBs, as well as ACs inside viewpoints on understanding SB/AC motive force; and evaluating the effectiveness of implementation by revealing the characteristics of supervisory functions in both sampled companies.

More research is needed to open the AC black box (Gendron *et al.* 2004), in order to understand how AC undertakes its tasks and why its impact cannot be adequately assessed (Spira 2003). Normally this thesis stresses that AC/SB members should be qualified with independent outside directorships, financial expertise and so on. The

motive force of AC/SB members has rarely received much attention. Yet the motive force is vital to the success of exertion of SB/AC authority and the development of its function. This research will also examine whether the role played by SB/AC merely has symbolic meaning or actual substance.

However, this research also aims to construct theoretical generalizations rather than statistical generalization (Ryan *et al.* 2002: 149) pertaining to AC's operations and co-ordination of the dynamic relationship with SBs. Actually, "Case studies can provide ways of thinking about problems" (Scapens, 1990: 279). Hence, this study uses case study and interview in order to examine the problems and difficulties involved in operations and co-ordination with the new regulations, and to evaluate the benefits of AC application. The study undertaken through the case studies and interviews is intended to point out findings for improving the effectiveness of supervisory functions in practice, through identifying the problems and difficulties faced in the implementation of the SBs and ACs in China.

Sample Target

Two case studies were conducted, in which interviews were held and two governors questioned about handling the framework of legislation and management of government in China. Data was then analysed and consolidated, in order to generate conclusions. For one company with SBs only, and one with ACs, the members of SBs and ACs and two governors were interviewed to understand their process of AC's relationship with the related parties and the AC's actual implementing situations; as well as future development on two systems on the framework of legislation and management of government in China.

Conversation Analysis

All interviews were video recorded and transcribed. Semi-structure interviews were used, to allow the interviewee to express their points of views for mutual understanding related to the AC's relationships (Rubin and Rubin, 1995). The interview transcripts were analysed through qualitative procedures (Miles and Huberman, 1994). Afterwards, for each corporation, a conceptual matrix was prepared, summarising the main themes discussed by the interviewees, before re-examining the interview material to gain a better understanding of the answers surrounding

implementation in motive force, process and problems and difficulties (Gendron and Bedard, 2006) and future expectations on the framework of legislation in China. To further ensure the validity of the interviews, the analysis ensured the interviewees' answers within the same corporation converged (Gendron *et al.*, 2004). The two case studies and two governors' conceptual matrices provide a database in preparing an outline on the findings of the theses.

Technique

Data analysis of interview transcripts was processed in four steps as follows:

1. To develop a coding scheme;
2. To modify the scheme when new themes emerged from the data;
3. To develop a conceptual matrix to summarise the main themes; and
4. To examine the relationships that might exist among these themes.

“The analysis has selected feelings, problems, and so on according to some explicit decision rules and has clustered discrete but similar items” (Miles and Huberman, 1994: 178). This phase study clarified similar variables along with two investigated case studies, interviewed two governors, in order to summarise the findings.

5.2.3 Qualitative Method of Survey by Telephone and Face-to-Face Interviews

Surveys are designed to answer the following questions:

Sub-Questions 1 (2.1): What is role of the AC played in China?

Sub-Question 2 (2.2): What are the overlapping and missing items and percentages between the SBs and the ACs in terms of functions?

Question 5 (3.2): What is the preferred linkage of interactions between the SBs and the ACs in terms of organisation?

The design of the surveys is described below.

Survey by telephone

The theory behind applying the survey by telephone

China started to introduce ACs by promulgating the Code of CG for listed companies in 2002. The AC was established in China only in the last five years. In 2002, only 20% of 312 listed companies had already established ACs; this number increasing to 41% (635) in 2007, though data such as financial statements or relevant database is still not available to the public. This research adopts the telephone surveys method for it facilitates collection of quality data in an efficient and timely manner. Lavrakas (1993) mentions telephone surveys as most closely approaching the level of unbiased standardization that is the goal of all good surveys.

The Plan for surveys by telephone

Survey research by telephone can be defined in this case as personal face-to-face interviews arranged in advance by telephone. "Skilful interviewing is important (Frey, 1989) for an anxiety could be produced during the conversation and hanging up is irrevocable by the respondent of the telephone." In a sense, an initial feeling of trust on the part of the interviewee can motivate the respondent to answer key confidential questions. Establishing such trust is critical, in order to obtain lower refusal rates and accurate information. Because of the limitation on complexity and length of the telephone interview, questionnaires should be designed to be no longer than 30 minutes: the aim being to avoid respondent fatigue (Lavrakas, 1993). Fully structured questions were designed for telephone interview; questionnaires were designed based on the research objectives, related regulation, literature review and experience, and with the aim that the interviewee should be familiar with the questions before the start of the fieldwork.

Sampling was via random selection from over 50% of the listed companies with ACs in China. The sample frame consists of 635 companies in 2007; from this, 330 companies were contacted. The respondent in a sampling unit was identified as the General Secretary of BoD, whose key function is to be in charge of the arrangement of the BoD, including the AC's business, and co-ordinator of ACs to the related

institutions. Telephone numbers for the sample frame were retrieved from the records on the information website of Chinese Listed Companies. A call sheet with a questionnaire for each number was prepared for use by the interviewer as the working paper for this research. The survey interview procedure was refined according to pilot testing of the first 50 selected companies, in order to ensure the validity and applicability of the survey. The working papers were collected to calculate the statistical number for each question as evidence of this research, once the sample calls were completed.

The execution of the telephone survey

First, pilot surveys with 50 companies were carried out in advance, in order to fine-tune the conversation towards efficient progress and research questions with an efficacious result. 12 of the 50 companies received the phone calls but only 3 out of these 12 companies were willing to respond to the survey questions. The major reason for rejecting the survey could be assumed to revolve around leaking confidential information. Some companies suspected the interviewer could be a potential investor seeking to obtain first hand information about their supervisory performance; while others even went as far as suspecting the interviewer to be an undercover agent from the Security Exchange Commission or other related Chinese government agencies. In light of this experience, the subsequent survey method was then adjusted: first by sending out emails featuring a biography of the interviewer, and which indicated sincere willingness to have positive mutual interactions with the responding companies, by sharing experience and exchanging knowledge about the subject matter.

Secondly, in 2007, fully structured questionnaires were sent out by email in five batches to the remaining 585 companies with ACs in China for the following two objectives: 1) to get their voluntary responses by email and 2) to introduce the interviewer in order to gain their trust and confidence, and inform them in advance that the interviewer may call them over the following days, so as to give them ample time to prepare answers to the survey should they be willing to respond.

Thirdly, the interviewer made calls to the sampled companies to whom the interviewer had sent out emails in advance in batches. An average of around 10

sampled companies was called each day, so every batch of 117 companies had been called within two or three weeks. It took four months to complete calls to all the 635 listed companies, including the pilot surveys of 50 companies. 305 out of 635 listed companies were called, but no one at the level of General Secretary of BoD could be contacted. There were various reasons for this, for example: no one answered the phone call; the wrong telephone number was used, or the General Secretary of the BoD was either not in the office or too busy to answer the call. However, these 305 listed companies may be considered as having the potential to respond to related questions as part of similar research in the future. For 330 of the listed companies, the General Secretary of BoD was contacted and over 50 responded to every survey question.

The survey questions were designed to gain sufficient understanding of the first sub-question of objective 2 (2.1) and objective 3 (3.2): the role of ACs in China and the co-ordination between ACs and SBs regarding their preferred interaction within the organisation. All survey questions are explained in detail to describe each related research purpose. The detailed descriptions are given in chapters of empirical study Phases II and III of this thesis.

Survey by face-to-face interview

The plan for survey by face-to-face interview

Gendron *et al.* (2004) found that most archival studies do not provide any meaningful information on the actual activities of ACs. To improve on such shortcomings, a survey based on face-to-face interviews was applied, focusing on identifying overlapping status by understanding the ACs' functional implementation with the SBs, in the hope of enriching knowledge about the concrete practices of ACs.

In order to clarify overlapping and gaps in the functions of the two institutions caused by their co-existence in the same system for the realization of effective supervision, the survey of five listed companies in Shanghai, China, was designed to discover the practice of the supervisory functions in each individual company. Furthermore, the functions of the SB and the AC at the practical level were compared. The purpose of conducting this survey by face-to-face interview is to complete the checklist of operation items of supervisory functions, which is defined by the study

of archival study of related regulations and charters presented in the empirical study chapter of phase II.

Prior to fieldwork, questionnaires were specified as checklists based on the research objective, literature review and experience of three themes of financial reporting, auditing and internal control related to key functions of ACs; while being flexible enough to explore new approaches during the interview. Semi-structured interviews allowed the interviewee to express their point of view for mutual understanding related to the ACs' co-ordination by function with SBs (Rubin and Rubin, 1995). Therefore, semi-structured questions were designed for in-depth interview based on the checklist for each sample company, to arrive at the general understanding of the co-ordination between ACs and SBs. Questions were prepared in order to design a checklist of supervisory functions including three aspects: (1) Financial reporting; (2) Auditing including internal audit and external audit; (3) Internal control, including compliance. The questions were made known to each category of interviewees before the fieldwork commenced. The General Secretary of the BoD was identified as the interviewee, as he is in charge and the co-ordinator of the BoD and SB, including ACs and its related parties. Each interviewee was asked about the process of typical supervisory functions, and the extent to which the company's AC fulfilled its mandate. In order to make data collection more systematic for each interviewee, it was intended to keep the interview fairly conversational and situational.

All surveys by in depth field study interviews were recorded by the checklist and partially video-recorded. The interview was processed through rigorous theoretical procedures in four steps as follows,

1. To develop a functionality checklist of supervisory functions as the main theme for each interview;
2. To mark on the functionality checklist through the interview and modify it when a new function emerges from an interview;
3. To consolidate the checklists from five surveys by in-depth interviews of five listed companies as a consolidated matrix of five checklists to summarise the main themes by matching and integrating the function items after completing the interview;

4. To arrive at statistics on overlapping, missing items and percentages among the five sampled companies.

A consolidated matrix of five checklists was prepared, in order to summarise the main themes discussed by the interviewees, then re-examine the interview material to gain a better understanding of the meanings surrounding the functions' overlapping and omissions of ACs and SBs in the internal supervisory mechanism. Each interviewee's answers were checked for consistency to ensure the validity of the interview. The data was then analysed through combining and consolidating the checklist results from all interviewees.

After analyzing the interview data, the samples from the five companies were coordinated and the statistics calculated to assess the degree of overlapping and omitted items. The experimental research was intended to point out what should be done in practice (Ryan *et al.*, 2002). This research is aimed at helping the internal supervisory mechanism work more effectively in China by providing a benchmark, gained from experience of the five sample companies. It is also aimed at providing a reference for other emerging markets and corporations, and for future researchers to enhance and improve both their research and evaluation of ACs.

The execution of the face-to-face interview

The five sampled companies were all located in Shanghai, China, and appointments were made during the first batch of telephone surveys. The interviewer asked each responding company whether they would agree to being visited, to explore further by in depth face-to-face interview the functions of the AC's empirical practices in their company. In July and August 2008, five of the companies allowed the interviewer to visit them. The interviews were subsequently conducted at the beginning of September 2008.

Each face-to-face interview lasted more than three hours and every company's interview was conducted on each functionality list, and marked on the checklist and partial conversation recorded on video. The interviewees were asked to describe their actual practices; the interviewees were encouraged to express their opinions when explaining their practices, especially on the items that were not listed on the functionality checklist, and the items on the functionality checklist that they did not

practice. During the interview, they were also encouraged to share their opinions freely on the interaction between ACs and SBs regarding the functions practised. After each interview, the interviewee received a copy of the functionality checklist to help them improve the practice of the AC in their company as a token of appreciation and reward for agreeing to be interviewed for over three hours.

Each company's functionality checklist was then consolidated into a matrix in order to check for overlapping and missing functions between ACs and SBs. The matrix is included in Table 42. The items were re-examined and re-classified to fit into the key aspects of financial reporting, auditing and internal control. Finally, the percentages and totals of the function overlaps and gaps were calculated from the total number of functions for each key aspect. These are the indicators for evaluating the overall impact across the three key aspects, to reveal the problems of function overlapping of co-ordination between ACs and SBs coexisting in China.

5.3 Summary

Based on the suggestions of shareholder's theory, stakeholder's theory and managerial hegemony theory, ACs may be expected to strengthen the effectiveness by the implementation of the monitoring functions. Composition of independence, expertise and operation are the three pillars used to evaluate the effectiveness of the internal supervisory mechanism, the key role of monitoring. From an international perspective, the adoption of the ACs in China can be brought about in a way that is different from that of the West and suited specifically to the context of China, or the ACs can merely be adopted as the standard form of CG introduced from the West.

The goal of this study is to advance the knowledge about the effectiveness, operations and co-ordination of two systems of SB alone and SBs plus ACs in China. The framework of the research methodology adopted is divided into three phases integrated with the document review, survey by telephone interview, survey by face-to-face interview and statistical data collection. The first phase is to understand the effectiveness; the second is to understand the operations and the final one is to learn about the co-ordination between ACs and SBs. Additionally, international guidelines are compared with those in China. Based on the findings of the key research

questions, each phase analyses gaps in practice and potential problems, and the findings presented in order to improve the effectiveness of the internal supervisory mechanism of CG in China.

In summary, the quantitative research method is applied to test objective 1 of the effectiveness of the sample representing the overall cases according to the principle of logic ratiocination. The quantitative method's test result is analysed by comparison of two systems to answer research questions 1 and 2 of this thesis. The main differences in companies before (without) and after (with) setting up the AC emerge following the research on this objective.

The qualitative method is applied to interview two governors, in order to establish the future development of legitimate framework; and two case studies of two systems of SB alone and SB plus AC, about their monitoring system's motive force, the operation processes, problems and difficulties faced in implementation, by exploring the characteristics and processes of factors in effectiveness, in order to identify a common explanation for overall cases in China. It is expected that the same feature or phenomenon in different cases may help to achieve the second research objective of the operations.

Meanwhile, the qualitative method is applied to survey, via the approaches of telephone and face-to-face interview, the general secretary of BoD, to explore three aspects of questions of the role of AC played in China, functional overlapping and the preferred connection between SBs and ACs in China. The comparative data analysis after the quantitative test result and the conversation analysis of qualitative interview and statistics of surveys will be summarized and concluded as the findings in this thesis.

Chapter 6 Empirical Studies

6.1 Effectiveness

6.1.1 Introduction

Some listed companies choose to establish ACs in addition to SBs; some to have SBs alone. The following two research questions therefore arise:

Q1: Which system – with or without ACs – has more effective supervisory functions in China?

It is intended to test which group of companies – with or without ACs – has more effective supervisory functions in improving market response to earnings (PER), firm size, growth rate of assets, return on assets and decrease of debt ratio as the proxy (PER) and control variables prove that companies – with or without ACs – improve their credibility to shareholders.

Q2: Will the AC contribute to the effectiveness of the supervisory functions in China?

It is intended to test whether listed companies, after adding in ACs, have improved in independence, expertise and operations, have decentralised the shareholding structure, and have decreased the number of dual positions of CEO and President of the BoD.

It is assumed that the companies with ACs have less confidence in SBs, so they add in ACs to improve the effectiveness of the supervisory functions. The following two hypotheses are therefore formulated, in order to seek evidence in this phase study.

This phase study is aimed to prove H1 and H2:

H1: Firms with SBs plus ACs are more likely to effectively engage in supervisory functions than the firms without ACs.

The Effectiveness of Supervisory Functions: $G2(WithAC) \geq G1(WithoutAC)$

H2: The AC is assumed to contribute to the effectiveness of supervisory functions

It is assumed that firms after adding in ACs have better coefficients in comparing the independence, expertise, diligence (size and annual number of meeting times), decentralise the shareholding structure and decrease the dual positions of CEO and President of the BoD than firms without ACs. $G2(WithAC) \geq G1(WithoutAC)$

This phase study is structured by starting with an introduction of the hypotheses, before designing a description the definition of variables and measures; section three defines the empirical models; section four describes the sample by demonstrating the industry, correlation coefficient analysis, and descriptive statistics for the sample; section five proves H1 and section six provides the evidence to prove H2.

6.1.2 The Definition of Variables and Measures

(A) Dependent Variable

Market responses to earnings (PER or P/E)

The detail has been explained in the literature review of this thesis. According to the definition of the CCER database, market response to earning is calculated by dividing market value per common stock price by earnings per share (EPS), and is also called the times of earnings to cost (PER or P/E). The formula of PER or P/E is

$$\text{PER or P/E} = \text{stock price per common share market value} / \text{EPS}$$

Conversely,

$$\text{Reasonable stock price} = \text{EPS} \times \text{reasonable market response to the earnings}$$

PER or P/E is an important indicator to evaluate the earnings ability of listed companies to reflect every investor's willingness to pay the price per dollar of net earnings.

Yang and Krishnan (2005) used the unexpected annual earnings scaled by stock price at the end of the year to control the incentives. Burgstahler and Eames (2002) and Abarbanell Lehavay (2003) suggest that earnings may also be managed to meet simple earnings expectations in the stock market. Jones (1991), Cahan (1992), Han and Wang (1998) and Yang and Krishnan (2005) use the natural logarithm of a firm's

market value of equity as the proxy variable for political costs, for their studies assume that managers of politically sensitive firms may manage earnings to minimise political or regulatory scrutiny against them. My study applies their concepts to define market response to earnings (PER or P/E) of the firm as the dependent variable, and assumes that the better PER of the firm will have better effective performance of supervisory functions. So it is assumed that the PER of firms and the performance of the supervisory functions lead to a positive relationship. In order to prevent periodic earnings of the industries or the corporations, the value should not only use one year's earnings. In this research, at least three years' statistics are used, to avoid deviation.

(B) Independent Variables

(1) Independent Directors' Percentage (ind%)

Braiotta (1999) found that independent directors are more objective than non-independent directors in performing supervisory functions. Deli and Gillan (2000) referred to the literature of CG intended to focus on the percentage of the external directors by the total BoD, and suggested that membership of ACs should be formed by the external directors. Klein (2002a) defined the independence of the ACs as the percentage of the independent directors of ACs compared to the total membership of ACs. By reference to their concepts, in my thesis, the independent directors' percentage is designed as one of the independent variables to evaluate the independence of implementing the supervisory functions, as the total number of independent directors of the BoD compared with the total members of the BoD; and it is assumed that a positive relationship exists, for firms with more independence will perform more effective supervisory functions. .

(2) The percentage of shareholdings by the supervisors: (ind2-sbsh%)

Yang and Krishan (2005) regarded stock ownership as a negative association on the extent of stock ownership by independent AC directors and quarterly earnings management. Bedard *et al.* (2004) regarded stock options held by the directors as having a potentially adverse effect on independence, when evaluating the effect of the supervisory institution's independence on aggressive earnings management. Lin (2005) applied the percentage of shareholdings by the supervisors as the proxy variable to measure the shareholding status of the SB. My thesis uses the percentage

of shareholdings by the supervisors as the independent variables to present the independence status of the SBs. A negative relationship is anticipated, for it is assumed that the higher percentage of the shareholding will lead to lower independence of the SBs and the BoDs, and a negative effect of supervisory functions.

With respect to shareholding, the Cadbury Committee (1992) asserted that share option schemes for outside directors could reduce their independence. Bédard et al. (2004) examined the association between share option schemes for non-related outside committee members, which could reduce their independence, and lead to the likelihood of aggressive earnings management. Yang et al. (2005) find that both independent and non-independent AC directors' stock ownerships are positively associated with earnings management. These research results are consistent with Carcello and Neal (2003) and Bédard et al. (2004), who conclude that the compensation by stock options may undermine an internal supervisory mechanism's independence.

(3) and (4) The number of the supervisors and directors receiving remunerations respectively; (Ind3-sbre; Ind4-indre)

The UK Code of Best Practice issued by the Cadbury Commission (1992) contains the following statement:

“An independent director is independent of management and free from any business or other relationship which could materially interfere with the exercise of their independent judgment, apart from their fees and shareholding. Their fees should relate to their working time.”

According to the SOX Act and to stress the independence of the AC, NYSE and NASDAQ stipulate that the AC must be formed by independent directors. They must not receive consultation or reward, and must not take part in any related transactions with the company or its subsidiaries.

The independent directors must not receive fees regarding consultation or reward, and must not have a share holding. My research checks the number of SBs and independent directors receiving remunerations as independent variables for the independence of performing supervisory functions. A negative association is

expected between the number of the supervisors and directors receiving remunerations or rewards respectively and the effect on supervisory functions.

(5-8) Expert: (Exp1-fa%; Exp2-leg%; Exp3-ia%; Exp4-party%)

According to the regulation in China, at least one expert of financial or accounting background and legal background is required. My research also checks the internal audit literacy and number of party-member employees. A positive association is anticipated: in other words, that a higher number of experts in accounting or with a financial, legal or internal audit background will lead to more effective performance of supervisory functions. On the contrary, party-member employees without any literacy related to accounting or a financial, legal or internal audit background is assumed to have a negative association on the effect of supervisory functions.

(9) The number of SB supervisors and independent directors respectively (Num1-SB)

My research checks the size of SBs as the independent variables for the operation of supervisory functions. A positive association is expected between the size of SB and the effect of supervisory functions.

(10-11) The number of meeting times (MT2-SB; MT2-BoD)

My research uses the meeting times of SBs and BoDs as independent variables for the operation of supervisory functions. A positive association is expected between the meeting times of two boards and the effect on supervisory functions.

(C) Others

(12) The shareholding structure (SH123%)

Owing to the background of special shareholding structure in China, it is aimed to examine the top 3 big stockholders' shareholding, to understand its relationship and effect on supervisory functions. A negative association is assumed between the higher shareholding by top 3 shareholders and the effect on supervisory functions.

In general, the more concentrated the ownership structure, the weaker the internal supervisory mechanism; hence there will be more opaqueness gains for the controlling shareholders (Chau and Leung, 2006). Therefore firms with larger controlling owners are more eager to choose a pliable auditor or supervisor so that they can easily prosper from benefit transferring under a lower level of monitoring. In addition, the controlling shareholders have monopolistic position and influence so they can easily control or dominate the nomination and appointment of directors and senior management officers and virtually preclude other shareholders from participation in making operating decisions, including hiring of auditors or supervisors or members of ACs. Hence a larger controlling shareholder is more likely to maintain a low-quality internal supervisory mechanism in order to realise and sustain the opaqueness gains.

(13) CEO dual positions

BRC (1999) suggested that the position of CEO should separate from the President of BoD to avoid undermining the development of supervisory functions. Abbott *et al.* (2000) proved if the CEO holds the concurrent position of President of the BoD, it would increase the fraud or negligence rate of financial reporting. Liu and Lu (2002) also proved that dual positions held by the CEO would result in less independence, so as to increase levels of earnings management. Lin (2005) used a dummy variable and assumed if the CEO holds the concurrent post of President, the company will have less willingness to establish ACs. My thesis also applies a dummy variable to measure if the President of the BoD serves as CEO concurrently. 1 represents when the CEO holds the concurrent post; 0 represents no concurrent post. A negative association is assumed between dual positions held by the CEO and the effect on supervisory functions in terms of independence may be negative if dual positions are held concurrently.

(D) Control

(14) Debt by Equity = Total Liability / Total Equity (total liability divided by total equity)

“Measuring closeness to the violation of debt covenant controls for lending contract incentives” (Yang and Krishnan, 2005). Tsai (2002) asserts that major agent problems

between stockholders and creditors are caused by debt. Dechow, Sloan and Sweeney (1996) pointed out that the higher proportion of liability, the stricter limitation on the debt contract, and the more management on retained earnings would occur, to avoid violation of the debt contract. Accordingly, the debt-monitoring hypothesis (Gul and Tsui, 1998 & 2001) asserted that higher percentage of debt would lead to more remarkable supervisory roles created by the creditors. On the contrary, if effective supervisory functions create higher confidence among the stockholders, the less debt results. In this thesis, it is assumed that the smaller percentage of total debt less total equities leads to more effective supervisory functions. An adverse relationship is expected between the debt percentage and the effect on supervisory functions in my thesis.

(15) Growth Rate by evaluating the total asset's growth rate = $TA(t) - TA(t-1) / TA(t-1)$

According to the definition of the CCER database, this indicator reflects increases in status of total assets. The formula of the total asset increase rate is equal to the increase asset in this period minus the total assets in the prior period.

Titman and Wessels (1988) used the total assets increased percentage to evaluate the growth rate; Chou (1992), Huang (1995), Bedard *et al.* (2004) and Lin (2005) also use the total asset increase rate as the proxy variable. My research applies the total asset increase rate, in order to evaluate the companies' future growth potentiality. It is assumed that a better performance of the supervisory functions will lead to higher potential growth. Therefore, it is expected that the growth potentiality and performance of supervisory functions form a positive relationship.

(16) Return on Asset (RoA)

According to the definition of the CCER database, the RoA is measured by the percentage of net income divided by average total assets. The formula is

$$\text{RoA} = (\text{net income} / \text{average total assets}) \times 100\%$$

Where

Average total assets = (beginning balance of total assets + ending balance of total assets) / 2

The analysis of RoA involves comparing net income and assets to demonstrate the effect of utilizing the assets by the companies. The higher rate of RoA is, the more effective usage of the assets will be. It also shows that companies achieve an effective result in increasing revenue and economising costs. The assets are a result of investment by the stockholders or debts to the creditors. So, the return on assets is a mixed variable related to the company's net income (returns), assets, and the effectiveness of the operation and management of the companies.

Bedard *et al.* (2004) applied RoA as a control variable to measure abnormal accruals and/or AC characteristics. It is assumed that more effective supervisory functions will result in better ability to use the assets, so that the return on assets (RoA) will be higher. A positive relationship is assumed to exist between RoA and the effect on supervisory function. My thesis applies RoA as a control variable to review the effect of supervisory functions and two supervisory institutions' characteristics in China. A positive association is expected between the RoA and the effect on supervisory functions.

(17) Firm Size

Tsai (2009) and Bedard *et al.* (2004) applied the natural logarithm of the assets as the firm size to control for the variables possibly correlated with the deviations in their measure of earnings management. Lin (2005) also used the natural logarithm of the assets as the firm size as a control variable for measuring the economic determinants for voluntary AC appointments. Becker *et al.* (1998) and Lee and Chen (2004) mentioned the firm size may present many omitted variables; and Yeh (1999) pointed out that the bigger the size of the companies, the more notable was the manager's performance. According to the aforementioned research, my work applies the natural logarithm of the assets representing the firm size as the control variable possibly correlated with the deviation in their measure of the effective performance of supervisory functions. It is assumed that listed companies have more effective supervisory functions and will have a bigger firm size. Yet their relationship is expected to be negative with market response of earnings, assumed that bigger firms will have a more stable market response to earnings.

Table 18. The Definition of Variables, Measures and Expected Sign.
(Source: Author)

| | <i>Code</i> | <i>Measured Method</i> | <i>Relationship Assumption – Expected Sign (Direction)</i> |
|---|-------------------------------------|---|--|
| <i>Dependant Variable</i> | | | |
| Market response to earnings | PER | The formula of market response to earnings = stock price of per common share /earnings per share (EPS). | + (positive) |
| <i>Independent Variables</i> | | | |
| Independent Directors' Percentage | (1) IND1% | The total number of independent directors by the size of the BoD | + (positive) |
| The percentage of shareholdings by the supervisors of the SBs. | (2) IND2-sbsh% | The shareholdings by the supervisors, divided by the total shareholding | - (negative) |
| The number of the supervisors and directors receiving remunerations or rewards respectively | (3) IND3-shre | The number of the supervisors and directors receiving remunerations or rewards respectively | - (negative) |
| | (4) IND4-dirre | | |
| Expert with Financial or Accounting background; Legal background; Internal Audit background and Party-Member Employee | (5) EXP1% (Financial or Accounting) | The of EXP1, 2, 3 and 4 by the size of SBs | EXP1 + (positive) |
| | (6) EXP2% (Legal) | | EXP2 + (positive) |
| | (7) EXP3% (Internal Audit) | | EXP3 + (positive) |
| | (8) EXP4% (Party-Member Employee) | | EXP4 – (negative) |
| The number of SB supervisors respectively | (9) NUM1-SB | The size of the SBs | + (positive) |
| The annual number of meeting times of SB and BoD respectively | (10) MT1-SB | The meeting times of SB and BoD (proxy variable of AC) respectively | + (positive) |
| | (11) MT2-BoD | | |
| <i>Other variables</i> | | | |
| The first, second, third, top 3 together stock holder's shareholdings | (12) SH123% | Shareholdings by the top 1-3 shareholders divided by the total shareholdings | - (negative) |
| CEO dual positions | (13) CEO dual | 1 – dual positions of CEO and President of the BoD concurrently 0 – no concurrent post | - (negative) |

| | Code | Measured Method | Relationship Assumption – Expected Sign (Direction) |
|--------------------------|----------------------------|---|---|
| <i>Control variables</i> | | | |
| Debt Equity | (14) DEBT % | Total Liability //(divided by) Total Equity | - (negative) |
| Growth Rate | (15) GR% | by evaluating the total asset's growth rate = TA (t) – TA (t-1) / TA (t-1) | + (positive) |
| Return on Asset | (16) RoA% | The RoA is measured by the percentage of net income by average total asset . The formula is calculated = (Net income / average total asset) * 100%, Average total asset=(beginning balance + ending balance of total asset)/2 . | + (positive) |
| Firm Size | (17) Ln _(Asset) | Ln _(Asset) : the natural logarithm of the assets as the proxy variable of firm size | - (negative) |

6.1.3 Empirical Model

Model 1 is designed for proving H1:

$$(1)PER/(2)DEBT/(3)GR/(4)RoA/(5)Ln(Asset) = Ttest(G2 - G1)mean$$

Five indicators are designed as proxy variables on effectiveness of supervisory functions including, market response to earnings (PER), debt ratio of total liability divided by total equity, total asset's growth rate, return on asset of net income divided by the average assets, and the firm size of the natural logarithm of total assets. The T test of the mean value of G2 with ACs deducted the G1 without ACs is used to diagnose the significance on the designed proxy variables of five indicators.

Model 2 and Model 3 are designed to examine the relationship between market response to earnings (PER) and governance characteristics by estimating the coefficients in the following multinomial linear regression of Panel data model:

Model 2: Independence, Activity and Control Variables

$$PER = \beta_0 + \beta_1Ind1 + \beta_2IndSBSH + \beta_3IndSBRE + \beta_4IndDIRRE + \beta_5NumSB + \beta_6MtSB + \beta_7MtBoD + \beta_8CEOdual + \beta_9Debt + \beta_{10}Gr + \beta_{11}RoA + \beta_{12}Ln(Asset) + \varepsilon$$

Model 3: Expertise, Shareholdings by the top 1-3 shareholders and Control Variables

$$PER = \beta_0 + \beta_1 Expfin + \beta_2 Expleg + \beta_3 Expia + \beta_4 Expparty + \beta_5 SH123 + \beta_6 Debt + \beta_7 Gr + \beta_8 RoA + \beta_9 Ln(Asset) + \varepsilon$$

Two models of model 2 and 3 are formed for the data is retrieved from different sources of the CCER database and financial statements respectively, so have a different sample size. The independence and activity data is retrieved from the CCER database as sample 2 to fit into Model 2 regression; the expertise data is retrieved from the financial statements as sample 3 to fit into Model 3 regression.

The independence, activity, expertise and the other with 13 variables measure supervisory characteristics and constitute my test variables; the next 4 control variables for omitted variables in market response to earnings (PER) as the proxy dependent variables on the effectiveness of supervisory functions.

6.1.4 Sample Description

(A) Introduction to the three samples

Three samples with two groups in each sample are selected to prove H1 and H2 in this research. Sample 1 and 2 are used to prove H1; and Sample 2 and 3 are applied to prove H2.

(1) Sample 1: Vertical Evaluation (The same sample size covering different years): Sample 1 is generated by those listed companies which started to establish ACs since 2004: 63 companies in total. The sample 1 is defined as a vertical evaluation in my thesis for two stages/groups are from the same sample size, identified by chronology. Stage 1/Group 1 is identified with SBs only (without ACs) before setting up ACs from 2000 to 2003; Stage 2/Group 2 is marked with SBs plus ACs after setting up ACs from 2004 to 2007.

(2) Sample 2: Horizontal Evaluation (The different sample size in same years):

Sample 2 is generated by dividing all of the listed companies with ACs or SBs alone between 2005 and 2007. Sample 2 is defined as a horizontal evaluation in this thesis for group 1 with 891 companies, identified only to have SBs without ACs; Group 2 with 624 listed companies identified as having both SBs and ACs. The sample size of Group 1 with SBs only is bigger than Group 2 with 59% and 41% respectively in 2007. Group 2, those establishing ACs, is 47%; 45% and 41%, respectively, between 2005 and 2007.

(3) Sample 3: Expertise Variables:

Sample 3 is created because no data of expertise is recorded in the CCER database. The level of expertise is randomly retrieved from financial statements from the websites of SSE with 100 listed companies' financial statements from 2005 to 2007. The overall figure for Group 2 of companies with ACs is 44% in Sample 3. This fits with the average percentage of 44% of those setting up ACs between 2005 and 2007, namely 47%, 45% and 41%, respectively. Sample 3 is presented in the table below.

Table 19. SB Members' Expertise and Party Status
(Source: Author, sample 100 listed companies, as supported by data from yearly financial statements retrieved from the websites of Shanghai Stock Exchange and Shenzhen Stock Exchange)

| | Number of expertise ^(*) | Average (2005-2007) | | 2007 | | 2006 | | 2005 | |
|--|------------------------------------|---------------------|----------------|-----------|-------------|-----------|-------------|-----------|-------------|
| | | No. | % | No. | % | No. | % | No. | % |
| Companies having SB members with financial or accounting expertise | 0 | 40 | 44.33% | 38 | 42% | 41 | 45% | 40 | 46% |
| | 1 | 34 | 38.00% | 35 | 39% | 35 | 39% | 31 | 36% |
| | 2 | 12 | 13.67% | 15 | 16% | 10 | 11% | 12 | 14% |
| | 3 | 3 | 3.00% | 3 | 3% | 4 | 4% | 2 | 2% |
| | 4 | 1 | 1.00% | 0 | 0% | 1 | 1% | 2 | 2% |
| Total | | 90 | 100.00% | 91 | 100% | 91 | 100% | 87 | 100% |
| Companies having SB members with legal expertise | 0 | 78 | 87.33% | 77 | 85% | 79 | 87% | 78 | 90% |
| | 1 | 11 | 11.67% | 14 | 15% | 11 | 12% | 7 | 8% |
| | 2 | 1 | 1.00% | 0 | 0% | 1 | 1% | 2 | 2% |
| Total | | 90 | 100.00% | 91 | 100% | 91 | 100% | 87 | 100% |
| Companies having SB members with auditing expertise ^(*) | 0 | 72 | 80.33% | 76 | 84% | 70 | 77% | 70 | 80% |
| | 1 | 14 | 16.00% | 13 | 14% | 17 | 19% | 13 | 15% |
| | 2 | 3 | 3.67% | 2 | 2% | 4 | 4% | 4 | 5% |
| Total | | 90 | 100.00% | 91 | 100% | 91 | 100% | 87 | 100% |
| Companies having SB members with party connections and without accounting, financial, legal or auditing expertise. | 0 | 55 | 62.00% | 58 | 64% | 57 | 63% | 51 | 59% |
| | 1 | 24 | 27.00% | 24 | 26% | 23 | 25% | 26 | 30% |
| | 2 | 7 | 8.00% | 5 | 6% | 8 | 9% | 8 | 9% |
| | 3 | 3 | 2.67% | 3 | 3% | 3 | 3% | 2 | 2% |
| | 4 | 0 | 0.33% | 1 | 1% | 0 | 0% | 0 | 0% |
| Total | | 90 | 100.00% | 91 | 100% | 91 | 100% | 87 | 100% |
| Companies having SB members with accounting, financial and legal expertise at the same time. | | 8 | 9.00% | 9 | 10% | 7 | 8% | 7 | 9% |

*1: The data excludes 2 banking companies, and 7 companies whose records were unclear regarding the SB members' expertise in 2005, 2006 and 2007. Therefore, the effective sample is 91 companies in 2006 and 2007. 4 companies were listed since 2006 and 2005 financial statements were unavailable, meaning 87 companies' data is presented for 2005.

*2: Expertise is defined as having audit skill and experience in the audit process. Experience of external auditing and a background of financial and accounting expertise has been counted in the item of the financial and accounting expertise.

(B) Industry types

The samples are categorised according to the CCER database; the CSRC definition described; and the sample industries in this research numbered in the table below:

Table 20. Industry Statistics of Research Samples
(Source: Author)

| CSRC Code* | S1:G1 and G2 No. of listed co. | S2:G1 No. of listed co. | S2:G2: No. of listed co. | S3:G1 No. of listed co. | S3:G2: No. of listed co. |
|------------|-----------------------------------|----------------------------|-----------------------------|----------------------------|-----------------------------|
| A | 1 | 25 | 13 | 3 | 0 |
| B | 1 | 19 | 11 | 0 | 0 |
| C | 27 | 529 | 353 | 33 | 22 |
| D | 6 | 31 | 31 | 0 | 1 |
| E | 0 | 20 | 13 | 0 | 3 |
| F | 6 | 33 | 34 | 3 | 1 |
| G | 2 | 57 | 39 | 2 | 3 |
| H | 6 | 46 | 46 | 0 | 2 |
| J | 5 | 34 | 29 | 3 | 0 |
| K | 5 | 24 | 22 | 0 | 0 |
| L | 1 | 9 | 5 | 0 | 0 |
| M | 3 | 19 | 1 | 0 | 0 |
| Z | 0 | 45 | 27 | 6 | 6 |
| Total | 63 | 891 | 624 | 50 | 40 |

* There are 13 industry categories for the listed companies:

- A: Agriculture, forestry, animal husbandry, fishery
(Sample 1: 1); (Sample 2: G1: 25; G2: 13); (Sample 3: G1: 3; G2:0);
- B: Mining industry (1; 1); (19; 11); (0; 0);
- C: Manufacturing (7; 7); (529; 353); (33; 22);
- D: Electricity, gas, and water production and provision (6; 6); (31; 31); (0; 1);
- E: Building trade (0; 0); (20; 13); (0; 3);
- F: Transportation and storage (6; 6); (33; 34); (3; 1);
- G: Information skill (2; 2); (57; 39); (2; 3);
- H: Wholesale and retail trade (6; 6); (46; 46); (0; 2);
- I: Finance and Insurance (0; 0; 0);
- J: Real estate (5; 5); (34; 29); (3; 0);
- K: Social service (5; 5); (24; 22); (0; 0);
- L: Advertising and culture industry (1; 1); (9; 5); (0; 0);
- M: Others (3; 3); (19; 1); (0; 0);
- Z: No Associated (0; 0); (45; 27); (4; 4).

The three samples cover almost every kind of industry – except finance and insurance – for their request for supervisory functions is stricter than the others, because their businesses are strongly or even fully reliant upon the trust of the public. In this research, manufacturing industry occupies over 50% of sample companies in both groups of sample 1-3, paralleling industry allocation in China.

(C) Correlation Coefficient Analysis

The correlations coefficient test among the identified variables is to demonstrate tolerance between two variables. This research is aimed to probe the correlation degree rather than a positive or negative direction, so the absolute value is considered as follows: the higher coefficient means a closer relationship between two variables, whereas a lower coefficient suggests less of a relationship between two variables. If the coefficient's absolute value is less than 0.3, it indicates a low correlation; a value between 0.4-0.7 indicates medium correlation; a value between 0.7-0.8 indicates high correlation; and a value above 0.8 indicates extremely high correlation. Where the correlation coefficient modulus (absolute value) is bigger than 0.8, it suggests a strong linear relationship and may have a harmful linear correlation (Chen, 2000; Tsai, 2004).

(1) Correlation coefficients for proving H1

In this research, the correlation coefficients from the table below have values between -0.11 and +0.29. The absolute value of each variable is less than 0.3, which means that these are of very low correlation and will not generate a co-linear problem. There is therefore no need to delete any variable from sample 1 and 2 for proving H1.

Table 21. Correlation Coefficients for Proving H1
(Source: Author)

| | | | | | |
|-------------------------|----------|----------|----------|----------|-------------------------|
| S1:G1:SB only | PER1 | DEBT1 | GR1 | RoA1 | Ln(asset)1 |
| PER1 | 1 | | | | |
| DEBT1 | 0.064644 | 1 | | | |
| GR1 | -0.105 | 0.10858 | 1 | | |
| RoA1 | -0.10548 | -0.26677 | 0.290067 | 1 | |
| Ln(asset)1 | -0.11498 | 0.05228 | 0.054513 | 0.207656 | 1 |
| S1:G2:SB+AC | PER2 | DEBT2 | GR2 | RoA2 | Ln(asset)2 |
| PER2 | 1 | | | | |
| DEBT2 | 0.038088 | 1 | | | |
| GR2 | -0.00532 | 0.02844 | 1 | | |
| RoA2 | -0.0155 | -0.0497 | -0.08162 | 1 | |
| Ln(asset)2 | 0.028454 | 0.082174 | -0.07168 | -0.0132 | 1 |
| S2:G1:SB Only | PER1 | RoA1 | GR1 | DEBT1 | Ln _(asset) 1 |
| PER1 | 1 | | | | |
| RoA1 | 0.000465 | 1 | | | |
| GR1 | -0.00709 | 0.061279 | 1 | | |
| DEBT1 | 0.020247 | -0.00339 | 0.005922 | 1 | |
| Ln _(asset) 1 | -0.05344 | -0.01181 | 0.187804 | 0.005156 | 1 |
| S2:G2:SB+AC | PER2 | DEBT2 | GR2 | RoA2 | Ln _(asset) 2 |
| PER2 | 1 | | | | |
| DEBT2 | 0.012033 | 1 | | | |
| GR2 | -0.02191 | 0.019437 | 1 | | |
| RoA2 | -0.00503 | 0.027934 | 0.193205 | 1 | |
| Ln _(asset) 2 | -0.11413 | 0.024194 | 0.247666 | 0.122812 | 1 |

(2) Sample 2: Correlation coefficients for proving H2

In this research, the correlation coefficient from the table below for both groups in Sample 2 are all less than 0.3. All in both groups have low correlations.

Table 22. Sample 2 – Correlations among Possible Correlated Variables
(Source: Author)

| S2G1 | per1 | ind1 | ind2sbsh | ind3sbre | ind4dirre | num1sbsize | mt1sb | mt2bod | ceo1 | debt1 | gr1 | roa1 | Ln(asset)1 |
|------------|---------|---------|----------|----------|-----------|------------|---------|---------|---------|---------|--------|---------|------------|
| per1 | 1.0000 | | | | | | | | | | | | |
| ind1 | 0.0175 | 1.0000 | | | | | | | | | | | |
| ind2sbsh | -0.0169 | 0.0155 | 1.0000 | | | | | | | | | | |
| ind3sbre | -0.0317 | -0.0193 | 0.0945 | 1.0000 | | | | | | | | | |
| ind4dirre | -0.0145 | -0.0860 | 0.0297 | 0.0981 | 1.0000 | | | | | | | | |
| num1sbsize | -0.0519 | -0.0878 | -0.0448 | 0.1976 | 0.1438 | 1.0000 | | | | | | | |
| mt1sb | 0.0847 | 0.0215 | -0.0220 | -0.0201 | 0.0089 | 0.0418 | 1.0000 | | | | | | |
| mt2bod | 0.0401 | 0.0063 | -0.0395 | -0.0063 | 0.0215 | -0.0264 | 0.2788 | 1.0000 | | | | | |
| ceo1 | -0.0004 | 0.0196 | -0.0040 | -0.0319 | 0.0026 | -0.0341 | -0.0344 | -0.0060 | 1.0000 | | | | |
| debt1 | 0.0203 | 0.0056 | -0.0044 | 0.0121 | 0.0057 | -0.0019 | -0.0053 | -0.0296 | -0.0332 | 1.0000 | | | |
| gr1 | -0.0069 | -0.0131 | 0.0085 | -0.0170 | -0.0025 | -0.0001 | 0.0614 | 0.0304 | -0.0211 | 0.0058 | 1.0000 | | |
| roa1 | 0.0005 | -0.1095 | 0.0124 | -0.0063 | 0.0080 | 0.0409 | 0.0315 | 0.0372 | -0.0404 | -0.0034 | 0.0614 | 1.0000 | |
| Ln(asset)1 | -0.0526 | -0.0313 | 0.0172 | 0.1582 | 0.0894 | 0.0868 | 0.0932 | 0.0556 | -0.0740 | 0.0049 | 0.1868 | -0.0116 | 1.0000 |
| S2G2 | per2 | ind1 | ind2sbsh | ind3sbre | ind4dirre | num1sbsize | mt1sb | mt2bod | ceo2 | debt2 | gr2 | roa2 | Ln(asset)2 |
| per2 | 1.0000 | | | | | | | | | | | | |
| ind1 | 0.0562 | 1.0000 | | | | | | | | | | | |
| ind2sbsh | -0.0221 | -0.0218 | 1.0000 | | | | | | | | | | |
| ind3sbre | -0.0567 | -0.0155 | 0.1395 | 1.0000 | | | | | | | | | |
| ind4dirre | -0.0676 | -0.0727 | 0.0519 | 0.0691 | 1.0000 | | | | | | | | |
| num1sbsize | -0.0472 | -0.1327 | -0.0343 | 0.1017 | 0.0592 | 1.0000 | | | | | | | |
| mt1sb | 0.0301 | 0.0209 | -0.0504 | -0.0512 | -0.0942 | 0.0297 | 1.0000 | | | | | | |
| mt2bod | 0.0202 | -0.0478 | -0.0166 | -0.0326 | -0.0214 | -0.0359 | 0.2598 | 1.0000 | | | | | |

| | | | | | | | | | | | | | |
|------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|--------|--------|--------|--------|
| ceo2 | 0.0147 | 0.0215 | 0.0353 | -0.0361 | 0.0405 | -0.0210 | -0.0539 | -0.0581 | 1.0000 | | | | |
| debt2 | 0.0120 | 0.0029 | 0.0029 | -0.0093 | -0.0252 | 0.0239 | 0.0265 | -0.0050 | -0.0689 | 1.0000 | | | |
| gr2 | -0.0219 | -0.0550 | 0.0301 | -0.0257 | -0.0352 | 0.0386 | 0.0858 | 0.1154 | -0.0303 | 0.0194 | 1.0000 | | |
| roa2 | -0.0050 | -0.0240 | 0.0248 | 0.0145 | -0.0370 | 0.0417 | 0.0836 | 0.0206 | -0.0439 | 0.0279 | 0.1932 | 1.0000 | |
| Ln(asset)2 | -0.1141 | -0.1217 | -0.0583 | 0.0826 | 0.0457 | 0.1852 | 0.0920 | 0.1308 | -0.0966 | 0.0242 | 0.2477 | 0.1228 | 1.0000 |

(3) Sample 3- Correlation coefficients for proving H2

In this research, the correlation coefficients from the table below for both groups in sample 3 are less than 0.5. Most of the coefficients fall under the 0.3 low relation threshold except the relationship between firm size ($\text{Ln}_{(\text{Asset})}$) and of party-member employee is 0.46 in Group 1; and the relationship between returns on assets (RoA) and the asset's growth rate (GR) is 0.37 in Group 2.

Overall, no value in both groups is bigger than 0.8. This will not generate a co-linear problem. There is therefore no need to delete any variable.

Table 23. Sample 3 – Correlations among Possible Correlated Variables
(Source: Author)

| S3G1 | PER1 | exp1%-fin | exp2%-leg | exp3%-ia | exp4%-party | Sh123%1 | debt%1 | gr%1 | roa%1 | $\text{Ln}_{(\text{A})1}$ |
|---------------------------|-------|-----------|-----------|----------|-------------|---------|--------|------|-------|---------------------------|
| PER1 | 1.00 | | | | | | | | | |
| exp1%-fin | 0.10 | 1.00 | | | | | | | | |
| exp2%-leg | 0.03 | 0.24 | 1.00 | | | | | | | |
| exp3%-ia | -0.11 | 0.00 | 0.16 | 1.00 | | | | | | |
| exp4%-party | -0.16 | 0.02 | -0.01 | 0.07 | 1.00 | | | | | |
| sh123%1 | -0.01 | 0.10 | 0.01 | 0.10 | 0.20 | 1.00 | | | | |
| debt%1 | -0.06 | -0.10 | -0.05 | 0.00 | -0.06 | -0.01 | 1.00 | | | |
| gr%1 | 0.00 | 0.16 | -0.05 | -0.06 | 0.04 | 0.07 | -0.02 | 1.00 | | |
| roa%1 | 0.03 | -0.06 | -0.07 | 0.00 | 0.16 | 0.07 | 0.01 | 0.17 | 1.00 | |
| $\text{Ln}_{(\text{A})1}$ | -0.17 | -0.15 | -0.13 | 0.07 | 0.46 | 0.04 | -0.11 | 0.28 | 0.27 | 1.00 |
| S3G2 | PER2 | exp1%-fin | exp2%-leg | exp3%-ia | exp4%-party | sh123%2 | debt%2 | gr%2 | roa%2 | $\text{Ln}_{(\text{A})2}$ |
| PER2 | 1.00 | | | | | | | | | |
| exp1%-fin | -0.12 | 1.00 | | | | | | | | |
| exp2%-leg | 0.15 | -0.06 | 1.00 | | | | | | | |
| exp3%-ia | 0.23 | -0.31 | 0.05 | 1.00 | | | | | | |
| exp4%-party | 0.05 | -0.30 | -0.08 | 0.20 | 1.00 | | | | | |
| sh123%2 | 0.01 | 0.04 | 0.01 | -0.09 | 0.14 | 1.00 | | | | |
| debt%2 | -0.06 | 0.00 | -0.03 | -0.04 | 0.16 | -0.08 | 1.00 | | | |
| gr%2 | -0.14 | 0.13 | -0.08 | -0.04 | -0.10 | 0.09 | 0.03 | 1.00 | | |
| roa%2 | 0.01 | 0.21 | 0.06 | 0.01 | -0.08 | 0.09 | -0.11 | 0.37 | 1.00 | |
| $\text{Ln}_{(\text{A})2}$ | -0.20 | 0.07 | 0.20 | 0.07 | 0.01 | 0.30 | -0.10 | 0.25 | 0.17 | 1.00 |

(D) Descriptive Statistics for the Sample

The samples for proving H1

It is intended to compare the outcome of the companies' dependent variables and four control variables for two groups with and without ACs to reveal that with more effective supervisory functions, and to list the Descriptive Statistics for Samples 1 and 2 in Tables 24-27: two groups of two samples with ACs or not. Sample 1 has 63 listed companies with 247 numbers of observations respectively. Group 1 is calculated from 2000 to 2003, and Group 2 from 2004 to 2007. In Sample 2, Group 1 has 891 listed companies with 2155 numbers of observations from 2005 to 2007, and Group 2 has 624 listed companies with 1873 numbers of observations from 2005 to 2007.

Samples for proving H2

In Sample 2, Group 1 and Group 2 consist of all listed companies with and without ACs, respectively. It is for the investigation the independent variables of independence, activity, and CEO dual position and control variables.

In Sample 3, Group 1 consists of 140 observations and Group 2 consists of 115 observations. This is for the investigation of the expertise and shareholding structure variables.

As has been mentioned, no data provided are related to the expertise variables from the CCER database. The expertise variables are retrieved from the financial statements in Sample 3 to understand the impact of expert percentage of SBs to market response to earnings (PER).

The shareholding structure, arrived at by measuring the top three shareholders' shareholding percentage is placed here in order to avoid harmful correlation. It is a serious co-linear problem by testing the correlation coefficient over 0.81 between the relationship of shareholding structure and debt percentage if the shareholding structure variable (SH123%) is arranged in Sample 2.

Both Sample 2 and Sample 3 are retrieved from 2005 to 2007, with three years' statistics.

The most important statistics are mean, median, standard deviation, the minimum and maximum. Mean and Median are used as the parameters to describe the central position of the statistic data in reviewing the trend of centralization. The standard deviation, minimum and maximum is used as parameters to review the trend of dispersion. This research aims to probe the effect on supervisory functions by comparing the average of the identified one proxy and four control variables of two groups of vertical and horizontal samples respectively, to prove H1. The comparison of two groups with and without ACs average (mean) presents Group 2 (with ACs) PER, growth rate (GR). These “mean” values are less than those of Group 1 of Sample 1. This finding is adverse to Hypothesis 1. Further analysis of the trend analysis observation of PER from year 2003-2007 is therefore developed and is presented in the next section.

Table 24. Sample 1 Descriptive Statistics for H1
(Source: Author)

| Sample 1 Description | | | | | |
|-----------------------------|---------|---------|-------|-------|-----------------------|
| S1:G1: SB only; G2:SB+AC | PER | DEBT | GR | RoA | Ln _(asset) |
| G1:Mean | 145.59 | 0.97 | 0.19 | 0.03 | 21.13 |
| G2:Mean | 70.27 | 1.09 | 0.13 | 0.05 | 21.46 |
| G1:Median | 52.29 | 0.73 | 0.08 | 0.04 | 21.03 |
| G2:Median | 35.19 | 1.10 | 0.06 | 0.03 | 21.36 |
| G1:Std.Dev. | 417.81 | 0.76 | 0.39 | 0.06 | 0.83 |
| G2:Std.Dev. | 124.14 | 9.51 | 0.56 | 0.69 | 1.07 |
| G1:Min. | -484.76 | 0.02 | -0.31 | -0.34 | 19.12 |
| G2:Min. | -63.4 | -132.22 | -0.99 | -1.87 | 14.16 |
| G1:Max. | 4310 | 4.06 | 3.04 | 0.21 | 23.10 |
| G2:Max. | 1280 | 61.90 | 7.53 | 10.53 | 23.92 |
| G1:No.of Samples | 247 | 247 | 247 | 247 | 247 |
| G2:No.of Sample | 247 | 247 | 247 | 247 | 247 |

Table 25. Sample 2 Descriptive Statistics for H1
(Source: Author)

| Sample 2 Description | | | | | |
|----------------------|----------|----------|-------|-------|-----------------------|
| S2:G1:SB only | PER | DEBT | GR | RoA | Ln _(asset) |
| G1:Mean | 83.79 | 1.80 | 0.162 | 0.02 | 21.25 |
| G2:Mean | 78.04 | 0.32 | 0.15 | 0.03 | 21.40 |
| G1:Median | 37.17 | 1.10 | 0.08 | 0.03 | 21.19 |
| G2:Median | 35.18 | 1.12 | 0.08 | 0.03 | 21.33 |
| G1:Std.Dev. | 222.68 | 18.32 | 0.76 | 0.27 | 1.17 |
| G2:Std.Dev. | 209.90 | 40.21 | 0.47 | 0.12 | 1.14 |
| G1:Min. | -2236.36 | -316.14 | -0.99 | -1.72 | 12.31 |
| G2:Min. | -733.25 | -1579.72 | -0.99 | -1.68 | 14.94 |
| G1:Max. | 3570 | 692.69 | 23.89 | 10.53 | 25.52 |
| G2:Max. | 5903.23 | 233.43 | 8.15 | 2.25 | 27.30 |
| G1:No.of Sample | 2155 | 2155 | 2155 | 2155 | 2155 |
| G2:No.of Sample | 1873 | 1873 | 1873 | 1873 | 1873 |

Table 26. Sample 2 Descriptive Statistics for H2
(Source: Author)

| Sample 2: From 2005-2007 (All Listed Companies) – Ind. ,Activity and CEO Variables | | | | | | | | | | | | | |
|--|--------|------|----------|----------|-----------|----------------|-------|--------|---------|--------|-------|-------|-------------------|
| S2:G1&G2 | PER1 | ind1 | ind2sbsh | ind3sbre | ind4dirre | num1 sbsize | mt1sb | mt2bod | CEOdual | debt | gr | roa | Ln _(A) |
| Mean1 | 83.77 | 0.35 | 0.00 | 0.71 | 6.27 | 4.05 | 3.81 | 8.03 | 0.10 | 1.81 | 0.16 | 0.02 | 21.25 |
| Mean2 | 78.04 | 0.35 | 0.00 | 0.68 | 6.25 | 4.22 | 4.01 | 8.24 | 0.07 | 0.32 | 0.15 | 0.03 | 21.40 |
| Median1 | 37.12 | 0.33 | 0.00 | 0.00 | 6.00 | 3.00 | 4.00 | 8.00 | 0.00 | 1.10 | 0.07 | 0.03 | 21.19 |
| Median2 | 35.19 | 0.33 | 0.00 | 0.00 | 6.00 | 4.00 | 4.00 | 8.00 | 0.00 | 1.13 | 0.08 | 0.03 | 21.33 |
| Std.Dev.1 | 222.99 | 0.07 | 0.01 | 1.12 | 3.06 | 1.43 | 1.73 | 3.42 | 0.30 | 18.35 | 0.76 | 0.28 | 1.16 |
| Std.Dev.2 | 209.90 | 0.07 | 0.00 | 0.99 | 3.11 | 1.53 | 1.75 | 3.50 | 0.26 | 40.21 | 0.47 | 0.12 | 1.14 |
| Min.1 | -2236 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 0.00 | -316 | -1.00 | -1.72 | 12.31 |
| Min.2 | -733 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 | 1.00 | 0.00 | -1580 | -0.99 | -1.68 | 14.94 |
| Max.1 | 3570 | 1.00 | 0.27 | 7.00 | 20.00 | 18.00 | 16.00 | 35.00 | 1.00 | 692.70 | 23.89 | 10.53 | 25.52 |
| Max.2 | 5903 | 0.71 | 0.07 | 6.00 | 16.00 | 14.00 | 17.00 | 36.00 | 1.00 | 233.44 | 8.14 | 2.25 | 27.30 |
| No of Obv.1 | 2148 | 2145 | 2148 | 2148 | 2148 | 2148 | 2148 | 2148 | 2148 | 2148 | 2148 | 2148 | 2148 |
| No.of Obv.2 | 1873 | 1873 | 1873 | 1873 | 1873 | 1873 | 1873 | 1873 | 1873 | 1873 | 1873 | 1873 | |

Table 27. Sample 3 Descriptive Statistics for H2
(Source: Author)

| Sample 3: With Expert & Shareholding Structure Variables | | | | | | | | | | |
|--|--------|---------|----------|--------|------------|--------|--------|-------|-------|-------|
| S3:G1&G2 | PER | exp1fin | exp2 leg | exp3ia | exp4 party | sh123% | debt% | gr% | roa% | Ln(A) |
| Mean1 | 73.03 | 0.22 | 0.04 | 0.03 | 0.16 | 0.47 | 2.94 | 0.27 | 0.02 | 21.29 |
| Mean2 | 71.23 | 0.19 | 0.03 | 0.10 | 0.11 | 0.53 | 3.46 | 0.17 | 0.02 | 21.61 |
| Median1 | 34.62 | 0.20 | 0.00 | 0.00 | 0.00 | 0.47 | 1.28 | 0.08 | 0.03 | 21.30 |
| Median2 | 40.38 | 0.20 | 0.00 | 0.00 | 0.00 | 0.57 | 1.22 | 0.08 | 0.02 | 21.45 |
| Std.Dev.1 | 135.03 | 0.22 | 0.10 | 0.10 | 0.22 | 0.17 | 13.80 | 0.97 | 0.15 | 1.53 |
| Std.Dev.2 | 115.84 | 0.21 | 0.08 | 0.16 | 0.16 | 0.19 | 21.72 | 0.35 | 0.07 | 1.21 |
| Min.1 | -90.46 | 0.00 | 0.00 | 0.00 | 0.00 | 0.11 | -2.38 | -0.87 | -0.90 | 17.12 |
| Min.2 | -21.75 | 0.00 | 0.00 | 0.00 | 0.00 | 0.12 | -8.37 | -0.34 | -0.35 | 19.33 |
| Max.1 | 805.88 | 0.75 | 0.40 | 0.50 | 1.33 | 0.85 | 161.06 | 9.09 | 0.78 | 25.35 |
| Max.2 | 818.52 | 1.00 | 0.40 | 0.67 | 0.60 | 0.86 | 233.44 | 1.77 | 0.26 | 25.96 |
| No. of Observation1 | 140 | 140 | 140 | 140 | 140 | 140 | 140 | 140 | 140 | 140 |
| No. of Observation2 | 115 | 115 | 115 | 115 | 115 | 115 | 115 | 115 | 115 | 115 |

6.1.5 Evidence for Proving H1

The objective is to find the evidence to prove in which group, with or without ACs, more effective supervisory functions are implemented, using the method described in the chapter on research method in this thesis.

The outcome is reviewed by evaluating the following five variables as one proxy variable and four control variables to evaluate the effect of the supervisory functions: Market response to earnings (PER); debt (total liability divided by total equity; DEBT); asset growth rate (GR); return on assets (RoA); and firm size (Ln(asset)) evaluated by the natural logarithm of the assets. Average (mean) value is compared and t test is developed to evaluate the significance of impact.

Furthermore, the t test is prepared to understand the significance of impact by comparing two groups' "mean" value of five variables. The t test result and mean (average) comparison between two groups of the listed companies of SBs alone and SBs plus ACs are listed in Tables 28-30.

Table 28. T Test Result and Significance
(Source: Author)

| Sample 1: 63 listed co. 2000-2007 G1: 2000-3; G2: 2004-7 | Variables | PER | DEBT | GR | RoA | Ln _(Asset) |
|--|---------------------------------------|-------------|--------|-------|---------|-----------------------|
| | G1: Mean | 145.59 | 0.97 | 0.19 | 0.03 | 21.13 |
| | G2: Mean | 70.27 | 1.09 | 0.13 | 0.05 | 21.46 |
| | Dif. (G2-G1) | -75.32 | 0.12 | -0.05 | 0.02 | 0.33 |
| | T value | -2.70 | 0.20 | -1.26 | 0.26 | 3.74 |
| | P value | 0.004 | 0.420 | 0.105 | 0.398 | 0.0003 |
| | Expectation | + | - | + | + | + |
| | H1 Test Result and Significance | Reverse *** | | | | *** |
| | Variables | PER | DEBT | GR | RoA | Ln _(Asset) |
| G1: Mean | 83.79 | 1.80 | 0.16 | 0.02 | 21.25 | |
| G2: Mean | 78.04 | 0.33 | 0.15 | 0.02 | 21.40 | |
| Dif. (G2-G1) | -5.75 | -1.47 | -0.01 | 0.00 | 0.15 | |
| t value | -0.841 | -1.466 | -0.686 | 0.328 | 4.098 | |
| p value | 0.199 | 0.071 | 0.246 | 0.371 | 0.00002 | |
| Expectation | + | - | + | + | + | |
| H1 Test Result and Significance | | * | | | *** | |

*, **, *** significant p-value is less than 10%, 5% and 1% respectively.

PER= Market response to earnings;

Debt = Total liability divided by total equity.

GR = Growth rate of assets;

RoA=Return on assets;

Ln_(Asset) = Firm size

Table 29. T Test: the Difference of Average (Mean Value) Test by Pairs of Populations
(Source: Author)

| Sample 1: 63 co. | | PER | DEBT | GR | RoA | Ln _(Asset) |
|--|----|----------|--------|--------|-------|-----------------------|
| Mean | G1 | 145.59 | 0.97 | 0.19 | 0.03 | 21.13 |
| | G2 | 70.27 | 1.09 | 0.13 | 0.05 | 21.46 |
| Variants | G1 | 174561.8 | 0.571 | 0.152 | 0.003 | 0.693 |
| | G2 | 15411.38 | 90.435 | 0.311 | 0.481 | 1.136 |
| The no. of observations | G1 | 247 | 247 | 247 | 247 | 247 |
| | G2 | 247 | 247 | 247 | 247 | 247 |
| Pearson Coefficient | | -0.024 | 0.092 | 0.016 | 0.023 | -0.016 |
| T statistics | | -2.699 | 0.201 | -1.259 | 0.259 | 3.742 |
| P(T<=t) single tail | | 0.004 | 0.420 | 0.105 | 0.398 | 0.0003 |
| Threshold limit value: single tail | | 1.651 | 1.651 | 1.651 | 1.651 | 1.651 |
| P(T<=t) double tail | | 0.007 | 0.840 | 0.209 | 0.796 | 0.0002 |
| Threshold limit value(TLV): double tail | | 1.969 | 1.969 | 1.969 | 1.969 | 1.969 |

Table 30. T Test: the Difference of Average (Mean Value) Test by Two Populations Assuming the Variants are Unequal (Source: Author)

| S2: all listed companies (2005-2007) | | PER | debt | GR | RoA | $Ln_{(Asset)}$ |
|--|----|----------|----------|----------|----------|----------------|
| Mean | G1 | 83.79 | 1.80 | 0.16 | 0.02 | 21.25 |
| | G2 | 78.04 | 0.32 | 0.15 | 0.02 | 21.40 |
| Variants | G1 | 49587.2 | 335.7434 | 0.572377 | 0.075441 | 1.360129042 |
| | G2 | 44059.96 | 1616.652 | 0.222016 | 0.015142 | 1.289533 |
| The no. of observations | G1 | 2155 | 2155 | 2155 | 2155 | 2155 |
| | G2 | 1873 | 1873 | 1873 | 1873 | 1873 |
| t statistics | | -0.841 | -1.466 | -0.686 | 0.328 | 4.098 |
| P(T<=t) single tail | | 0.199 | 0.071 | 0.246 | 0.371 | 0.000021 |
| Threshold limit value: single tail | | 1.645 | 1.645 | 1.645 | 1.645 | 1.645 |
| P(T<=t) double tail | | 0.399 | 0.142 | 0.492 | 0.742 | 0.000042 |
| Threshold limit value (TLV): double tail | | 1.960 | 1.960 | 1.960 | 1.960 | 1.960 |

Data Analysis for H1

(1) The comparison of PER

This is measured by market response to earnings (PER).

In sample 1, the difference between two groups' PER is -75.32, t value is -2.70; and p value is 0.004. This means that after the companies with ACs decrease the mean value of PER and the impact is most significant with***, which is adverse to Hypothesis 1, the positive expectation for establishing ACs.

In sample 2 (horizontal), the difference is -5.75, t value is -0.84; p value is 0.2. The impact is not significant.

The PER test result of Sample 1 is different from Sample 2. Furthermore, the trend of PER is studied from 2003 to 2007, as presented in Tables 28-30. China started to announce regulations for encouraging the establishment of ACs at the end of 2002, so it is measured from 2003 to 2007 in this thesis. In Table 31 and Figure 9 below, the evidence from comparing the trend of average market response to earnings, two groups of the listed companies are in Group 1. The trend of market response to earnings from 2003-2007, Group 1 without ACs with mean value 94, 72, 53, 69, 121; the trend of mean value difference of the current year deducted by the prior year shows up -22, -19, +16, +52 and Group 2 with mean value 77, 61, 45, 69, 120; the

trend of the mean value difference of the current year deducted by the prior year shows up -16, -16, +24, +51.

The two groups' tendencies show Group 2 has a better performance of mean value tendency: in Group 2, the companies with ACs in 2004 and 2006 have a better performance over the mean value 6 than Group 1, although the mean value of Group 1 is better than Group 2 with 1 mean value higher in year 2007, but by comparing the average of the tendency with Group 2 of 10.75 better than Group 1 of 6.75. So it is concluded that Group 2 with ACs has better tendency by comparing the average tendency of mean value and the tendency performance of mean value in 2004 and 2006.

It is concluded that in comparison of market response to earnings (PER), the result of Sample 1 is adverse *** significance to Hypothesis 1, but with no significant impact in terms of Sample 2. It may be explained that the shareholders still have better confidence in Group 1 – the listed companies without ACs (SBs alone) – than Group 2 in response to earnings (PER) currently.

Yet, Group2 with ACs is better than Group 1 by comparison of the trend of mean value of market response to earnings (PER). It may be explained that Group 2 of listed companies after adding in ACs have a better growth rate of mean value of market response to earnings (PER). It may encourage the listed companies to establish ACs in the future.

Table 31. The Trend of Market Response to Earnings (PER)
(Source: Author)

| Number of Companies | Group | YEAR | PER | Group 1(SB Alone) | Group 2 (SB+AC) |
|---------------------|----------|------|--------|--|--|
| | | | (Mean) | Tendency (Mean Dif. =Current – Prior Year) | Tendency (Mean Dif. =Current – Prior Year) |
| 779 cos. | SB Alone | 2003 | 94 | | |
| 477 cos. | SB+AC | 2003 | 77 | | |
| 747 cos. | SB Alone | 2004 | 72 | -22 | |
| 595 cos. | SB+AC | 2004 | 61 | | -16 |
| 710 cos. | SB Alone | 2005 | 53 | -19 | |
| 631 cos. | SB+AC | 2005 | 45 | | -16 |
| 784 cos. | SB Alone | 2006 | 69 | 16 | |
| 631 cos. | SB+AC | 2006 | 69 | | 24 |
| 861 cos. | SB Alone | 2007 | 121 | 52 | |

| | | | | | |
|------------------|-------|------|-----|------|-------|
| 618 cos. | SB+AC | 2007 | 120 | | 51 |
| Average Tendency | | | | 6.75 | 10.75 |

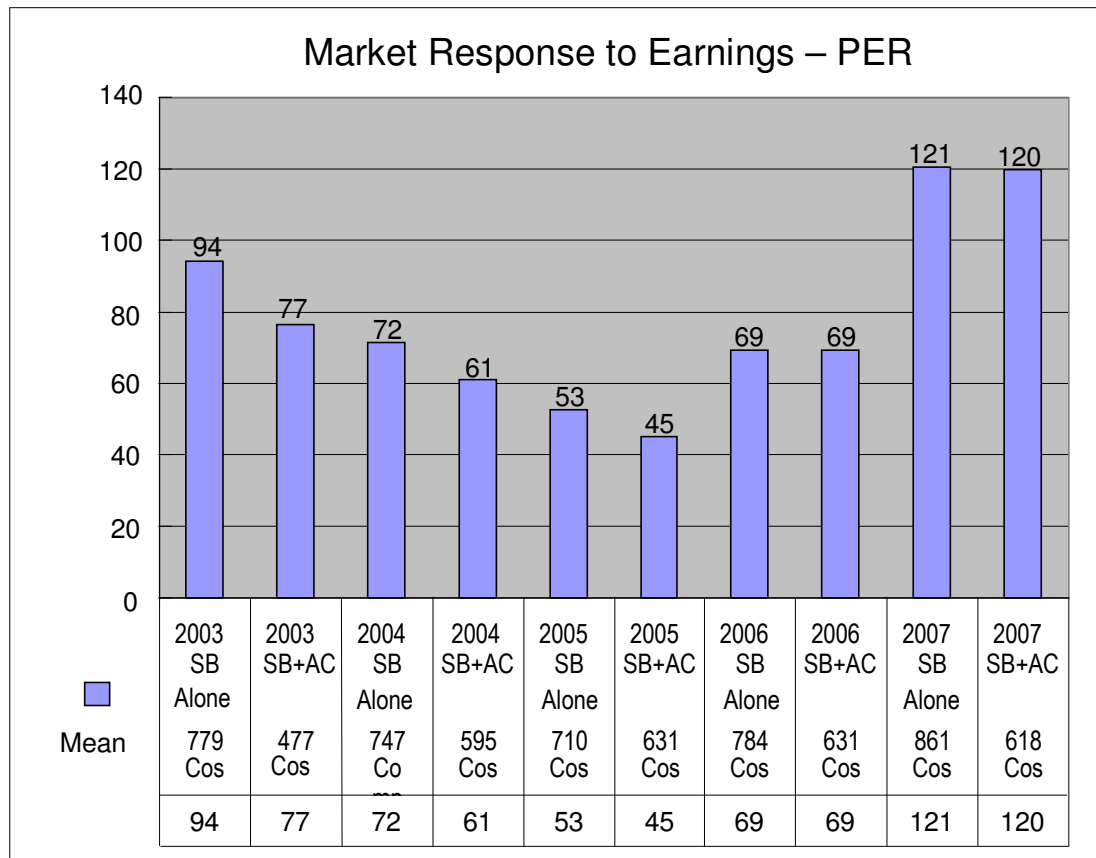


Figure 9. The Trend of Market Response to Earnings (PER) --(Source: Author)

(2) The comparison of Debt

Sample 1: the result of two groups comparison shows no significance for p value is 0.42 higher than 0.1;

Sample 2: the result of two groups comparison show * significance with t value -1.46; p value 0.071. This result is positive, proving that shareholders’ confidence in Group 2 with ACs is higher than that of Group 1 without ACs. The shareholders are more willing to invest in companies with ACs than Group 1 without ACs. It should also be explained that Group 1 without ACs companies’ leverage capability is higher than Group 2 with ACs.

(3) The comparison of growth rate of assets (GR)

No significance for both samples.

(4) The comparison of returns on assets (RoA)

No significance for both samples.

(5) The comparison of firm size ($Ln_{(Assets)}$)

As discussed in the literature review (page 194) firm size is often used as a control variable on the basis that that larger listed companies are more likely to have ACs with more effective supervisory functions. Therefore, the firm size (measured by total assets) is taken as one control variable to supplement the test of the proxy variable of the effectiveness of supervisory functions in China.

The results in tables 28-30 show that for both samples companies with ACs (G2) have bigger firm size than those that do not have an AC ($Ln_{(Assets)}$ mean value Sample 1: $G2:21.46 > G1:21.13$; & Sample 2: $G2:21.40 > G1:21.25$), and a t test presents both samples (vertical and horizontal) with *** significance. The results thus present statistically significant evidence that that listed companies with ACs will have a bigger firm size than those without. To the extent that it can be assumed that size will be associated with greater attention to the effectiveness of supervisory functions this provides indirect support for H1 in this thesis.

Sample 1: t value 3.74; p value 0.0003 less than 0.01, it presents *** positive significance;

Sample 2: t value 4.10; p value 0.00002 less than 0.01, it presents *** positive significance.

The test results for firm size with *** significance suggest that there would be value in further research in the future to test more directly the relationship between firm size and the effectiveness of supervisory functions. Such research could examine whether the bigger sizes' companies have more effective supervisory functions and whether listed companies with ACs have more effective supervision which creates conditions for growth in firm size.

Summary

Except two variables of Return on Asset (RoA) and Growth Rate on total Assets (GR), which are of no significance, the other three variables are of at least * significance.

(1) Market response to earnings (PER) of Sample 1 shows a negative relationship with *** significance, adverse to H1 that G1 – the listed companies without ACs – have a higher market response to earnings (PER). Shareholders have more confidence in responding their earnings than the companies without ACs. Yet there is no significance found in Sample 2. The difference between Samples 1 and 2 is that Sample 1 with the same sample size but in different years – from 2000 to 2003 – formed as G1 and from 2004 to 2007 as G2; Sample 2 has a different sample size in two groups with and without ACs but in the same years. This finding from Sample 1 may need to consider the time change issue including the economic and political environment from 2003 to 2007, in order to clarify the gap of these research results between Sample 1 and 2. The trend of market response to earnings (PER) is therefore observed from 2003 to 2007 for Sample 2 size of all of listed companies of two groups, with and without ACs in China. It shows that the tendency of G2 with ACs has average 10.75 growth trend; more than G1 without ACs with an average 6.75 growth rate of market response to earnings (PER). G2 with ACs has an average 4 mean value of market response to earnings (PER); higher than G1 without ACs, which may attract more companies to add in ACs in addition to SBs. It may be concluded that ACs in China may need more time to prove their effectiveness and need more listed companies to have confidence to add in ACs in their internal supervisory mechanism.

(2) The debt ratio with * significance in Sample 2 but no significance in Sample 1. The findings from Sample 2 suggest that companies with ACs have a lower debt ratio than G1 without ACs. It may be explained the shareholders have more confidence and invest more in companies with ACs than G1, so G2 with ACs requires less debt than G1 without ACs.

(3) The firm size ($\ln_{(Assets)}$) with *** significance of both Samples 1 and 2 indicate a positive relationship to H1. Listed companies with ACs have a bigger firm size from the evidence of both samples 1 and 2: t test result of mean value. It may be an indirect

indicator to explain that listed companies with ACs may, as a result of more effective supervision, create conditions which help companies to grow and to enlarge the amount of total assets of the companies. It may also be an indirect indicator to explain that the companies after adding in the ACs will increase the investors' trust and confidence to improve the effectiveness of the internal supervisory mechanism of CG.

Both vertical (Sample 1) and horizontal (Sample 2) samples, except two variables which show no significance, prove H1 positively, and the average growth trend of market response to earnings (PER) also proves H1, though the findings from Sample 1 t test result of mean value of market response to earnings (PER) is adverse to H1.

Hypothesis 1 is the effectiveness of supervisory functions:

$$G2(\text{WithAC}) \geq G1(\text{WithoutAC})$$

In this thesis, the evidence provides the following conclusion:

Though the supervisory functions of G1 of listed companies without ACs are more effective than G2 with ACs by evaluating the market response to earnings (PER) in Sample 1 but with no significance in Sample 2, so the factor of time is considered in order to understand the gap between the findings. The test result finds that the average growth trend of market response to earnings (PER) also proves H1. The other two variables: significance of firm size, and debt ratio, also prove H1. In summary, according to evaluations of the average growth trend of market response to earnings (PER), firm size and debt ratio, G2 firms with both SBs and ACs are more likely to effectively engage in supervisory functions than G1 firms without ACs.

The first question is examined using a T-test of five characteristics of the listed companies by evaluating the PER, Debt ratio, Growth Rate, RoA and firm size for two groups in two samples. There is no relationship between the independent variables and the dependent (proxy) variable present in answering the first question. It should be noted, however, that T-tests as a statistical test are subject to certain limitations, related to the assumptions about the shape of the underlying distribution, the assumed independence of the samples and the fact that the absence of a significant difference does not allow a conclusion that the samples are the same. In order to enhance and strengthen the understanding of question 1, question 2 is therefore designed: will the AC contribute to the effectiveness of supervisory functions in

China? The first and second questions are therefore complementary to each other for investigating the first research objective from two different angles: to understand the effectiveness of SBs and ACs in China. The limitations of simple comparisons mean that T tests on these five variables may not reflect the relationship between the proxy variable of PER and the independent variables. Question 2 is presented in the following section 6.1.6 to examine the relationship between the proxy variable of PER and the relevant independent variables for evidence that allows a conclusion to be drawn in respect of H2. So the results of tests of Questions 1 and 2 complement each other as a basis for investigating Objective one.

6.1.6 Evidence for Proving H2

A. Applied Effect Model

The detailed reasoning of choosing suitable effect models for the related studies has been described in the chapter of research method. The model thus chosen for this research is as follows:

Sample 2: The over all test results' p values of both groups are 0.000 and 0.002. These indicate that it is acceptable to apply random effects ML regression on both groups.

Sample 3: The over all test result' p value of Group 1 is 0.000, which is acceptable to apply random effects ML regression on it. On the other hand, the over all test result's p value of Group 2 is 0.2438, so it might not be applicable in theory to use the random effect model. Instead, the fixed effects ML regression is used on Group 2.

Thus, the results of testing Groups 1 data with random effects ML regression and testing Group 2 data with fixed effects ML regression (Model 1) is as follows:

Table 32. Data of Effect Model 1 of Sample 3
(Source: Author)

| G1: Number of Observations: 140; Number of Groups: 50 | | | | | | | |
|---|----------|-------------------------------|--------|---------|-------------------------------|--------|----------|
| G2: Number of Observations: 115; Number of Groups: 40 | | | | | | | |
| Sample 3: with expertise variables | | Group 1: SB only (Without AC) | | | Group 2: SB plus AC (With AC) | | |
| Variables | Exp Sign | P Value | Coef.1 | G1:Sig. | P Value | Coef.2 | G2: Sig. |
| (5)exp1fin% | + | 0.402 | 48.16 | | 0.838 | -26.38 | |
| (6)exp2leg% | + | 0.851 | -23.54 | | 0.046 | 577.59 | ** |
| (7)exp3ia% | + | 0.454 | -93.85 | | 0.041 | 443.15 | ** |
| (8)exp4party% | - | 0.277 | -71.47 | | 0.890 | -23.19 | |
| (12)SH123% | - | 0.747 | -20.79 | | 0.966 | 7.84 | |

However, there is the concern that the comparison of the resulting significance of these two regression methods might not be meaningful, so an alternative model (Model 2) is done using the random effects ML regression on the data of both groups. The results are shown in the table below:

Table 33. Data of Effect Model 2 of Sample 3
(Source: Author)

| G1: Number of Observations:140; Number of Groups: 50 | | | | | | | |
|--|----------|-------------------------------|--------|---------|-------------------------------|--------|----------|
| G2: Number of Observations 115; Number of Groups: 40 | | | | | | | |
| Sample 3: with expertise variables | | Group 1: SB only (Without AC) | | | Group 2: SB plus AC (With AC) | | |
| Variables | Exp Sign | P Value | Coef.1 | G1:Sig. | P Value | Coef.2 | G2: Sig. |
| (5)exp1fin% | + | 0.428 | 48.16 | | 0.871 | -8.63 | |
| (6)exp2leg% | + | 0.851 | -23.54 | | 0.045 | 268.70 | ** |
| (7)exp3ia% | + | 0.454 | -93.85 | | 0.008 | 178.38 | *** |
| (8)exp4party% | - | 0.277 | -71.47 | | 0.980 | 1.70 | |
| (12)SH123% | - | 0.747 | -20.79 | | 0.235 | 67.57 | |

The test purpose of Sample 3 is to understand the impact of four expertise variables (finance, legal, internal audit and party employee) and top three shareholders (SH 123%) to the PER. Both results of Effect Model 1 and Effect Model 2 indicate that items 5, 6 and 12 are better with G1 and items 6 & 7 with G2. Only the significance of Item 7 is slightly different in both models, i.e., ** in Effect Model 1 and *** in Effect Model 2.

It is therefore concluded that either model of Sample 3 is acceptable in this research, so for simplicity, in this research, random effects ML regression is used on both Sample 2 and Sample 3.

It is also noted that the control variables' test results of items 14-17 (DEBT%; RoA%; GR% and Ln(Asset)) are all based on Sample 2. This is because the sample size of Sample 2 includes all listed companies in China whereas that of Sample 3 is only 100, so the test results from the complete data with all listed companies is reasonably more reliable than those results with limited sample size.

B. Panel Data Analysis

Panel Data Analysis is applied for proving H2 in the table below:

Table 34. The Results of Two Empirical Models (Sample 2 and Sample 3) to Prove H2 (Source: Author)

| Sample 2: all listed co. | | Group 1: SB only | | | Group 2: SB plus AC | | |
|--|----------|----------------------------------|--------|-----------|----------------------------------|--------|----------|
| Variables | Exp Sign | P Value | Coef.1 | G1:Sig. | P value | Coef.2 | G2: Sig. |
| (1)ind1% | + | 0.834 | 14.18 | | 0.139 | 111.65 | |
| (2)ind2sbsh% | - | 0.531 | -395.4 | | 0.445 | -988.8 | |
| (3)ind3sbre | - | 0.620 | -2.23 | | 0.144 | -7.61 | |
| (4)Ind4dirre | - | 0.917 | -0.17 | | 0.014 | -3.93 | ** |
| (9)num1sbsize | + | 0.048 | -6.96 | Reverse** | 0.545 | -2.06 | |
| (10)mt1sb | + | 0.000 | 11.45 | *** | 0.269 | 3.21 | |
| (11)mt2bod | + | 0.467 | 1.07 | | 0.275 | 1.61 | |
| (13)CEO dual | - | 0.819 | -3.84 | | 0.747 | 6.20 | |
| (14)DEBT% | - | 0.501 | 0.18 | | 0.607 | 0.06 | |
| (15)ROA% | + | 0.890 | 2.38 | | 0.660 | 17.51 | |
| (16)GR% | + | 0.960 | 0.32 | | 0.943 | 0.77 | |
| (17)Ln _(asset) | - | 0.026 | -10.21 | ** | 0.000 | -20.31 | *** |
| G1: Number of Observations:140; Number of Groups: 50 | | | | | | | |
| G2: Number of Observations 115; Number of Groups: 40 | | | | | | | |
| Sample 3: with expertise variables | | Group 1: SB only (Without AC) | | | Group 2: SB plus AC (With AC) | | |
| Variables | Exp Sign | P Value | Coef.1 | G1:Sig. | P Value | Coef.2 | G2: Sig. |
| (5)exp1fin% | + | 0.428 | 48.16 | | 0.871 | -8.63 | |
| (6)exp2leg% | + | 0.851 | -23.54 | | 0.045 | 268.70 | ** |
| (7)exp3ia% | + | 0.454 | -93.85 | | 0.008 | 178.38 | *** |
| (8)exp4party% | - | 0.277 | -71.47 | | 0.980 | 1.70 | |
| (12)SH123% | - | 0.747 | -20.79 | | 0.235 | 67.57 | |

Summary

The purpose of the test of significance is to examine the relationship between the dependent variable (PER) as a proxy for the effectiveness of supervisory functions and the individual independent variables. After the test of Panel Data Analysis, 6 out of 17 independent variables show significant results, as summarized in Table 35. The significance of these results is as follows:

(A) Independence

Four measures of independence are included to examine if G2 companies with ACs have:

- (1) Higher percentage of independent directors out of total board size;
- (2) Lower shareholding percentage of SBs;
- (3) Lower numbers of supervisors receiving remunerations;
- (4) Lower numbers of directors receiving remunerations.

The test result shows item 4 of Group 2 with ACs is statistically significant.

Item 4: Here, a negative relationship is assumed, in that the greater number of directors receiving remuneration will lead to a lower market response to earnings. The results for Group 2 show a p value 0.014 and a negative coefficient -3.93 and positively support this assumption with **significance. This result supports the hypothesis that listed companies with AC will have higher levels of independence than companies without ACs.

(B) Expertise

Four indicators of expertise are included as items 5-8 to examine if Group 2 companies with ACs have more financial, legal and internal audit expertise but lower numbers of party-member employee supervisors without financial, legal and internal audit expertise than Group 1 companies without ACs. The test shows significant result that for item 6-7, namely legal and internal audit expertise.

Item 5: Legal expertise is measured by the percentage of supervisors to have legal expertise (exp2leg). A positive relationship is assumed, in that more supervisors with legal expertise of SBs will lead to higher market response to earnings. The result of Group 2 with p value 0.045 and coefficient 268.70 positively support this assumption with ** significance.

The result of this comparison supports the assumption that Group 2 companies with ACs have more legal expertise than Group 1 without AC. This result may be explained in that listed companies with ACs recognize that Chinese regulations require a legal background in performing supervisory functions. The companies who added ACs have increased the legal expertise of SB in implementing supervisory functions.

Item 6: Internal audit expertise (exp3ia): a positive relation is assumed, whereby more supervisors with internal audit expertise will lead to a higher market response to earnings. The result of Group 2's test with p value 0.008 and coefficient 178.38 positively support this assumption at *** significance. The results show that in Group 2, listed companies with ACs have more internal audit expertise in performing supervisory functions than Group 1 without ACs.

(C) Activities

Three variables for supervisory activities, items 9-11, are tested to compare between Group 2 with ACs and Group 1 without AC for the link between SB size and frequency of SB meetings and frequency of BoD meeting and supervisory effectiveness. The test result shows that item 9-10 with significance as follows:

Item 9: The SB size (num1sbsize): A positive relationship is assumed, whereby larger SBs will enjoy higher levels of market response to earnings. The result for Group 1 has a p value of 0.048 and a negative coefficient -6.96, which is contrary to the assumption with **significance. It may be explained that the quantity of supervisors cannot ensure the effectiveness of supervisory functions to increase market response to earnings. The quality of supervisory functions may be not decided by the quantity of SB members. It may be explained that SBs in Group 2 with ACs bear more supervisors and have more effective supervisory functions, judging by market response to earnings. The effectiveness of supervisory functions in China may be developed by the two institutions together. This finding suggests that after adding in ACs companies increase the size of SBs to enhance the effectiveness of supervisory functions, though the effectiveness of supervisory functions may not be decided specifically by the size of SBs. ACs cannot entirely replace the SBs in China at present.

Item 10: The SB meeting frequency (mt1sb): a positive relationship is assumed, whereby more regular meetings will result in a higher market response to earnings. The result of Group 1 without ACs – p value 0.000 and positive coefficient 11.45 – positively supports this assumption with *** significance. The explanation may be that listed companies without ACs have to run supervisory functions through SBs only. The operations of SBs in Group 1 without ACs are not merely rubber stamps, given more meetings than Group 2 with ACs. Yet the companies after adding ACs do not increase the activities of meetings of SBs to improve the effectiveness of the overall supervisory functions in China. It seems that ACs still cannot supercede the SBs in China at the current stage for the SBs in the G1 without ACs still work out its functions as reflected in more meeting times.

(D) Others

The independent variable items 12-13 assume that Group 2 with ACs has lower centralised shareholding structure and lower dual CEO / President of BoD positions than Group 1 without AC. The test results show no significant differences between two groups.

It is expected that after adding ACs companies will decrease their centralised shareholding structure and dual positions. However the results for both groups of both samples do not suggest this is the case. A possible explanation is that companies after adding in ACs cannot neither decrease their centralised shareholding nor decrease the practice of dual CEO and President appointments.

(E) Control Variables

For the control variables at items 14-17, it is expected that the group 2 with ACs has better performance of supervisory function, leading to lower debt, higher growth in total assets, higher rate of return on assets, and bigger firm size than group 1 without ACs. A significant difference is found for item 17, firm size.

Item 17: Firm size is evaluated through the natural logarithm of the assets ($\text{Ln}_{(\text{Asset})}$): a negative relationship is assumed, whereby larger firms will have lower fluctuation (more stable) market responses to earnings. The results of Group 1 with p value 0.026 and negative coefficient -10.21 with ** significance and Group 2 with p value 0.000

and negative coefficient -20.31 with ***significance are consistent with the expectation that there is a negative relationship between firm size and market response to earnings: larger companies will have more stable market response to earnings.

Table 35. The Summary of Hypothesis and Test Result
(Source: Author)

| <i>Hypothesis (H)</i> | Better Group | | <i>Impact Significance</i> | |
|--|---------------------|----------------------|----------------------------|--------------------------|
| (A) Independence (1-4) – Group 2 with ACs has more independence item 1-4 than group 1 without AC. | √ Ind4-indre-G2 | | G1 | G2 |
| The Test Result and Hypothesis | <i>Hypothesis</i> | Test Result (√ or X) | Positive (P) /Reverse(R) | Positive (P) /Reverse(R) |
| 1. The higher of independent directors out of BoD will have higher market response to earnings (the proxy variable of effectiveness of supervisory functions). | G2 | | | |
| 2. The higher shareholding of SBs will have lower market response to earnings. | G2 | | | |
| 3. The more supervisors receive remunerations will have lower market response to earnings. | G2 | | | |
| 4. The more directors receive remunerations will have lower market response to earnings. | G2 | G2 √ | | P** |
| (B) Expertise: Group 2 with ACs has more financial, legal and internal audit expertise but has lower of party-member employee supervisors without financial, legal and internal audit expertise than Group 1 without AC. | √ Leg-G2 √ IA-G2 | | | |
| The Test Result and Hypothesis | <i>Hypothesis</i> | Test Result (√ or X) | Positive (P) /Reverse(R) | Positive (P) /Reverse(R) |
| 5. The higher of financial expertise in SBs will have higher market value to earnings. | G2 | | | |
| 6. The higher of legal expertise in SBs will have higher market value to earnings. | G2 | G2 √ | | P** |
| 7. The higher of internal audit expertise in SBs will have higher market value to earnings. | G2 | G2 √ | | P** |
| 8. The higher of party-member employee without financial, legal or internal audit background in SBs will have lower market response to earnings. | G2 | | | |

| <i>Hypothesis (H)</i> | Better Group | | <i>Impact Significance</i> | |
|--|---------------------------------------|-------------------------|-----------------------------|-----------------------------|
| (C) Activities Group 2 with ACs (AC) has more active operations of bigger size and more meeting times of SBs and more meeting times of BoD than Group 1 without AC. | (X) num1sbsize-G1 (R) (X) mt-sb-G1 | | | |
| The Test Result and Hypothesis | <i>Hypothesis</i> | Test Result (√ or X) | Positive (P) /Reverse(R) | Positive (P) /Reverse(R) |
| 9. The bigger size of SBs will have higher market response to earnings. | G2 | G1 (R**) | R** | |
| 10. The more active meeting times of SBs will have higher market response to earnings | G2 | G1 (X) | P*** | |
| 11. The more active meeting times of BoD will have higher market response to earnings | G2 | | | |
| (D) Others: Group 2 with ACs (AC) has lower centralised shareholding structure and lower dual positions of CEO and President of BoD acted by the same person than Group 1 without AC. | | | | |
| The Test Result and Hypothesis | <i>Hypothesis</i> | Test Result (√ or X) | Positive (P) /Reverse(R) | Positive (P) /Reverse(R) |
| 12. The higher centralised shareholding structure will have lower market response to earnings | G2 | | | |
| 13. The higher dual positions of CEO and President of BoD acted by the same person will have lower market response to earnings | G2 | | | |
| (E) Control Variables The group 2 with ACs has better performance of supervisory function, so that to have lower debt rate, higher growth rate of total asset; higher rate of return on asset; and bigger firm size than group 1 without ACs. | √ Ln _(Asset) -G2 | | | |
| The Test Result and Hypothesis | <i>Hypothesis</i> | Test Result (√ or X) | Positive (P) /Reverse(R) | Positive (P) /Reverse(R) |
| 14. The higher debt will have lower market response to earnings (DEBT) | G2 | | | |
| 15. The higher return on assets will have higher market response to earnings (ROA) | G2 | | | |
| 16. The higher growth rate of total assets will have higher market response to earnings (GR) | G2 | | | |
| 17. The bigger firm size will have lower market response to earnings. (Ln _(Asset)) | G2 | G2 √ | P** | P*** |

Note: √ means support the hypothesis; (X) means conflict to the hypothesis.

6.1.7 Conclusion on Effectiveness

The answers to Question 1:

The effectiveness of supervisory functions is expected to increase the confidence among shareholders, so increasing the market response to earnings (PER), the trend (growth) of mean value of market response to earnings (PER), the growth rate of total assets, the return on assets, the firm size; and decreasing the debt ratio (total liability divided by total equity). The test result shows that Group 2 of listed companies after adding in ACs increase the shareholders' confidence in the companies by comparison to Group 1 without ACs in the growth trend of mean value of market response to earnings (PER), firm size (total asset) and debt ratio. Group 1 of listed companies without ACs has a better market response to the earnings (PER) with *** significance. Yet the trend of the market response to earnings (PER) from 2003-2007 shows that G2 with ACs is bigger than G1 without ACs. The t test results of mean values of firm size and debt ratio also prove H1. In summary, listed companies with ACs have a higher average growth trend of market response to earnings, bigger firm size, and a lower debt ratio than the Group 1 without ACs.

Meanwhile, after the test to prove H2, One control variable indirectly proves that Group 2 with ACs has a better performance of supervisory function with larger firm size than Group 1 without ACs. Specifically, the test result of the firm size of total assets present significance ** in Group 1 and *** in Group 2 with positive impact. The control variable of firm size's test result in H2 of both samples all are complimentary to answer Question 1 by proving H1: that companies after adding ACs have more effective supervisory functions by the significance response to market response to earnings (PER).

The answers to Question 2

(A) Independence

It is hypothesized that Group 2 with ACs has more independence evaluated by variables 1-4. According to the test results for the independence hypothesis as the following: One of four independent variables that the G2 of independent directors receiving remunerations (ind4dirre) shows ** significance, yet no significance shows

in Group 1 without AC. Listed companies after adding in ACs have higher levels of independence to improve the effectiveness of supervisory functions by the test results of independent directors receiving remunerations positively supports this assumption with ** significance.

(B) Expertise

It is hypothesized that Group 2 with ACs has more expertise evaluated by variables 5-8. The test results on legal and internal auditing expertise are the same as the hypothesis. Group 2 with ACs has a higher of legal and internal auditing expertise in SBs than Group 1 without ACs. Listed companies after adding in ACs do not increase their financial expertise nor decrease their of party-member employees on the SB; but increase the legal and internal auditing expertise in SBs with positive impact ** significance respectively.

(C) Activities

It is hypothesized that Group 2 with ACs has more activity evaluated by variables 9-11. The test result on the sizes of SBs and the meeting times of SBs both present G1 without ACs has more activity than G2 with ACs, which is adverse to the hypothesis. They may be explained as the following:

The test result on the sizes of SBs shows that Group 1 without ACs is inverse to the impact assumption with ** significance. It may be explained that quantity of the size of SBs may not be factors impacting on the effectiveness of supervisory functions. It is concluded that companies after adding in ACs increase the number of supervisors; though the size of SBs may not be a factor to increase the quality of supervisory functions.

The test result of meeting times of SBs shows adverse to the hypothesis with *** positive influence. Group 1 with SBs alone has more meeting times than Group 2: this is adverse to the hypothesis. This result suggests that companies without ACs have higher coefficients of market response to earnings as the proxy variable of the effectiveness of supervisory functions, than Group 2 with ACs. It is concluded that companies after adding in ACs do not increase the meeting times of SBs. It may be

explained that the companies after adding in ACs put more focus on strengthening the ACs but not SBs by increasing meeting times.

(D) Others

It is hypothesized that Group 2 with ACs has a lower centralised shareholding structure and lower numbers of dual positions of CEO and President of the BoD held by the same person than Group 1 without AC evaluated by variables 12-13. No significance shows in both of the test results. The results may be explained that companies after adding in ACs do not decentralise the shareholding structure or decrease the numbers of dual positions of CEO and President of the BoD in China.

(E) Control Variables

Four control variables of growth rate of total asset and return on assets, debt ratio and firm size are hypothesized that $G2(\text{WithAC}) \geq G1(\text{WithoutAC})$. Group 2 with ACs is assumed to have a better performance of supervisory function, so has a higher market response impact to earnings of the asset's growth rate and returns on assets; debt ratio and firm size. Specifically, the test results on firm size suggest a positive impact ** and *** significance in both Groups 1 and 2. The same result of the firm size control variable as the test result of H1 proves that the AC can contribute to effectiveness of supervisory functions, so companies after adding audit committees are more effective in engaging supervisory functions in China.

Overall, 6 of 17 independent variables' test results show that the AC contributes to the effectiveness of supervisory functions in China.

6.2 Operations

6.2.1 Introduction

Question 3 of this thesis is to understand:

What are the operation processes, problems and difficulties faced in the implementation of the supervisory functions by SBs and ACs in empirical practice in China?

This phase's study aims to reveal the answer of this question by interviewing the members of two supervisory institutions in two case studies/firms. Two further sub-questions are raised during the interviews:

1. What is the role of the AC played in China?
2. What are the overlaps and missing items and percentages between the SBs and the ACs in terms of functions?

The structure of this objective's study introduces two sampled companies and the interviewees through a background of the sampled companies, the features of SB/AC of both sampled companies, and the background of SB/AC members in the sampled corporations. Conversations by face-to-face interview are then presented for both sampled companies. The interviews are summarised following every individual interview and the two sub-questions above are answered by the findings from the surveys.

6.2.2 The Sampled Companies and the Interviewees

Two companies were invited to be the sampled companies for this research. One chemical industrial group with one SB chairman and two SB members were interviewed; and one engineering machinery company with one general secretary of BoD, one AC member, and one SB chairman were also interviewed. The AC of the sampled chemical company is under construction, and the sampled machinery company was only set up just over six months before the interview. The two sampled companies with six interviewees are listed in the table below:

Table 36. Sample Companies and Interviewees Contacted for the Interviews
(Source: Author)

| <i>Sampled Companies</i> | <i>Interviewees</i> |
|---|---|
| <ul style="list-style-type: none"> Corporation A: A Chemical Industrial Group Co., Ltd. (Without current AC) | <ul style="list-style-type: none"> One SB Chairman Two SB members |
| <ul style="list-style-type: none"> Corporation B: An Engineering Machinery Co., Ltd. (With AC) | <ul style="list-style-type: none"> One General Secretary of BoD. One AC member One SB Chairman |

(I) Background of the sampled companies

The table below contains the background of the two sampled companies. The sampled chemical company bears 24.3 billion Yuan and the sampled machinery company bears 757.205 million Yuan; both returned common shareholders' equity of over 30% in 2006. State-owned equity percentage occupies over 10% of the sampled machinery company and 0% of the sampled chemical company, though her majority shares were owned by the state before being merged in 2006. Both bear 1 and 2 shareholders respectively possess more than 10% of the company's voting shares. Both CEOs are also Presidents of the BoD. The current auditing firm has been in charge of the external audit engagement for 7 and 4 years respectively; and over 0.35% of the annual proportion of total fees (in the last three years) was charged by the external auditor.

Both sampled companies are growing, according to their return on equity over the past three years, and both are in the process of transitioning from being state owned companies to the employee and the public. The independence of both is questionable, for both CEOs are also Presidents of the BoD. Both sampled companies should face no serious problems in implementing supervisory functions, given what both spend on auditing fees.

Table 37. Background of the Sampled Corporations
(Source: Author)

| <i>Feature</i> | <i>Corporation A</i> | <i>Corporation B</i> |
|---|--|---|
| 1. Industry | Chemical | Machine Manufacturing |
| 2. Financial Characteristics | | |
| (1) Book value of total assets | 24.3 billion Yuan | 757.205 million Yuan |
| (2) Return on common shareholders' equity within the three years | 23.61%(2004); 26.87%(2005); 32.53%(2006) | 36.71%(2004); 26.87% (2005); 35.79% (2006) |
| 3. Dispersion of ownership | | |
| (1) State-owned Equity | 0 (The majority shares were owned by the state before being merged in 2006.) | 10% |
| (2) No. of shareholders possess more than 10% of the company's voting shares. | 1 | 2 |
| (3) CEO is President of BoD | Yes | Yes |
| 4. External Auditor | | |
| (1) No. of years in which the current audit firm has been in charge of the external audit engagement | 7 years | 4 years |
| (2) Annual proportion (in the last few years) of audit fees to total fees charged by the external auditor | From 2003 – 2005 0.4% (2003); 0.3(2004); 0.4% (2005) | From 2004 – 2006 0.4%(2004); 0.36%(2005); 0.65%(2006) |

(II) Features of SB/AC of both sampled companies

The following table is based on the data provided by the two samples companies and financial statements.

(A) *Composition*

(1) Independence: AC members are comprised of solely outside and unrelated directors in the sampled chemical company; yet 2 out of 3 members of the AC of Corporation B are external directors, who are not officers or employees of the corporation or any of its affiliates. Both corporations have one outside director in their SBs; yet none of the members of the SB of either company is independent, i.e. both SBs comprise zero unrelated outsiders as members.

(2) Expertise: Both companies have at least one outside director in the AC; moreover, the sampled machinery company's SB is a financial expert and has experience serving on other SB/AC as an outside director. Yet no such expertise exists within the SB of the sampled chemical company. 75% and 100% of members who sat on the SB/AC

during the last three years in both sampled companies respectively; and no data exists on the experience of AC members, for ACs have only been established within the last year.

(B) Authority – Formal oversight responsibilities

(1) Financial Reporting: both sampled companies' SBs and the sampled machinery company's AC are responsible for financial reporting. The responsibilities of Corporation A's future AC are as yet unclear.

(2) Auditing: both internal and external auditing functions are performed by the SB of the sampled chemical company but by the AC of the sampled machinery company. The SB of Corporation B performs no related auditing functions. The responsibilities of Corporation A's future AC are as yet unclear.

(3) Internal Control: the sampled machinery company's SB and AC are involved with internal control; but there is no involvement of the SB of Corporation A, and the responsibilities of its future AC are as yet unclear.

(4) Corporate Performance: the SB of the Corporation B is involved in corporate performance, but there is no such involvement by the AC of Corporation B or the SB of Corporation A. The responsibilities of the future AC of Corporation A are unclear.

(C) Resources

(1) Number of individuals serving on the SB/AC: Three members serve in both ACs and the SB of Corporation A. Four members serve in the SBs of Corporation B.

(2) Direct access to auditors: This can allow the supervisory institutions to use the resources of the internal and external auditors. Only the AC of Corporation B can direct access to auditors. The SBs of both corporations do not have direct access to the auditors. The responsibilities of the future AC of Corporation A are unclear.

(3) Access to legal advice: Direct access to legal advice can allow the supervisory institutions to use the resources of the legal advisor. Only the SB of Corporation B can direct access to legal advice. The AC of Corporation B and the SB of Corporation A do not have such direct access. The responsibilities of the future AC of Corporation A are unclear.

(D) Diligence

(1) Number of meetings per year: Over three times by the SB of Corporation B, and over two and four times by the SB and AC, respectively, of Corporation A. The meeting frequency of the AC of Corporation A is unclear.

(2) Number of private meetings per year: Apart from formal meetings each year, the SB of Corporation B also has private meetings; but no such private meeting occur in the SB of the sampled chemical company. The possible results of Corporation A's future AC are unclear; and no data were provided for the AC of Corporation B.

In terms of independence of both corporations, one conforms to the international standard of 100% independence; and the other to Chinese national regulations, with two thirds of its directors being independent. Both corporations have at least one financial expert, conforming to international guidelines.

Corporation A's AC is still under construction. It is therefore in the process of developing of its functions and regulations so its authority over formal overseeing responsibilities, resources and diligence were unclear when the interview was conducted. As the AC of Corporation B was in its second year after being established at the time the interview was conducted, it could provide more clear information than Corporation A, apart from two items: namely, the proportion of members who sat on the SB/AC during the previous three years, and the number of private meeting per year. In these two cases, no data were provided. The supervisory institutions have over three members, conforming with international guidelines; and in Corporation A's case the number of meetings of SB is fewer than four. Corporation B total with 4 times seems to be more active in the operations of its SB than Corporation A.

Table 38. Features of SB/AC of the Sampled Corporations
(Source: Author)

| A. Composition | Corporation A-Chemical | | Corporation B-Machinery | |
|--|------------------------|---------|-------------------------|---------|
| | (a1) SB | (a2) AC | (b1) SB | (b2) AC |
| 1. Independence | | | | |
| (1) Comprises solely outside directors If not, how many directors are there? (Note 1) | 1 | Yes | 1 | 2 |

| | | | | |
|---|--------------|----------------------------|--------------|------------------|
| (2) Comprises solely outside, unrelated directors (Note 2) If not, how many directors are there? | 0 | Yes | 0 | 2 |
| 2. Expertise | | | | |
| (1) At least one outside director on the SB/AC is a financial expert (Note 3) | 0 | 1 | 1 | 1 |
| (2) At least one outside director on the SB/AC has experience serving on other SB/AC as an outside director | 0 | 1 | 1 | 1 |
| Proportion of members who sat on the SB/AC during the last 3 years. | 2 out of 3 | Under establishing in 2007 | 100% | No data provided |
| B. Authority – Formal oversight responsibilities | | | | |
| (1) Financial Reporting | Yes | Not clear yet | Yes | Yes |
| (2) Auditing – Internal / External | Yes | Not clear yet | No | Yes |
| (3) Internal Control | No | Not clear yet | Yes | Yes |
| (4) Corporate Performance | No | Not clear yet | Yes | No |
| C. Resources | | | | |
| (1) Number of individuals serving on the SB/AC | 3 | 3 | 4 | 3 |
| (2) Direct access to auditors | No | Not clear yet | No | Yes |
| (3) Access to legal advice | No | Not clear yet | Yes | No |
| D. Diligence | | | | |
| (1) Number of meetings per year | Over 3 times | Not clear yet | Over 2 times | Over 4 times |
| (2) No. of private meeting per year | 0 | Not clear yet | Over 2 times | No data provided |

Notes:

- (1) An external director is a director who is not “an officer or employee of the corporation or any of its affiliates”.
- (2) An unrelated director “is a director who is independent of management and is free from any business or other relationship which could, or could reasonably be perceived to, materially interfere with the director’s ability to act with a view to the best interests of the corporation, other than interests and relationships arising from shareholding”.
- (3) A member is classified as a financial expert when she or he holds a professional certification in accounting or in financial analysis, or when she or he has experience in finance or accounting.

(III) Background of SB/AC Members in the Sampled Corporations**Corporation A:**

There are three members in SB and AC respectively. Three members of SBs are interviewed: one chairman and two members. They are all employees of the affiliate

company, in charge of the internal audit department, and the administration department of the sampled chemical company respectively. The Chairman has a lawyer's license, one supervisor is an experience auditor, and all have no financial expertise. No AC members were interviewed in the chemical company for the AC was not yet fully established on the day of the interview.

Corporation B:

There are four SB members and three AC members in the sampled machinery company. One general secretary of BoD, one chair of the SB and one AC member were interviewed. Three supervisors are all employees, and the Chairman is also in charge of the legal department. The second supervisor has the certificate of public accountant in charge of the accounting department. The third supervisor is employed as a mechanic. The fourth supervisor was not interviewed, but is independent and is CPA certified. Overall, two out of four supervisors have financial expertise.

Among the interviewed members of the AC, one is an employee and shareholder in charge of the finance department; one is an independent director in the economics profession. Another independent director is a professor without a financial background. Overall, one of the three members of the AC has financial expertise.

Table 39. Background of SB/AC Members in the Sampled Corporations
(Source: Author, as supported by the sampled corporations)

| Members | Whether Member Was Interviewed | Whether Member Holds a Professional Accounting Designation or Any License | Whether Member Is Unrelated (note 1) | Other Qualifications |
|---------------------------------|--------------------------------|---|---|----------------------|
| Corporation A – Chemical | | | | |
| SB – Member 1 (Chairperson) | Yes | No (Was a Lawyer) | Employee in the affiliate company. | |
| SB – Member 2 | Yes | No (An experienced Auditor) | Employee – in charge of Internal Audit dept. | |
| SB – Member 3 | Yes | No (Keep on serving in SB) | Employee – in charge of administration dept. | |
| AC-Member 1 | No | No data provided | No data provided | |
| AC-Member 2 | No | No data provided | No data provided | |
| AC-Member 3 | No | No data provided | No data provided | |
| Corporation B | | | | |
| SB – Member 1 (Chairperson) | Yes | No | Employee (In charge of Law Dept) | Lawyer |
| SB – Member 2 | No | Yes (CPA) | Employee (In charge of Accounting Dept) | |
| SB – Member 3 | No | No | Employee | Mechanics |
| SB – Member 4 | No | Yes (CPA) | Independent | |
| AC-Member 1 | Yes | Yes (CPA) | Employee and shareholders (in charge of finance dept) | |
| AC-Member 2 | No | No | Independent | Economist |
| AC-Member 3 | No | No | Independent (Professor) | Post-doctor |

6.2.3 Interview of the Sampled Corporation A – Chemical Industry (Without the AC)

The general secretary of the BoD is co-ordinated the individual interview meetings with members of the supervisory institutions. Mr. Qian introduced his company to the author before progressing into the individual interview, as transcribed below.

Qian, Z-y. 錢之揚 (2007). *Interview with Mr. Qian Zhi Yang (錢之揚), Secretary of the BoD of the Zhejiang Transfar Co., Ltd. (Chuanhua, 傳化公司), on 23rd July 2007. Hangzhou. [Video recording in possession of author]*

1. How is the growth of your organisation?

Wynca was established 20 years earlier than Transfar, and it floated earlier than the latter, too. It had its own culture. Since the merger in 2005, there has been a process of cultural integration. During the transition from being state owned to being privately owned, there is also the transition from the spirit of a party run enterprise to that of a private enterprise.

2. What is the role of the independent directors in your company?

The independent directors play the role of consultancies in the BoD. They have the responsibility of professional supervision. First, they have the right to suggest to the elite organisation in the enterprise on issues of the competence of the latter's operations. Secondly, they can indicate the level of operations of the elite organisation in comparison with its rivals. Since independent directors are external to the organisation, it is possible to expect them to play the role of supervising the supervisors internal to the organisation.

The conversation with Mr. Qian provides a background on this company's cultural integration from being state- owned to being privately owned, and from the spirit of a party run enterprise to that of a private enterprise. His personal viewpoints on the role of the independent directors naturally lead to curiosity regarding the implementation of supervisory functions in this sampled company A. The first interviewee, the Chair of the SB is then introduced as follows:

Zhao, 趙總 (2007). *Interview with Mr. Zhao (趙總), Chair of the SB of Wynca (Zhejiang Xinan Chemical Industrial Group Co., Ltd., 新安公司), a subsidiary of the Zhejiang Transfar Co., Ltd. (Chuanhua, 傳化集團), on 23rd July 2007. Hangzhou.*
[Video recording in possession of author]

1. What is the key to the rapid growth of Transfar?

I am the Vice General Manager of Transfar and I have been on the SB of Wynca for about a year. Transfar was established in 1986, and it has floated since 2005. The key to its growth is the instillation of the desired culture. In the last two years, Transfar has bought the previously state-owned Xin-An Corp. As the organisational culture of a state-owned enterprise is different from that of a private company such as Transfar, the organisational culture of the former has to be transformed to that of the latter so as to bring new momentum to its operations, and an open, fair and honourable managerial culture is instilled. I was previously a legal consultant to Transfar when I was appointed by the management as the Vice General Manager. As a manager with a background in law, I think the manager of an enterprise must be diligent in obeying the law, as being law-abiding is the basis of management; after all, management and control are linked.

2. What is your opinion on the supervisory system since its introduction in 1993?

It is very important to have an independent supervisory system. It is especially so for our company. Since its flotation, the expectation from our investors has grown steadily as we improve the execution of the supervisory system in our company year on year. There is first the SB and then the independent directors in the Chinese system. Since I first served on the SB of Wynca, I have been neither a stockholder nor a beneficiary of the company. I do not receive supervisory fees from Wynca on top of my salary for my post at Transfar. The other members of the SB are employees of Wynca, and they do not receive any payment in addition to their respective salary except an annual traffic expense of RMB 5000. It is stressed that the BoD and the SB should operate independently. It is the responsibility of the SB to independently supervise the BoD, so it should not be led by the latter. Though my speciality is in law (rather than finance or accounting), there are several finance and accounting professionals in the auditing department of the company, and all

public financial reports and information have all been audited by the external auditor before their submission. The external audits of both Transfar and Wynca are provided by the Tianjian Accounting Ltd. (天健事務所).

3. How does the SB operate?

The SB holds the internal supervisory meeting before the meeting of BoD. I personally review the managerial report of the BoD before their meeting. I attend about 6 to 8 meetings at Wynca every year. These include the meetings of both the BoD and the SB. The main purpose of attending the meetings of the BoD is to listen to their proposals and resolutions. I call for the meeting of the SB once a season. The minimum number of such meetings every year required by law is two, and these are usually held after the meetings of the BoD (in other companies). I also keep regular contacts with relevant departments because problems cannot all be identified by merely reviewing financial data, as demonstrated by the Enron scandal. To supervise, therefore, involves physically visiting relevant department such as the financial and auditing departments to investigate on site. The auditing department is utilised heavily. The auditing of the financial reports is solely handled by the external auditor, whereas the main responsibility of the auditing department is to alert the SB of potential problems and perform necessary investigation. This is because the supervisory function of the SB should act as the radar system in the company that can detect problem in advance to prevent its occurrence and damages to the company. It is important to allow flexibility in the power of management within the confine of the law, but the SB should, like a radar system, sound the alarm and request control whenever the boundary is crossed. In short, the SB should perform its function of prevention.

4. What are the foci of the SB's supervision over the financial reports, auditing reports and internal control?

These are truthfulness, the analysis of the rationality of data, and the proper operations of the SB. The reports of the SB are signed by the Chair of the SB before its submission.

5. What is your view on acting as a member of the SB?

It is a matter of organisational culture. The culture of our company stress "sincerity, innovation and development," so we are not afraid to identify problems. As our

MD says, “it is our wisdom to identify problems, it is our attitude to face problems, it is our virtue to acknowledge problems, and it is our responsibility to solve problems.” By the end of this month, he is to hold a meeting asking every department to identify problems. This enterprise cannot develop if problems are not identified. Even though Wynca has been around for a long time and the SB has been installed for quite a while, the purpose that the MD appoints me to serve on the SB is to identify problems to prevent these causing damages to the company.

6. Now that it is the government's policy to encourage the installation of the AC, Does your company plan to have one?

We have considered installing the AC. If you come visiting us this time next year, our AC would definitely have been installed. It is determined that the MD will be its Chair and I will be the Executive Officer.

7. Why do you want to install the AC?

First, we value the work of auditing very highly. Secondly, we must have it, (as) if it functions properly; it shows that the top management is determined to execute (proper auditing). It can hardly function if the top management does not value it.

8. Once the AC is installed, will there be organisational or functional overlap with the SB?

There will not be any organisational overlap, as the AC is under the BoD whereas the SB is a peer of the BoD. The installation of the AC will only let the auditing function be valued more and make the operations more transparent, thus making it easier to identify problems, by utilizing the supervision of the public departments. Furthermore, as our enterprise grows and expands, there has to be an auditing department in each company and it is definitely necessary to have an AC in the umbrella company. As to the issue of functional overlap, the focus of the AC is on internal audit, whereas that of the SB is on the BoD.

9. Do you think there is any space for improvement in the current supervisory mechanism?

This is the focus of the government. There are cases of falsification all over the world. False reporting should be severely punished.

Summary

Mr. Chao said, “I think the manager of an enterprise must be diligent in obeying the law”. Mr. Chao’s professional background makes him highlight the importance of compliance, for he views this as the foundation for management to have a tight connection between management and supervision. His viewpoint may explain the reasons why Chinese regulations point out the legal requirement for the member’s composition of the SB, according to the Code of CG for Listed Companies in China.

Mr. Chao stresses two points on independence: first that he did not receive any remuneration, nor did the other two supervisors acting in the SB; second, that the SB should be independent from the BoD. Though Mr. Chao is not a financial expert, he recognises the requirement of financial expertise in implementing supervisory functions by using the resources of internal and external auditors. He thinks that the main responsibility of the auditing department is to alert the SB to potential problems and perform necessary further investigation.

Mr. Chao implements the process of SB by attending the meetings of the BoD to listen to their proposals and resolutions. He also calls for the meeting of the SB once a season – over the minimum number of 1 time in every year required by law – after the meetings of the BoD. Besides attending or calling the meetings, he also keeps regular contacts with relevant departments to supervise, which involves physically visiting the relevant departments to investigate on site. He expects that the implementation of supervisory functions can detect problems in advance, in order to prevent its occurrence and damage to the company: in other words, he views it as a radar system. Mr. Chao, the Chair of the SB signs the report of the SB after ensuring the truthfulness and rationality of data according to the implementation procedure of the SB.

Mr. Chao asserts that the purpose of the SB is to establish problems; and the culture of his company is sincere in facing problems from the top management to the bottom employee. His company’s President of the BoD holds similar meetings to search for problems. He underlines that establishing the success of implementing the supervisory functions involves sincerely welcoming and facing problems from top to bottom. Meanwhile, he points out that the AC exists in order to present the high concern and

determination of top management in implementing supervisory functions. This may explain why the company is willing to install AC in addition to SB.

Mr. Chao said “there will not be any organisational overlap; as to the issue of functional overlap, the focus of the AC is on internal audit, whereas that of the SB is on the BoD.” He intends to follow the government’s encouragement to install ACs because he stresses once more the importance of strengthening the supervisory functions by installing dual supervisory systems at the same time.

Regarding overlapping problems in implementation of supervisory functions, the two supervisors express their opinions as follows:

(B & C) Bao, 包主任 & Jia, 賈主任 (2007). *Interview with Mr. Bao, 包主任 and Ms. Jia, 賈主任, two members of the SB of Wynca (Zhe Jiang Xinan Chemical Industrial Group Co., Ltd., 新安公司), a subsidiary of the Zhejiang Transfar Co., Ltd. (Chuanhua, 傳化集團), on 24th July 2007. Hangzhou. [Video recording in possession of author]*

Mr. Bao, 包主任 has been a member of the SB for fifteen years, a representative of state owned stocks previously and employee owned stocks now, and Ms. Jia, 賈主任 has been a member of the SB for five years.

1. As your company is forming the AC, there will soon be both the SB and the AC in your company. Do you think these two institutions will have similar or identical characteristics?

Bao: (The adoption of these two institutions is) adapted to the Chinese context, the functions and powers of these two institutions are different, and these will be clearly stated in the constitution of the company.

2. Do you think it is necessary to form the AC?

Jia: Judging from the specifications in the regulations, I feel there will be overlaps between the responsibilities and powers of the AC and the SB, but I personally think that the members that form these institutions will be different. The members

of the SB are internal representatives of employees, so they know about the situation of internal management better. The members of the AC are external independent directors, who have more involvement with external roles, and consequently have a better, more macroscopic view of the external environment, but they may not be as familiar with internal operations as the SB members. Thus, the existence of the AC can enhance the SB's understanding of the external economic and supervisory environment. Therefore, I think the two institutions can be complementary to each other and work together to improve the supervisory mechanism.

3. In your opinion, once the AC is formed, how should the functions of the two institutions be distributed in practice?

Due to the different types of members forming the two institutions, the SB that is formed by internal staff should be responsible for the supervision of internal matters, whereas the AC that is formed by external independent directors could engage in the collection of external development related data for the development of the supervisory function. External independent directors engage in investigation only under special circumstances. Thus one works from without, one from within, with proper communication between them; the two institutions can complement each other in the supervision of the company.

4. The AC and the SB are at different positions in the organisational structure. How should these two institutions interact with each other?

The BoD, leading the whole management team, is responsible of the practical running of the business. The AC is under the BoD, and is responsible of assisting the BoD to confirm with laws and regulations. It can supervise before a decision/resolution is made by the BoD. It can also supervise during the operations, such as overseeing if the management is operating according to the decision/resolution of the BoD, or if the reporting confirm to the requirements of the laws and regulations. The SB is of equal rank with the BoD. It remains to be seen how these two institutions should interact with each other in organisation.

5. What is the SB's role in regards to supervising the financial report, the audit report and internal control?

There are many regulations about the financial report, the audit report and internal

control of a listed company. It is essential to comply with the regulations. We have to keep up with the pace of innovation in order to progress.

6. How does your company keep up with the pace of innovation?

Our company has clear enterprise culture, transparency and continues to improve quality, engaging in creating global competitiveness. We believe that, to have sustainable management and development, we need to strive to enter the global market. It is our company's core culture to "work and share together, preparing new wine for its future maturation". Our four core business philosophies are as follows: "Wynca is the enterprise". It used to be a state-owned enterprise, based on a communion production model, but now it is a privately run enterprise, it must be market-oriented, meeting market demand. "Wynca is the school", so employees continuously learn and constantly update their knowledge. "Wynca is the family", everyone should respect and love one another like in a family. "Wynca is the stage/platform". There is internal competition on performance. There are tests for employees on the management. One cannot be a leader without performance. So Wynca is a big stage for the staff to perform. This promotes the enhancement of the quality of each employee, and this makes the company competitive. This is because the staff is the most important assets for the development of the enterprise, and staff quality consists of qualities of both the operational capacity and the ideological character. To sum up, the staff should not only do their own work well, but also to treat the company like their own family.

7. How does the SB of your company work?

Jia: According to the responsibilities specified in the Company Act and the company's constitution, we must read the data before each meeting of the BoD to ensure all data on the financial report are correct. We also audit before submission all quarterly, biannual and annual reports and all other data that need to be submitted. In case of any problem, we will first contact the relevant department before discussing it in our meetings. We meet at least three or four times. Each meeting lasts at least three hours. We check if the data reflects the actual situation of the company, make resolutions, and then submit the findings. In addition to holding SB meetings, we also attend the meetings of the BoD, during which we also make suggestions and ask questions.

8. What do you think are the strengths and weaknesses of the current SB of your company?

Bao: According to the Company Act, both the BoD and the SB are elected by the General Assembly Meeting. There are two stockholders' representatives in the SB, who are elected by the stockholders, who hold votes according to their shares. There are stakeholders' representatives in the SB, who are elected by the stakeholders. Additionally, according to our company's constitution, there must be stakeholders on the SB, and at least one third of the members of the SB should be stakeholders' representatives. I myself am a representative of both the stakeholders and the union, and I represent the stakeholders (on the SB). The purpose of the SB is to supervise the BoD. If the BoD supervises itself, there will be no independence (in supervision). There have been the Three Old Institutions and the Three New Institutions in the Chinese system. The Three New Institutions are the General Assembly Meeting, the BoD and the SB, whereas the Three Old Institutions in state-owned enterprises are Party Officers' Committee, the Union and the Stakeholders' Representatives' Committee. Now there is the problem of bridging the Three Old Institutions and the Three New Institutions. The elected representatives are responsible to the stockholders and the stakeholders; they are supposed to take their responsibilities seriously even though there is no additional financial reward for taking up these responsibilities. Hence, the strength is that the SB members are elected. Whoever does not perform well will not be elected again next time. First, this suits the Chinese context and can cater for the spirits of both the Three Old Institutions and the Three New Institutions. Secondly, as it is mandatory to have the SB, it can perform its supervisory function. Furthermore, now that the company is to form the AC, so its organisational structure can comply with the international supervisory mechanism. The weakness is that all the SB members are "part-timers". Their focus is on their paid works, so they cannot fully dedicate to their supervisory roles. After all, there are limits to one's energy. If the supervisory role is a full-time paid position, the performance of the supervisory function can be expected to be better. Moreover, whenever the subject of supervision is the member's main department, there will be conflict of interest and independence is lost. For instance, Ms. Jia is responsible of internal audit

department, so she loses his supervisory independence whenever the SB needs to supervise the internal audit department.

9. How do you think the supervisory function will be improved?

Once the AC is formed with independent directors in addition to the SB, the independent directors have the advantage of having an external and macroscopic viewpoint, so they can play the advisory role well, whereas the SB is more familiar with the company's internal operations, so it can supervise better. The co-operation between them will enhance the supervisory function.

10. How do you think can the supervisory function be executed in the current Chinese context?

It is about the Three Old Institutions and the Three New Institutions. In the days of the state owned enterprises, the supervisory function was not realised in practice. After enterprise renovation, state owned enterprises are restructured to become private enterprises or even listed companies. The Three new Institutions are formed in addition to the Three Old Institutions. The BoD focuses on the development of the enterprise. The SB focuses the supervisory function. The existence of the SB itself makes a difference. Its existence represents the emphasis on the supervisory function. The SB has to perform its expected supervisory function in supervising the BoD and the higher management in any case. Furthermore, if the position of the SB in the organisational structure can enable it to perform its functions, its independence can help it perform better. Moreover, if it can evaluate operations during the audit process, this involvement can avoid the sense of powerless to correct existing problems that comes with retrospective audit. If the problem of having dedicated positions can be rectified, the supervisory personals can then dedicate more of their energy in the work of supervision. Experts can be appointed to help wherever there is lack of expertise. The dedication of the supervisory position and the enhancement of professional competence will be conducive to the performance of the supervisory mechanism.

11. What is the motivation behind the forming of the AC?

It is the emphasis on legitimacy. It is necessary to operate according to the regulations. It is obvious that such operations are good for the company.

12. How, after its formation, should the AC interact with the internal audit

department?

The positions in the internal audit department are dedicated paid positions. The AC is led by the independent directors, whereas the SB is independent to the BoD. Once the AC is formed, hierarchically, the internal audit department will work under the AC; functionally, it remains to be seen how these institutions should work together.

13. Ms. Jia is responsible for internal audit department. Could you share with us how your department performs internal audit?

Jia: It is mainly financial audit. It is based on the audit plan, and the focus is on rationality and legitimacy. If any problem in management or internal control is identified during the process, it will be followed through. Otherwise, the audit report is first double-checked by the relevant department to affirm its authenticity and accuracy, and submit its plan for improvement to the internal audit department. Once it is checked by the internal audit department, the audit report is then sent directly to the Managing Director, and any instruction of the Managing Director is executed. Then the management of the relevant department is asked according to the usual procedure to implement the suggestions and plans. The performance of the implementation is then audited again in the next month or, in the case of major changes, in three months' time.

Summary

Ms. Bao points that applying two systems simultaneously is adapted to the Chinese context and both functions and powers are different, as stated in the regulation. But Ms. Jia said, "I feel there will be overlaps between the responsibilities and powers". Ms. Jia describes that both members' composition is different: for the supervisors are formed by the internal staff and the members of ACs are formed by external directors. She said, "Therefore, I think the two institutions can be complementary to each other and work together to improve the supervisory mechanism" with proper communication between them. They assert that the independent directors have the advantage of having an external and macroscopic viewpoint, so they can play the advisory role well, whereas the SB is more familiar with the company's internal operations, so it can supervise better. "It remains to be seen how these two institutions

should interact with each other in organisation”. The next phase’s study therefore will investigate the co-ordination of organisation between these two institutions.

These two supervisors highlight their role in implementing supervisory functions, according to the responsibilities specified in the Company Act and the company’s constitution, as the following: (1) read the data before each meeting of the BoD to ensure all data on the financial report are correct; (2) audit before submission all quarterly, biannual and annual reports and all other data that need to be submitted; (3) first contact the relevant department before discussing it at meetings; (4) attend the meetings of the BoD, during which they also make suggestions and ask questions.

Both supervisors recognise the strength of adopting two institutions simultaneously:

1. This suits the Chinese context and can cater for the spirits of both the Three Old Institutions and the Three New Institutions.
2. The SB can perform its supervisory function (they are formed by internal staff more familiar with the functions).
3. The AC’s organisational structure can comply with the international supervisory mechanism.

Both supervisors also identify weaknesses:

1. The SB members are “part-timers”, their focus is on their paid work, so they cannot fully dedicate to their supervisory roles.
2. Independence will be impacted upon whenever the subject of supervision is the member’s main department, leading to conflicts of interest and loss of independence.

Both supervisors expect the co-operation between them, by way of SBs implementing supervisory functions and ACs advising this, to enhance the supervisory function. They also stress the reason to expect the implementation by the SB: for the existence of the SB reflects an emphasis on supervisory function. The position of the SB in the organisational structure of independence from the BoD and the higher management can enable it to perform its functions better. They also expect to be full time supervisors, dedicating more of their energy to the work of supervision, so that they can evaluate operations during the audit process in advance of problems occurring in

the company, and also promote the professional competence of the supervisors. Overall, they expect to improve the implementation of the supervisory functions by increasing their dedication and enhancing the professional competence of the supervisors.

Regarding the formation of the AC, both view it in terms of legitimacy, and as good for the company. On operations after the formation of ACs, they said, "it remains to be seen how these institutions should work together." Obviously, this sampled chemical company has decided and expect to install the AC but they are at the stage of exploring how to implement the supervisory functions afterwards.

The reflection to these answers is thus: What is the role of the AC played in China? Both interviewed supervisors view it in an advisory capacity. Will other companies have the same viewpoint?

6.2.4 The Roles of the AC Played in China

A. Questionnaire Design:

This is based on Resource Dependency theory, aimed at understanding the role of AC played in the listed companies in China. Telephone survey with the designed questionnaires on the main functions of the AC was employed, as follows:

1. Does the AC involve itself in making important company policies? (Decision Maker)
2. Does the AC diagnose and provide solutions as an expert to the problems facing the company during its development? (Advisor/consultant)
3. Does the AC provide professional training to the middle and senior management of the company? (Trainer)
4. Does the AC give professional opinions on related transactions? (Overseer of the process)
5. Does the AC supervise and audit the company's major information disclosure? (Financial Supervisor)

B. Sample and Survey Operations:

The telephone survey sample was selected from listed companies with ACs. 330 listed companies have been contacted, and 65 of them – over 15% – were willing to respond.

C. Findings from Survey

The telephone survey based on the questionnaire presented in the table below was conducted in July 2008. From the responses, the statistics of the roles defining the regulated main functions of the AC in a listed company were calculated and then compared to the stipulated functions and summarised as follows:

- (1) 95 per cent of companies perform as the financial supervisor by providing the supervising and auditing the company's major information disclosure, which is the key function of the AC defined by the regulation.
- (2) 92 per cent of companies perform as the overseer by giving professional opinions on related transactions, which is the extended function of ACs retrieved from the broad definition of regulation.
- (3) 60 per cent of companies perform the role of advisors by diagnosing and providing solutions as an expert on problems facing the company during its development, which service of advisor, which provides added value to the companies.
- (4) 49 per cent of companies' ACs act as the decision maker through involvement in making important company policies, which seems in conflict with the independent supervisory functions of AC.
- (5) 23 per cent of companies act as the trainer by providing professional training to the middle and senior management of the company, which provides extra service to the companies.

Table 40. The Role of the AC Played in China
(Source: Author - Findings are obtained from telephone surveys.)

| Role | Questionnaires | Response % (# of Companies) |
|-------------------------|--|--------------------------------|
| Decision Maker | Does the AC involve itself in making important company policies? | 49% (32/65) |
| Advisor/consultant | Does the AC diagnose and provide solutions as an expert to the problems facing the company during its development? | 60% (39/65) |
| Trainer | Does the AC provide professional training to the middle and senior management of the company? | 23% (15/65) |
| Overseer on the process | Does the AC give professional opinions on related transactions? | 92% (60/65) |
| Financial Supervisor | Does the AC supervise and audit the company's major information disclosure? | 95% (62/65) |

Summary

To implement the ACs under the dual layers governance structure in China, would impact upon the original practice and differentiate from what is internationally recognised. The AC in China is still at the rudimentary and experimental stage. It is a process of innovation as well as trial and error. Therefore the AC in every company seems in the process of exploring practices suitable to its unique CG setting and model in China. Over 92 per cent of sampled companies can meet the definition of the role of AC as overseers in their actual practices; 60 per cent of companies perform the role of advisors/consultants providing added value to the companies; 23 per cent of companies act as trainers providing the extra service to the companies; yet 49 per cent of companies' ACs act as the decision maker through involvement in making important company policies, which seems in conflict with the independent supervisory functions of AC.

It is concluded that this result supports the theory of Resource Dependency. The AC provides added value and extra services in addition to independent control of overseer in the actual process and the supervision.

In order to know more about the operations of the supervisory functions, a sampled machinery company with the AC has been interviewed as the following:

6.2.5 The Sampled Corporation B – Machinery Industry (with the AC)

The general secretary of the BoD arranged the interview between author and interviewees. Before conducting the interviews with the supervisors and the members of the AC, Mr. Wang was interviewed as follows:

Wang, F-x. 王阜西 (2007). *Interview with Mr. Wang Fuxi (王阜西), Secretary of the BoD of the Hangcha Engineering Machinery Co., Ltd. (杭叉公司), on 25th July 2007. Hangzhou. [Video recording in possession of author]*

1. Please describe the AC of your company.

It was formed within the last year. It works under the BoD. According to the constitutions of the company, it audits the operations of the whole company and the performance of the higher management. Its goal on financial audit is the same as that of the SB.

2. Since the goals of the AC and the SB are the same, is there overlap between their functions? Has there been any consideration on the cost of supervision? How do they share the workload of supervision?

Because of the formation of the AC by the introduction of the independent directors was not done until the end of the previous year (2006), its operation does not fully comply with the requirement. The function of the AC has not been identified in the last half year or so. Whereas the SB publishes its supervisory report biannually, and is mainly retrospective supervision, so theoretically, there is a need to increase progressive and concurrent supervisions. As there is the additional supervisory institution, I suppose the scope of supervision can be widened. Our company has not yet looked into the issue of the cost of supervision, probably because the supervisory function of the AC has not yet been fully realised, and there is no monetary cost for the SB. Currently, there are two stakeholders' SB members, who are paid nothing other than their salaries for their respective roles in the company. The stockholder SB member is appointed by the government, who receives his own salary from his own organisation. The company does not need to pay these members for their supervisory work. The company only needs to pay the independent directors. It is a fixed sum determined by the General Assembly

Meeting. The independent directors mainly attend the meetings of the BoD, and they tend to take the viewpoints of the minor and medium stockholders in their advice during the decision making process of the meetings of the BoD. On the other hand, the SB tends to take the viewpoints of the major stockholders in their retrospective supervision on the operations of the company. The functions of the two institutions are different.

3. How does the SB operate?

Its operation is simple. It does not operate much since its formation. Currently, it only reviews the financial and audit reports before the meetings, and discuss in their own meetings if there is any major problem. Apart from these, it does not perform any day-to-day supervision. Its focus is not the same as the internal audit department. The SB supervises mainly by reviewing reports, followed by oral enquiries if necessary.

4. Which documents are provided for the members of the SB?

Essentially, it is the same data available for the BoD before their meetings, such as the audit report, the BoD report, financial report, and the assessment of the performance of the higher management.

5. Is there specific meeting agenda for the SB? Is there clear specification as to which documents should be reviewed by the members of the SB? Do its members meet before the meetings of the BoD?

Yes, there is. I will give you a copy of the regulations on the meetings of the SB for your reference. This is compiled according to the responsibilities and procedures specified in the Company Act. The meetings of SB are held after the meetings of the BoD rather than before, but copies of relevant documents will be delivered by the Secretary of the BoD (me) to the Directors and SB members ten days before the meeting of the BoD.

6. Are there areas for improvement in the current supervisory system?

There are three areas (concerning the SB) for improvement. First, it is not a dedicated role. Improvement is needed to improve the level of participation. Secondly, there is need to enhance professional competence, especially for the stakeholder members, who might not be able to understand financial reports. Thirdly, its membership should be a dedicated position. Currently, it is overseen by

stakeholders, and it is difficult to realise its supervisory function. There is justifiable consideration behind having stakeholder members elected by the union, but there is the issue of independence. On the other hand, there is specific requirement on the professional level of the AC, and it consists of independent directors, so it is expected to be able to compensate the weakness of the SB.

7. There are both the SB and the AC in Chinese system. How should these be organised in the organisational structure?

The Chinese system has been through the history of the Three Old Institutions and the Three New Institutions. Combining with the global trends in the supervisory mechanisms, the special context of the Chinese system is formed. The Three Old Institutions (in state owned enterprises) are the Stakeholders' Representatives' Committee, the Management and Party Officers' Committee. Our company was a Party-owned enterprise. The political atmosphere was a bit strong then. Now under the system of market economy, the economic tone is stronger. Currently, it is a semi-state-owned-and-semi-private enterprise. These characteristics need to be further integrated to suit the specific culture of China.

8. How should the supervisory function be enhanced in practice in the future?

First the professional competence of the members needs to be improved. Then the supervisory culture of the enterprise needs to be improved, and an environment conducive to proper supervision needs to be formed. The fundamental issue of independence need to be resolved, otherwise it is difficult to realise the supervisory function.

9. Are there informal meetings between the SB and the AC?

No.

10. How long is a meeting by either the SB or the AC?

A meeting of the SB is usually about half an hour, and it never lasts longer than an hour. It usually checks if there is any problem and then follow the motion of the specified agenda and procedures rather than investigating deeply into any problem. The AC has not met yet.

Summary

This sampled machinery company established the AC only within one year of the interview day. It is in the process of completing the operation of ACs. Mr. Wang admitted that “its operation does not fully comply with the requirement.” Its coordination with the SB is also under construction. He identified the functions of the two institutions as being different, and differentiated them in terms of the AC tending to take the viewpoints of the minor and medium stockholders into account during the decision making process of the meetings of the BoD, whereas the SB tends to focus on the viewpoints of the major stockholders in their retrospective supervisions.

Mr. Wang said the operation of SB is simple, and does not operate much since its formation. A meeting of the SB is usually about half an hour when not investigating deeply into any problem. Currently the SB supervises mainly by reviewing reports of the same data available for the BoD before their meetings: such as the audit report, the BoD report, financial report, and the assessment of the performance of higher management, followed by verbal enquiries if necessary. Then the meetings of SB are held after the meetings of the BoD rather than before. Mr. Wang identified the areas for improvement in the current supervisory system as follows:

1. It does not have dedicated supervisors. Improvement is needed to improve the level of participation. Its membership should be a dedicated position. Currently, it is overseen by stakeholders, and it is difficult to realise its supervisory function.
2. There is a need to enhance professional competence, especially among stakeholder members, who might not be able to understand financial reports.
3. There is justifiable consideration for having stakeholder members elected by the union, but this leads to issues of independence.
4. Then the supervisory culture of the enterprise needs to be improved, and an environment conducive to proper supervision formed.

Mr. Wang expects the installation of the AC to enhance levels of professionalism and independence, compensating for the weakness of the SB. He also mentioned that his company has been transformed from fully state owned to a semi-state-owned-and-semi-private enterprise, and he recognises it is now part of a system of market

economy, so highlights the necessity of introducing the AC to fit into international practice, while simultaneously suiting the specific culture of China with the SB.

In order to understand more about the operations of SB, the Chair of the SB was introduced by Mr. Wang for interview by the author as follows:

Shen, J-h. 沈劍華 (2007). *Interview with Mr. Shen Jianhua (沈劍華), Chair of the BoD and Legal Advisor of the Hangcha Engineering Machinery Co., Ltd. (杭叉公司), accompanied by Mr. Wang Fuxi (王阜西), Secretary of the BoD, on 25th July 2007. Hangzhou. [Video recording in possession of author]*

1. There are both the SB and the AC in the Chinese system. What is your view on the functions and operations of these two institutions?

I have not been the Chair of the SB for long, but I have been involved in the process of company transition. Currently, both institutions have been formed in our company. This is to comply with the requirement of the Company Act, and concerns the legitimacy of the conduct of both the company and the higher management according to the constitution of the company. In my opinion, the AC is a more microscopic viewpoint. As to me, I am Chairs of both the SB and the committee of the Union, so the conduct of both the company and the higher management should be reviewed for their legitimacy and rationality. The consideration of rationality is from the angle of the Union, but this should not conflict with legitimacy.

2. Is it your recommendation to have two stakeholders' representatives on the SB?

Yes.

3. Having both the SB and the AC, there is the possibility that their functions may overlap. What is your opinion on this issue?

In my opinion, there is not much overlap. The independent directors mainly participate in the operations of the BoD. The SB is parallel to the BoD. It is an independent institution; whereas the AC observes the operations of the company from a microscopic angle.

4. What are the focal points when you call for the meetings of the SB?

First, it is the level of execution of the resolutions by the BoD after the General Assembly Meeting. Secondly, it is the supervision of the taking of major decisions by the BoD according to the Company Act, Stock Exchange Regulations and the constitutions of the company. Thirdly, it is the level of legitimacy of the conducts of the BoD and the higher management, supervised by the members of the SB.

5. In your opinion, what is the level of professional competence of the SB regarding the auditing of the financial report?

I myself am definitely not an expert. There are accounting professionals in the SB. As the SB needs to oversee financial reporting, this is mainly done by the member with expertise in accounting. If he raises any questions, other members will assist accordingly.

6. Has the SB performed any supervision or interpretation about the assessments, including the internal auditing?

The BoD is more mature in its operations in this regard. Since this term of service of mine (which is my first term), there have not been many questions raised. This is because the SB mainly supervises the BoD, and the BoD is the main decision making institution.

7. How frequently does the SB interact with the management under the BoD?

Not frequently, but I attend every meeting of the BoD.

8. Your job description is the permanent supervisor. Do you hold any other post in the company?

I am also the Chair of the union and the internal legal advisor. The latter is for the conveniences of internal operations even though the company has also appointed external legal advisors.

9. In your opinion, what are the strengths and weaknesses of the current operations of the SB?

Our company has gone through certain historic transitions. It transformed from a wholly state owned organisation to a semi-state-owned one by releasing its stocks to its stakeholders, so the strength of the SB is that it is more democratic, having a good people foundation. A strength and weakness is its members are both stakeholders and stockholders. There are members elected by the stockholders as well as by stakeholders, so the relationship with the BoD is not the simple

relationship between the supervised and the supervisor. Hence, there are interactions before problems reach the explicit process of supervision in which a common ground is reached and problems solved or hidden. As to the weakness of the SB, the professional level of the members of the SB, including I myself, need to be improved to the international standard. This applies to both financial and management professions.

10. Are there areas in the mechanism and interaction between the two institutions where improvements are needed?

The interaction between the two institutions should collect more regularly the operational information of the company. The BoD does respect the SB, and does notify the SB in advance about new policies and resolutions. Improvements are needed in the understanding of day-to-day operations. Enhancement in this understanding can further pinpoint the source of problems. I personally do not understand much of the operations of the AC, and I suppose they have the same problem towards us. For instance, upon the call for meetings, the independent directors might not be able to grasp the day-to-day operations of the company, and there are considerations on the qualities of their members.

11. How do you expect the two institutions to interact and cooperate?

The AC consists of independent directors and it is expected that they will sing a different tune. In some respect, it is good to have different voices. Having everyone singing in accord is not necessary a good thing. It is also expected that the independent directors can bring in the benefits of external links. This is because what they have experienced and encountered is different from those of our internal staff. They should be allowed to utilise their advantages to bring positive assistance to the company. To sum up, it is expected that they will bring in new ideas and links to the external environment, utilising their resources to enhance the company.

12. What is the standard of supervision?

For instance, the financial reports are audited according to the earnings conditions, following the GAAP, from structural items to practical items.

13. Are you involved in appointing external auditors?

No. It is determined by the BoD.

14. In your opinion, what improvements are needed to realise the supervisory

mechanism of corporate governance?

To further enhance or perfect supervisory effectiveness and function, first the quality of the members needs to be improved. Secondly, more attention is needed on the understanding of the process of the operations of the SB. Thirdly, the viewpoint of the SB is somewhat macroscopic; efforts might be needed to deepen and refine its view to be able to identify problems in advance and act as a problem prevention mechanism.

Summary

Mr. Shen is Chair of both the SB and committee of the Union, as well as the internal legal advisor. Like the SB Chair of sampled chemical Corporation A, he also has a legal professional background. The other two supervisors were recommended by Mr. Shen; and it may be assumed that, as its Chair, he has absolute power in implementing its supervisory functions in this sampled machinery Corporation B.

Mr. Shen believes there is not much overlapping in these two institutions' functions for they are located in different organisations. He stresses that the AC has a more microscopic viewpoint and the SB, a more macroscopic one. He also highlights key functions of the SB, namely: (1) Resolutions by the BoD after the General Assembly Meeting; (2) Supervising the major decisions by the BoD; (3) Supervising the compliance level of legitimacy of the conduct of the BoD and higher management. Mr. Shen is also aware that the SB needs to oversee financial reporting, which he admitted he has no expertise in. Accordingly, this is mainly carried out by the member with accounting expertise. The SB does not interact with or use the resource of internal auditing, nor frequently interact with the management: the SB merely supervises the BoD, and the latter is the main decision making institution. Thus he attends every meeting of the BoD.

Mr. Shen asserts that a strength and weakness of the SB pertains to its membership being both stakeholders and stockholders. As members are elected by stockholders and stakeholders, its relationship with the BoD is not merely that between supervised and supervisor. Hence, one clear weakness of the SB lies in the interactions in which common ground is reached and problems solved or buried occur before an explicit

process of supervision becomes necessary. Moreover, it is urgent for it to have more members from a financial or managerial background to conform to international standards.

Mr. Shen highlights two areas in which the co-ordination of the two institutions when implementing supervisory functions needs to be improved:

- (1) The interaction between the two institutions should collate more regularly the operational information of the company.
- (2) Improvements are needed in the understanding of day-to-day operations. Enhancement in this understanding can further pinpoint sources of problems.

He also expects to utilise the independent directors, bringing in new ideas and external links to enhance the company.

Mr. Shen summarises his comments as follows: first, membership quality needs to be improved. Second, more attention is needed on understanding the processes of the SB. Third, the perspective of the SB is somewhat macroscopic; efforts might be needed to deepen and refine its view, in order to identify problems in advance and act as a problem prevention mechanism.

To understand the process behind the implementation of the AC, its Chair was introduced to the author by Mr. Wang, General Secretary of the BoD. The resulting interview was as follows:

Xu, L. (2007). *Interview with Mr. Xu Lida (許立達), AC member and Chief Financial Officer of the Hangcha Engineering Machinery Co., Ltd. (杭叉公司), accompanied by Wang Fuxi (王阜西), Secretary of the BoD, on 25th July 2007. Hangzhou. [Video recording in possession of author]*

1. Your company has just installed the AC. In your opinion, what is the reason behind its installation?

I don't think there is conflict between the SB and the AC. I think that the SBs in China's enterprises have not yet attained the standard it should have been in theory.

Perhaps it is because of this, or because of the different operations in different countries, that we have observed some differences between our operations and the French companies that we came in touch with. Their SB operates at a different level than ours. The BoD has to report to the SB, and does not execute their plans without the approval of the latter. Whereas in our system, both the BoD and the SB report to the General Assembly Meeting. The BoD does not require the prior approval of the SB for its operations. Such a difference in corporate structure may have affected the effectiveness of the CG functions.

2. Now that you have both the SB and the AC, how should these two departments share their supervisory roles?

Theoretically, there must be some point in introducing the AC from the Anglo-American model. There are several reasons why the SB has not functioned as expected. First, in the Chinese context, many things are just formalities. There is no actual cultural backing for supervision. The members of the SB might be wary that they would be shunned by the management and the colleagues if they try too hard. Without the backing of the proper cultural environment, they are powerless in supervision. Secondly, the members of the SB mostly take on the role on a part-time basis, so they are reluctant in involving in the actual processes of supervision, so they probably do not really understand the onus of supervision, and ended up reviewing the final reports only. The main reason, basically, is that they don't really want to supervise. Therefore, work should be done on changing the culture. The management should value the supervisory functions, and provide the members of the SB with necessary data and documents, rather than preventing the latter's involvement in the operations.

3. What do you think the main focus of the financial supervision of the AC would be?

It would be to abide by relevant laws and regulations. Their evaluation and selection of external auditors should be based on the latter's reputation and track record.

4. How do you think should the AC function?

Currently, there are three members of the AC. Two of these are independent directors, and I am the only internal member. The operation of the AC should be

led by the two independent directors to ensure the independence of the AC. I myself am the Chief Financial Officer overseeing financial reporting. I don't think there is any regulatory concern over this, but if the independent directors think otherwise, we should follow their opinion, which account for two thirds of the AC. Also, current regulation dictates that more than half of the members of the AC should be independent directors, but I think it would be more in line with the consideration on the independence of the AC if all members would be independent directors.

5. How should the AC operate?

There is an internal constitution for the AC, so the AC should operate accordingly. The independent director should call for meetings. The members of the AC meet once a season, but there isn't much communication amongst them otherwise.

Secretary Wang: We have just formed our AC in the beginning of this year (2007) and its operation and promotion is still wanting. The convener is experienced (in auditing and supervision), and we expect him to direct us in the operations of the AC. We have focused on complying with the relevant regulations for the sake of being a listed company.

6. Please elaborate on the relations between the AC and the internal audit in your company.

Initially, the internal audit was under the direct control of the Managing Director. Now it is promoted to be directly under the BoD. Though both the AC and internal audit have the functions of auditing, each has its own emphasis. The internal audit focuses on the details such as the supervision of internal control, whereas the AC takes a more macroscopic view. In the future, the internal audit unit should be installed under the AC so as to facilitate their co-operations. My primary role is the Chief Financial Officer, which is supposed to be supervised (by the internal audit), yet I am also a member of the AC (which is above the internal audit), and this is somewhat unusual. There are only three employees in the internal audit. I think it is necessary to enhance its function. Now the regulation for this is in place, we should focus on its installation. This should start with the formation of a culture and mindset conducive to its proper operation to distil the sense of importance in the auditing functions and willingness of the colleagues in cooperating with auditing

departments in enabling their proper operations.

7a. What are the problems facing supervision?

As the AC has just been installed, it is still not fully functioning as specified by the regulations and expectations, so it is difficult to say if there would be any further problem in its operation.

7b. Is there any area in its three main functions of the AC, i.e., financial reporting, auditing and internal control, in which improvement is needed?

The crucial point, theoretically, is to instil the mindset throughout the organisation of the importance of supervision and to improve the quality of the auditing staff. The operation of the SB and the AC should focus on the levels specified by the regulations so as to identify problems. In the current operation, the SB mainly oversees the results rather than the processes, and the members do not really strive to perform properly as this is not their main roles in the company. It is lacking in the level of supervision of the processes and the level of support the company gives to supervision.

8a. Does the members of the AC meet before the meetings of the BoD to review the reports? How does it overcome the neglects in supervising the processes?

This is not done at the moment.

8b. Will it be done in the future?

The Chief Financial Officer stresses the importance of financial data, and the effect of internal control is shown in the data. The supervision of processes should have been done on a daily basis rather than waiting for the AC to evaluate it before the Board of Director meetings.

(The Chief Financial Officer went to answer a phone call)

Secretary Wang: Because of his unique position in the company, Mr. Xu needs to know the financial condition because of his main role as the Chief Financial Officer, and since he is also the Chair of the AC, it is not necessary for the AC to meet before the BoD' meetings to know the situation of internal control. Actually, the financial unit itself provides certain level of daily control.

Summary

Mr. Xu is a member of the AC and also the Chief Financial Officer overseeing financial reporting. He said: “My primary role is the Chief Financial Officer, which is supposed to be supervised (by the internal audit), yet I am also a member of the AC (which is above the internal audit), and this is somewhat unusual.” Yet he thinks that the supervision of processes should be done on a daily basis, rather than wait for the AC to evaluate it before Board of Director meetings. Secretary Wang added that because of his unique position in the company as Chief Financial Officer, and since he is also the Chair of the AC, it is not necessary for the AC to meet before BoD meetings in order to know the situation of internal control. Mr. Wang points out that the financial unit itself provides certain levels of daily control. Regarding the composition of the AC, its current status still meets with Chinese regulations, in that over half the members are independent directors. Mr. Xu concluded: “I think it would be more in line with the consideration on the independence of the AC if all members would be independent directors.”

The other two members of the AC are independent directors. Explaining the reasons behind installing the AC, Mr. Xu stressed that the SB has not functioned as expected:

- (1) Because of different operations in different countries of direct line reporting, in China, the BoD does not require the prior approval of the SB for its operations. He therefore considers such a difference in corporate structure may have affected the effectiveness of CG functions.
- (2) The members of the SB might be wary that they would be shunned by the management and the colleagues if they try too hard. Without the backing of the proper cultural environment, they are rendered powerless.
- (3) The members of the SB mostly take on the role on a part-time basis, so are reluctant to involve themselves in the actual processes of supervision. Consequently, they probably do not truly understand the process of supervision, so end up reviewing the final reports only.

Mr. Xu commented simply that, “the main reason, basically, is that they (supervisors) don’t really want to supervise; therefore, work should be done on changing the culture.” Mr. Xu has the same viewpoint on the question of implementing supervisory

functions, in order to comply with the relevant laws and regulations. Mr. Wang added that: “We have focused on complying with the relevant regulations for the sake of being a listed company.” It seems that complying with the regulations for being a listed company was another reason behind installing the AC.

AC meetings are mainly called by the Chair (as well as once each season by the independent directors), but there is not much communication amongst the members; nor are any meetings held before meetings of the BoD. As the AC was installed just over half a year before the day the interview was conducted, Mr. Xu admitted, “it is still not fully functioning as specified by the regulations and expectations, so it is difficult to say if there would be any further problems in its operation.” Mr. Xu expects the internal audit reports of the AC to help facilitate better co-operation in the future. Mr. Xu focused on the formation of a culture and mindset conducive to proper operation of the AC: distilling a sense of importance in the auditing functions and willingness of colleagues to co-operating with auditing departments.

Mr. Xu identified ways in which to improve the implementation of supervisory functions, by improving the level of supervision of the processes, and the level of support the company gives to supervision. He believes it is important to improve the quality of auditing staff, and remedy the current problem of members not really striving to perform their AC roles properly.

The SB and AC are the supervisory institutions under different CG models. It is assumed that incorporating both into one model will result in functional overlaps and gaps.

What is the overlapping status of the supervisory functions of two institutions? This sub-question has been raised during the interviews of two sampled companies. The following section is therefore intended to provide an answer.

6.2.6 The Overlapping Status of the Supervisory Functions of the SB and the AC in China

Introduction

According to the evidence of the six interviewees, two of them, Ms. Jia and Mr. Xu, believe the functions of the two institutions overlap in practice; whereas the remaining four, Mr. Chao, Mr. Bao, Mr. Wang and Mr. Shen, could not find common agreement. Some assert the levels of overlap are not much; some described one as the supervisory unit, the other as the executing unit. Considering that of the two sampled companies, one had only just begun to form the AC, whereas the other had formed it barely six months previously, the interviewees' understanding of the overlap of supervisory functions may not reflect the reality: indeed, Mr. Shen specifically mentioned the need to better understand the day-to-day operations of the two institutions' supervisory functions. Further investigation on operational aspects of these two institutions – the overlapping items and percentages between them – was therefore performed through a survey of five listed companies with experience of having implemented ACs.

The operational aspects of supervisory functions by SBs and ACs

It was found that there was overlapping in both financial oversight and compliance oversight. First, in 2006, China's National People's Congress (NPC) specified the SB as the special institution for financial inspection and supervision, whereas in 2002 the Chinese Security Regulatory Commission (CSRC) mandated that both the SB and the AC were responsible for financial supervision, and both have the same financial supervisory function of overseeing the authenticity and reasonableness of the disclosure of the company's accounting information. Second, both are responsible for safeguarding against questionable conduct of the Directors, and related transactions of senior managers. Therefore, both try to operate within their functions on the same issue, identified as including financial reporting, auditing, internal control and compliance, as listed in Table 41.

The following operational items of supervisory functions are itemised and summarised through research of the charters of the SB and the AC of the five

surveyed companies, survey by face to face interview of two sampled companies, and through related professional websites, mainly www.knowledgeleader.com; www.aicpa.org; www.nyse.com; www.sec.gov; and the Sarbanes-Oxley Act.

Aspect A: Financial Reporting, totalling 23 items.

This was broken down into three key supervisory areas:

(A) Review the documents, meeting and discussion: 11 items.

(B) Oversight of the interim financial report: 4 items; and

(C) Oversight of the annual financial report: 8 items.

(A) Review the documents, meeting and discussion:

(1) To review the filings with the SEC and other published documents (1.1.1).

(2) To review the chairman of the unit participate in a telephonic meeting among finance management and the public accounting firm prior to earnings release (1.1.2).

(3) To review the Company's critical accounting policies (1.1.3).

(4) To have a full understanding of the composition of the company's balance sheet (1.1.4).

(5) To review financial ratios and indicators (1.1.5).

(6) To discuss significant/complex/unusual transactions (1.1.6).

(7) To discuss assumptions/approaches regarding which areas represent high risk of material mis-statement of the financial statements (1.1.7).

(8) To review any significant changes to GAAP and/or MAP policies or standards (1.1.8).

(9) To review policies and procedures with respect to transactions which are not a normal part of the Company's business (1.1.9).

(10) To understand and approve the Company's approach to providing earnings guidance, and to discuss financial information and earnings guidance provided to analysts and rating agencies with management, ideally before the information/guidance is released (1.1.10).

(11) To review periodic reports on the appropriateness of executives', officers', and directors' expenses and perquisites (1.1.11).

(B) Oversight of Interim Financial Reports:

(1) The unit's involvement prior to release of earnings/filings (1.2.1).

(2) All the unit's members involved in overseeing interim reports (1.2.2).

(3) To review and discuss the earnings releases and any significant issues, in order to be satisfied that disclosures are adequate, before the earnings are released (1.2.3).

(4) To review and discuss with management (and the external auditors) the quarterly filings, any related issues, and any differences from earnings releases, before filing takes place (1.2.4).

(C) Oversight of Annual Financial Reports:

(1) To review with finance management and the public accounting firm at the completion of the annual audit:

(a) The Company's annual financial statements and related footnotes (1.3.1.a).

(b) The public accounting firm's audit of the financial statements and its report therein (1.3.1.b).

(c) Any significant changes required in the public accounting firm's audit plan (1.3.1.c).

(d) Any serious difficulties or disputes with management encountered during the courses of the audit (1.3.1.d).

- (e) Other matters related to the conduct of the audit, which are to be communicated to the Committee under Generally Accepted Accounting Principles (1.3.1.e).
- (2) To commit sufficient time to review, discuss and consider the financial statements (1.3.2).
- (3) To discuss with selected corporate officers (e.g. compliance officer, legal counsel, tax director, Internal Audit etc.) and external auditors the substance and quality of reserves, judgements, and estimates used in the financial statements, and the issues that may have an impact on such reserves and estimates (1.3.3).
- (4) Based on its review and discussions with management and the external auditors, establishing whether the unit is comfortable in recommending to the BoD/shareholders that the audited financial statements be included in the company's SEC filing (1.3.4).

Aspect B: Auditing: 21 items:

There are two major functions on oversight auditing, broken down into:

- (A) Oversight of independent auditors: 12 items;
- (B) Oversight Internal Audit: 9 items.

(A) Independent Auditor

- (1) To appoint, approve the compensation of and provide oversight of the public accounting firm (2.1.1).
- (2) To confirm annually the independence of the public accounting firm, and quarterly review the firm's non-audit services and related fees (2.1.2).
- (3) To embrace its direct responsibility to oversee the engagement of the external auditors (2.1.3).
- (4) To pre-approve the audit work to be performed (2.1.4).

- (5) To approve the proposed audit fees and be comfortable they are appropriate for the scope of work envisioned (2.1.5).
- (6) To discuss with the external auditors the scope of their annual audit, key risk areas, how the auditing plan responds to the risk of financial statement fraud and approves modifications to the annual auditing plan (2.1.6).
- (7) To review material written communications the external auditors provide to management and discuss any concerns (2.1.7).
- (8) To receive annually the letter disclosing all relationships between the external auditors and the company, discuss it with the external auditors, assess impacts on the auditor's independence, and make any recommendations needed to the board/shareholder for actions to ensure the auditor's independence (2.1.8).
- (9) To discuss with the external auditors difficulties encountered in performing the audit and improvements considered for future engagements (2.1.9).
- (10) To resolve disagreements between management and the external auditors regarding financial reporting, if needed (2.1.10).
- (11) To pre-approve all non-audit work to be performed by the external auditors, after considering its permissibility under SEC rules and its impact on auditor independence (2.1.11).
- (12) To set clear hiring policies for employees or former employees of the external audit firm (2.1.12).

(B) Oversight of the Internal Audit

- (1) Does the unit consider and review with Finance management and the Internal Audit Director?
 - a. Significant findings during the year and management's responses thereto (2.2.1.a).
 - b. Any difficulties encountered in the course of their audits, including any restrictions on the scope of their work or access to required information (2.2.1.b).

- c. Any changes required in planned scope of their audit plan (2.2.1.c).
- (2) To review and concur in the appointment, replacement, reassignment, or dismissal of the Chief Audit Executive (CAE) (2.2.2).
- (3) To ensure direct access to Internal Audit – either through a direct or dotted line reporting relationship with Internal Audit – supporting its independence from management (2.2.3).
- (4) To hold regular private meetings with the director of Internal Audit to allow frank discussion of issues and concerns (2.2.4).
- (5) To review with the Internal Audit Director, the public accounting firm and Finance management the audit scope and plan, and co-ordination of audit efforts to assure completeness of coverage, reduction of redundant efforts, the effective use of audit resources, and the use of independent public accountants other than the appointed auditors of MS (2.2.5).
- (6) ACs and SBs interact with the public accounting firm and the Chief Internal Audit as regards:
- (a) The adequacy of the Company's internal controls including computerised information system controls and security (2.6.a).
- (b) Any related significant findings and recommendations of the independent public accountants and Internal Audit together with management's responses thereto (2.6.b).

Aspect C: Internal Control and Compliance: 22 items

There are two major functions on oversight internal control and compliance, broken down into:

- (A) Oversight of internal control: 13 items.
- (B) Oversight of compliance: 9 items.

(A) Internal Control

- (1) To understand internal controls, their role in the organisation, and how they are to work (3.1.1).
- (2) To discuss with management any significant deficiencies or material weaknesses identified in the design or operation of internal controls, implications, steps management has taken to ensure the financial reports are reliable, and the adequacy of corrective actions underway; and as appropriate, the committee discusses these internal control issues with the internal and external auditors (3.1.2).
- (3) To meet regularly with Internal Audit and discuss internal control deficiencies discovered during the course of its work, its recommendations for addressing the deficiencies, and management's response. The committee then monitors the status of management's corrective action (3.1.3).
- (4) To discuss with the external auditors any significant deficiencies or material weaknesses discovered during the course of their work and control improvement suggestions. Does it discuss with management how the deficiencies are being addressed? (3.1.4).
- (5) To consider the need to engage outside advisors (e.g. counsel, forensic auditors) when concerns arise about significant fraud or impropriety on the part of management; the unit actively directs such advisors and expert in their engagements (3.1.5).
- (6) To review regularly the trends in complaints received about accounting, internal accounting controls, and auditing matters, and be satisfied with corrective actions taken by management and that management and the external auditors have adequately taken into account the impact of the complaints on the financial statements and the audit (3.1.6).
- (7) To ask members of management or others to attend the meeting and provide pertinent information as necessary (3.1.7).

- (8) To enquire of Finance management, the Internal Auditor head, and the public accounting firm about significant risks or exposures and assess the steps management has taken to minimise such risk to the Company (3.1.8).
- (9) To have sufficient time provided for private meetings with Internal Audit, external auditors, and management (3.1.9).
- (10) To meet with the public accounting firm in executive session to discuss any matters that the unit or the public accounting firm believe should be discussed privately with the unit (3.1.10).
- (11) To meet with the Internal Audit Director in executive sessions to discuss any matters that the unit or the Internal Audit Director believes should be discussed privately with the unit (3.1.11).
- (12) To meet with Finance management in executive sessions to discuss any matters that the unit or Finance management believes should be discussed privately with the unit (3.1.12).
- (13) To prepare the agenda for the unit's meetings in consultation between the unit's Chair (with input from the Committee members), Finance management, the Internal Audit Director and the public accounting firm (3.1.13).

(B) Compliance

- (1) To understand and periodically update its understanding of the major legal and compliance risks facing the company, how management addresses those risks; what impact the risks have on the financial statements; and how management monitors emerging risks (3.2.1).
- (2) To monitor the appropriate standards adopted as a code of conduct for the company. Does the unit review with Finance management and Legal and Corporate Affairs the results of the review of the Company's monitoring compliance with such standards and its compliance policies? (3.2.2).

- (3) To review legal and regulatory matters that may have a material impact on the financial statements, related Company compliance policies, and programs and reports received from regulators (3.2.3).
- (4) To discuss periodically with management policies with respect to risk assessment and risk management. This discussion includes an understanding of how management learns about emerging risks (3.2.4).
- (5) To provide an open avenue of communication between the Internal Auditors, the public accounting firm, finance management and the BoD; and to report the unit's actions to the BoD / shareholders with such recommendations as the unit may deem appropriate (3.2.5).
- (6). To overview the establishment of procedures for receipts, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters, including anonymous submissions by employees (3.2.6).
- (7) To have the power to conduct or authorise investigations into any matters within the unit's scope of responsibilities; to be empowered to retain independent counsel, accountants, or others to assist it in the conduct of any investigation (3.2.7).
- (8). To report after each meeting to the board/shareholders' meeting on the unit's activities, major issues discussed, and recommendations for board/shareholder actions (3.2.8).
- (9) To provide a report in the annual proxy that includes the unit's review and discussion of matters with management and the independent public accounting firm (3.2.9).

Table 41. The Supervisory Functions between the SB and the AC
(Source: Author with data from charters & websites: www.knowledgeleader.com; www.aicpa.org; www.nyse.com; www.sec.gov; and the Sarbanes-Oxley Act)

| No. | Appraisal Questions | Overlapping(O) / Missing (M) | | SB | | | AC | | |
|-----|---------------------------------------|------------------------------|----|-----|----|---|-----|----|---|
| | | O | M | Yes | No | U | Yes | No | U |
| 1 | Financial Reporting (Total O/M Items) | 21 | 12 | | | | | | |

| No. | Appraisal Questions | Overlapping(O) / Missing (M) | | SB | | | AC | | |
|--------|--|---------------------------------|---|-----|----|---|-----|----|---|
| | | O | M | Yes | No | U | Yes | No | U |
| 1.1 | Review Documents and Meeting and Discussion (Total O/M Items) | 10 | 7 | | | | | | |
| 1.1.1 | Does the unit review filings (including interim reporting) with the SEC and other published documents containing the Company's financial statements and does it consider whether the information is accurate? | 3 | 2 | 3 | 2 | 0 | 3 | 2 | 0 |
| 1.1.2 | Will the Chairman of the unit participate in a telephonic meeting among Finance management and the public accounting firm prior to earnings release? | 0 | 3 | 0 | 4 | 1 | 1 | 3 | 1 |
| 1.1.3 | Does the unit review the Company's critical accounting policies with Finance management and the public accounting firm at least annually? | 1 | 2 | 1 | 4 | 0 | 3 | 2 | 0 |
| 1.1.4 | Does the unit have a full understanding of the composition of the company's balance sheet, including the degree of management judgement inherent in the various accounts? | 1 | 0 | 1 | 4 | 0 | 5 | 0 | 0 |
| 1.1.5 | Does the unit understand which financial ratios and indicators are key to the company and industry, how the company's performance compares with its budgetary targets and its competitors, and how management plans to address any unfavourable variances? | 3 | 1 | 3 | 1 | 1 | 4 | 1 | 0 |
| 1.1.6 | Does the unit discuss significant/complex/unusual transactions with management and the external auditors? | 3 | 0 | 3 | 1 | 1 | 5 | 0 | 0 |
| 1.1.7 | Does the unit understand which areas represent high risk for material mis-statement of the financial statements, and discuss assumptions/approaches used with management and the external auditors? | 3 | 1 | 3 | 2 | 0 | 4 | 1 | 0 |
| 1.1.8 | Does the unit review with Finance management any significant changes to GAAP and/or MAP policies or standards? | 3 | 0 | 3 | 1 | 1 | 4 | 0 | 1 |
| 1.1.9 | Does the unit review policies and procedures with respect to transactions between the Company and officers and directors, or affiliates of officers or directors, or transactions that are not a normal part of the Company's business? | 4 | 0 | 4 | 0 | 1 | 4 | 0 | 1 |
| 1.1.10 | Does the unit understand and approve the company's approach to providing earnings guidance? Does the unit discuss financial information and earnings guidance provided to analysts and rating agencies with management, ideally before the information/guidance is released? | 3 | 1 | 3 | 1 | 1 | 3 | 1 | 1 |
| 1.1.11 | Does the unit review periodic reports on the appropriateness of executives', officers', and directors' expenses and perquisites? | 1 | 3 | 1 | 3 | 1 | 1 | 3 | 1 |
| 1.2 | Interim Financial Reports (Total O/M Items) | 4 | 0 | | | | | | |
| 1.2.1 | Is the unit clear about its responsibilities for overseeing interim reports-discussing both earning releases and quarterly filings? Ideally, is the unit's involvement prior to release of earnings/filings? | 4 | 0 | 5 | 0 | 0 | 4 | 1 | 0 |

| No. | Appraisal Questions | Overlapping(O) / Missing (M) | | SB | | | AC | | |
|-------|---|---------------------------------|----|-----|----|---|-----|----|---|
| | | O | M | Yes | No | U | Yes | No | U |
| 1.2.2 | Are all the unit's members involved in overseeing interim reports? | 4 | 0 | 5 | 0 | 0 | 4 | 1 | 0 |
| 1.2.3 | Does the unit review and discuss the earnings releases and any significant issues, and is satisfied disclosures are adequate, before the earnings are released? | 4 | 0 | 5 | 0 | 0 | 4 | 1 | 0 |
| 1.2.4 | Does the unit review and discuss with management (and the external auditors) the quarterly filings, any related issues, and any differences from earnings releases, before filing takes place? | 4 | 0 | 5 | 0 | 0 | 4 | 1 | 0 |
| 1.3 | Annual Financial Reports (Total O/M Items) | 7 | 5 | | | | | | |
| 1.3.1 | Review with Finance management and the public accounting firm at the completion of the annual audit: | | | | | | | | |
| | a. The Company's annual financial statements and related footnotes. | 3 | 0 | 3 | 2 | 0 | 5 | 0 | 0 |
| | b. The public accounting firm's audit of the financial statements and its report thereon. | 4 | 0 | 4 | 1 | 0 | 5 | 0 | 0 |
| | c. Any significant changes required in the public accounting firm's audit plan. | 3 | 1 | 3 | 2 | 0 | 4 | 1 | 0 |
| | d. Any serious difficulties or disputes with management encountered during the course of the audit. | 0 | 3 | 0 | 3 | 2 | 0 | 3 | 2 |
| | e. Other matters related to the conduct of the audit, which are to be communicated to the Committee under Generally Accepted Accounting Standards. | 3 | 1 | 3 | 2 | 0 | 4 | 1 | 0 |
| 1.3.2 | Does the unit commit sufficient time to review, discuss and consider the financial statements? | 4 | 1 | 4 | 1 | 0 | 4 | 1 | 0 |
| 1.3.3 | Does the unit discuss with selected corporate officers (e.g., compliance officer, legal counsel, tax director, Internal Audit, etc.) and external auditors the substance and quality of reserves, judgments, and estimates used in the financial statements, and the issues that may have an impact on such reserves and estimates? | 2 | 1 | 2 | 2 | 1 | 3 | 1 | 1 |
| 1.3.4 | Based on its review and discussions with management and the external auditors, is the unit comfortable in recommending to the BoD/shareholders that the audited financial statements be included in the company's SEC filing? | 5 | 0 | 5 | 0 | 0 | 5 | 0 | 0 |
| 2 | Auditing (Total O/M Items) | 19 | 19 | | | | | | |
| 2.1 | Oversight Independent Auditor (Total O/M Items) | 11 | 11 | | | | | | |
| 2.1.1 | Does the unit appoint, approve the compensation of, and provide oversight of the public accounting firm? | 1 | 3 | 1 | 4 | 0 | 2 | 3 | 0 |
| 2.1.2 | Does the unit confirm annually the independence of the public accounting firm, and quarterly review the firm's non-audit services and related fees? | 2 | 2 | 2 | 3 | 0 | 3 | 2 | 0 |
| 2.1.3 | Has the unit embraced its direct responsibility to oversee the engagement of the external auditors? | 1 | 2 | 1 | 4 | 0 | 3 | 2 | 0 |
| 2.1.4 | Does the unit pre-approve the audit work to be performed? | 1 | 1 | 1 | 3 | 1 | 3 | 1 | 1 |

| No. | Appraisal Questions | Overlapping(O) / Missing (M) | | SB | | | AC | | |
|--------|--|---------------------------------|----------|-----|----|---|-----|----|---|
| | | O | M | Yes | No | U | Yes | No | U |
| 2.1.5 | Does the unit approve the proposed audit fees and is comfortable they are appropriate for the scope of work envisioned? | 2 | 2 | 2 | 2 | 1 | 3 | 2 | 0 |
| 2.1.6 | Does the unit discuss with the external auditors the scope of their annual audit, key risk areas, how the audit plan responds to the risk of financial statement fraud and approves modifications to the annual audit plan? | 2 | 2 | 2 | 2 | 1 | 3 | 2 | 0 |
| 2.1.7 | Does the unit review material written communications the external auditors provide to management and discuss any concerns? | 3 | 0 | 3 | 1 | 1 | 5 | 0 | 0 |
| 2.1.8 | Does the unit annually receive the letter disclosing all relationships between the external auditors and the company, discuss it with the external auditors, assess impacts on the auditor's independence, and make any recommendations needed to the board/shareholders for actions to ensure the auditor's independence? | 2 | 1 | 2 | 1 | 2 | 2 | 1 | 2 |
| 2.1.9 | Does the unit discuss with the external auditors difficulties encountered in performing the audit and improvements considered for future engagements? | 2 | 1 | 2 | 3 | 0 | 3 | 1 | 1 |
| 2.1.10 | Does the unit resolve disagreements between management and the external auditors regarding financial reporting, if needed? | 0 | 2 | 0 | 5 | 0 | 2 | 2 | 1 |
| 2.1.11 | Does the unit pre-approve all non-audit work to be performed by the external auditors, after considering its permissibility under SEC rules and its impact on auditor independence? | 1 | 2 | 1 | 4 | 0 | 2 | 2 | 1 |
| 2.1.12 | Does the unit set clear hiring policies for employees or former employees of the external audit firm? | 1 | 3 | 1 | 3 | 1 | 1 | 3 | 1 |
| 2.2 | Oversight Internal Audit (Total O/M Items) | 8 | 8 | | | | | | |
| 2.2.1 | Does the unit consider and review with Finance management and the Internal Audit Director: | | | | | | | | |
| | a. Significant findings during the year and management's responses thereto? | 1 | 1 | 1 | 1 | 3 | 2 | 1 | 2 |
| | b. Any difficulties encountered in the course of their audits, including any restrictions on the scope of their work or access to required information? | 2 | 1 | 2 | 1 | 2 | 2 | 1 | 2 |
| | c. Any changes required in planned scope of their audit plan? | 2 | 1 | 2 | 1 | 2 | 2 | 1 | 2 |
| 2.2.2 | Does the unit review and concur in the appointment, replacement, reassignment, or dismissal of the Chief Audit Executive (CAE)? | 0 | 3 | 0 | 4 | 1 | 0 | 3 | 2 |
| 2.2.3 | Does the unit ensure direct access to Internal Audit – either through a direct or dotted line reporting relationship with Internal Audit – supporting its independence from management? | 2 | 1 | 2 | 1 | 2 | 2 | 1 | 2 |
| 2.2.4 | Does the unit hold regular private meetings with the director of Internal Audit to allow frank discussion of issues and concerns? | 1 | 1 | 1 | 2 | 2 | 2 | 1 | 2 |

| No. | Appraisal Questions | Overlapping(O) / Missing (M) | | SB | | | AC | | |
|-------|--|---------------------------------|---|-----|----|---|-----|----|---|
| | | O | M | Yes | No | U | Yes | No | U |
| 2.2.5 | Does the unit review with the Internal Audit Director, the public accounting firm and Finance management the audit scope and plan, and co-ordination of audit efforts to assure completeness of coverage, reduction of redundant efforts, the effective use of audit resources, and the use of independent public accountants other than the appointed auditors of MS? | 2 | 1 | 2 | 2 | 1 | 3 | 1 | 1 |
| 2.2.6 | Does the unit consider and review with the public accounting firm and the Internal Audit Director: | | | | | | | | |
| | a. The adequacy of the Company's internal controls including computerised information system controls and security? | 2 | 1 | 2 | 1 | 2 | 3 | 1 | 1 |
| | b. Any related significant findings and recommendations of the independent public accountants and Internal Audit together with management's responses thereto? | 3 | 0 | 3 | 0 | 2 | 4 | 0 | 1 |
| 3. | Internal Controls and Compliance (Total O/M Items) | 22 | 9 | | | | | | |
| 3.1 | Internal Control (Total O/M Items) | 13 | 7 | | | | | | |
| 3.1.1 | Do the unit's members understand internal controls, their role in the organisation, and how they are to work? | 4 | 0 | 4 | 0 | 1 | 4 | 0 | 1 |
| 3.1.2 | Does the unit discuss with management any significant deficiencies or material weaknesses identified in the design or operation of internal controls, implications, steps management has taken to ensure the financial reports are reliable, and the adequacy of corrective actions underway, and as appropriate, the committee discusses these internal control issues with the internal and external auditors? | 1 | 1 | 1 | 3 | 1 | 3 | 1 | 1 |
| 3.1.3 | Does the unit regularly meet with Internal Audit and discuss internal control deficiencies discovered during the course of its work, its recommendations for addressing the deficiencies, and management's response? Does the committee then monitor the status of management's corrective action? | 1 | 2 | 1 | 3 | 1 | 2 | 2 | 1 |
| 3.1.4 | Does the unit discuss with the external auditors any significant deficiencies or material weaknesses discovered during the course of their work and control improvement suggestions? Does it discuss with management how the deficiencies are being addressed? | 1 | 1 | 1 | 2 | 2 | 3 | 1 | 1 |
| 3.1.5 | Does the unit consider the need to engage outside advisors (e.g. counsel, forensic auditors) when concerns arise about significant fraud or impropriety on the part of management? Does the unit actively direct such advisors and experts in their engagements? | 1 | 1 | 1 | 1 | 3 | 1 | 1 | 3 |

| No. | Appraisal Questions | Overlapping(O) / Missing (M) | | SB | | | AC | | |
|--------|---|---------------------------------|---|-----|----|---|-----|----|---|
| | | O | M | Yes | No | U | Yes | No | U |
| 3.1.6 | Does the unit regularly review the trends in complaints received about accounting, internal accounting controls, and auditing matters, and is it satisfied with corrective actions taken by management and that management and the external auditors have adequately taken into account the impact of the complaints on the financial statements and the audit? | 2 | 2 | 2 | 2 | 1 | 2 | 2 | 1 |
| 3.1.7 | May the unit ask members of management or others to attend the meeting and provide pertinent information as necessary? | 5 | 0 | 5 | 0 | 0 | 5 | 0 | 0 |
| 3.1.8 | Does the unit enquire of Finance management, the Internal Auditor head, and the public accounting firm about significant risks or exposures and assess the steps management has taken to minimise such risk to the Company? | 5 | 0 | 5 | 0 | 0 | 5 | 0 | 0 |
| 3.1.9 | Is sufficient time provided for private meetings with Internal Audit, external auditors, and management? | 4 | 0 | 4 | 0 | 1 | 4 | 0 | 1 |
| 3.1.10 | Does the unit meet with the public accounting firm in executive session to discuss any matters that the unit or the public accounting firm believe should be discussed privately with the unit? | 3 | 0 | 3 | 1 | 1 | 4 | 0 | 1 |
| 3.1.11 | Does the unit meet with the Internal Audit Director in executive sessions to discuss any matters that the unit or the Internal Audit Director believes should be discussed privately with the unit? | 2 | 1 | 3 | 1 | 1 | 2 | 2 | 1 |
| 3.1.12 | Does the unit meet with Finance management in executive sessions to discuss any matters that the unit or Finance management believes should be discussed privately with the unit? | 4 | 0 | 4 | 0 | 1 | 4 | 0 | 1 |
| 3.1.13 | Will the agenda for the unit's meetings be prepared in consultation between the unit's chair (with input from the Committee members), Finance management, the Internal Audit Director and the public accounting firm? | 3 | 1 | 3 | 1 | 1 | 3 | 1 | 1 |
| 3.2 | Compliance (Total O/M Items) | 9 | 2 | | | | | | |
| 3.2.1 | Does the unit understand and periodically update its understanding of the major legal and compliance risks facing the company, how does management address those risks, what impact the risks have on the financial statements, and how does management monitor for emerging risks? | 2 | 0 | 2 | 2 | 1 | 4 | 0 | 1 |
| 3.2.2 | Does the unit monitor the appropriate standards adopted as a code of conduct for the company? Does the unit review with Finance management and Legal and Corporate Affairs the results of the review of the Company's monitoring compliance with such standards and its compliance policies? | 2 | 0 | 2 | 2 | 1 | 4 | 0 | 1 |

| No. | Appraisal Questions | Overlapping(O) / Missing (M) | | SB | | | AC | | |
|---|--|---------------------------------|---|-----|----|---|-----|----|---|
| | | O | M | Yes | No | U | Yes | No | U |
| 3.2.3 | Does the unit review legal and regulatory matters that may have a material impact on the financial statements, related Company compliance policies, and programs and reports received from regulators? | 2 | 0 | 2 | 2 | 1 | 4 | 0 | 1 |
| 3.2.4 | Does the unit periodically discuss with management policies with respect to risk assessment and risk management? This discussion includes an understanding of how management learns about emerging risks. | 1 | 0 | 4 | 0 | 1 | 1 | 2 | 2 |
| 3.2.5 | Does the unit provide an open avenue of communication between the Internal Auditors, the public accounting firm, finance management and the BoD? Does the unit report the unit's actions to the BoD / shareholders with such recommendations as the unit may deem appropriate? | 4 | 0 | 4 | 1 | 0 | 5 | 0 | 0 |
| 3.2.6 | Has the unit established procedures for receipts, retention, and treatment of complaints received by the company regarding accounting, internal accounting controls, or auditing matters, including anonymous submissions by employees? | 1 | 2 | 1 | 3 | 1 | 2 | 2 | 1 |
| 3.2.7 | Shall the unit have the power to conduct or authorise investigations into any matters within the unit's scope of responsibilities? Shall the unit be empowered to retain independent counsel, accountants, or others to assist it in the conduct of any investigation? | 5 | 0 | 5 | 0 | 0 | 5 | 0 | 0 |
| 3.2.8 | Does the chair report after each meeting to the board/shareholders' meeting on the unit's activities, major issues discussed, and recommendations for board/shareholder actions? | 5 | 0 | 5 | 0 | 0 | 5 | 0 | 0 |
| 3.2.9 | Does the unit provide a report in the annual proxy that includes the unit's review and discussion of matters with management and the independent public accounting firm? | 4 | 1 | 4 | 1 | 0 | 4 | 1 | 0 |
| Note: O: overlapping; M: missing; U: un-applied | | | | | | | | | |

Finding on the overlapping status of the supervisory functions through surveying five listed companies

The definition of overlapping and missing items:

Overlapping items: it is defined that at least one of the sampled companies performed the identified supervisory functions by ACs and SBs at the same time.

Missing items: it is defined that at least one of the sampled companies did not perform the identified supervisory functions by ACs or SBs.

The overlapping and missing items were identified as follows:

Aspect A: Financial Reporting

23 items of supervisory functions of financial reporting are included, supervising the following four key areas:

- Overseeing the auditing results by the external independent accountants;
- Examining all the accounting policies of the company, and reporting major changes and other dubious points;
- Previewing the interim and annual financial reports and the reports of the BoD;
- Organizing special investigations on the company's financial activities.

The findings of overlapping and missing items and percentages (findings divided by total items) are summarised individually in the table below:

Company 1: Overlapping with 3 items, 14%; missing 7 items, 30%.

Company 2: Overlapping with 1 item, 4%; missing 2 items, 9%.

Company 3: Overlapping with 9 items, 39%; missing 3 items, 13%.

Company 4: Overlapping with 7 items, 30%; missing 0 items, 0%.

Company 5: Overlapping with 1 item, 4%; missing 0 items, 0%.

Companies 4 and 5 have no missing items, but every surveyed company has overlapping items.

Table 42. The Overlapping and Missing Items and Percentages on Financial Reporting (Source: Author)

| Financial Reporting | | | | | |
|---------------------|-------------------|-----|--|---------------|-----|
| Sampled Companies | Overlapping Items | | | Missing Items | |
| | Item Numbers | | | Item Numbers | |
| Company 1 | 3 | 14% | | 7 | 30% |
| Company 2 | 1 | 4% | | 2 | 9% |
| Company 3 | 9 | 39% | | 3 | 13% |
| Company 4 | 7 | 30% | | 0 | 0% |
| Company 5 | 1 | 4% | | 0 | 0% |

Aspect B: Auditing

21 auditing items of supervisory functions were found, covering the following two key areas:

- Internal Audit: through the oversight function of the Internal Audit, overseeing key financial and management risks and the internal control, examining the scopes of the Internal Audit plans, appraising the skills of the Internal Auditors, and determining the financial budgets of the Internal Audit, etc.
- External audit: presiding over the affairs of the external audit, selecting the independent accountants, discussing the scope, process and plan of external audit, evaluating the capabilities of the independent accountants; in order to give suggestions for the appointments and dismissal of the external auditing institutions, the AC should be confined to supporting sound suggestions made by the chartered accountants and actively co-ordinate with the latter on major auditing matters, as well as co-ordinating the relations between the latter and the management to ensure the smooth operation of the auditing tasks.

The results are presented individually in the table below:

Company 1: Overlapping with 7 items, 33%; missing 10 items, 48%.

Company 2: Overlapping with 10 items, 48%; missing 6 items, 29%.

Company 3: Overlapping with 2 items, 10%; missing 3 items, 14%.

Company 4: Overlapping with 0 items, 0%; missing 0 items, 0%.

Company5: Overlapping with 0 items 0%; missing 0 items, 0%.

Both the fourth and fifth companies show no overlapping and missing items in auditing.

Table 43. The Overlapping and Missing Items and Percentages on Auditing including Internal Audit and External Audit
(Source: Author)

| Auditing | | | | |
|-------------------|-------------------|-----|---------------|-----|
| Sampled Companies | Overlapping Items | | Missing Items | |
| Survey Result | Item Numbers | | Item Numbers | |
| Company 1 | 7 | 33% | 10 | 48% |
| Company 2 | 10 | 48% | 6 | 29% |
| Company 3 | 2 | 10% | 3 | 14% |
| Company 4 | 0 | 0% | 0 | 0% |
| Company 5 | 0 | 0% | 0 | 0% |

Aspect C: Internal Control and Compliance

22 items of internal control and compliance were found, including:

- Overseeing the recommendations on internal control made by internal and external auditing.
- Overseeing the company's compliance with regulations and business ethics, keeping effective control in revealing conflict of interest and errors through reviewing reports of outstanding litigations, major conflict of interests, and various policies of the company.

The results are presented individually in the table below:

Company 1: Overlapping with 6 items, 27%; missing 7 items, 32%.

Company 2: Overlapping with 5 items, 23%; missing 2 items, 9%.

Company 3: Overlapping with 2 items, 9%; missing 0 items, 0%.

Company 4: Overlapping with 5 items, 23%; missing 0 items, 0%.

Company5: Overlapping with 4 items, 18%; missing 0 items, 0%.

The third, fourth and fifth companies show no missing items on internal control and compliance items of supervisory functions, yet every surveyed company has overlapping items.

Table 44. The Overlapping and Missing Items and Percentages on Internal Control and Compliance
(Source: Author)

| Internal Control and Compliance with total | | | | |
|--|-------------------|-----|---------------|-----|
| Sampled Companies | Overlapping Items | | Missing Items | |
| | Item Numbers | | Item Numbers | |
| Survey Result | | | | |
| Company 1 | 6 | 27% | 7 | 32% |
| Company 2 | 5 | 23% | 2 | 9% |
| Company 3 | 2 | 9% | 0 | 0% |
| Company 4 | 5 | 23% | 0 | 0% |
| Company 5 | 4 | 18% | 0 | 0% |

Summary

A summary of the overlapping and missing items and percentages on the integration of the financial reporting, auditing, and internal control and compliance reports from five surveyed companies is presented in the table below:

Company 1: overlapping with 16 items, 24%; missing 24 items, 36%.

Company 2: overlapping with 16 items, 24% missing 10 items, 15%.

Company 3: overlapping with 13 items, 20% missing 6 items, 9%.

Company 4: overlapping with 12 items, 18% missing 0 items, 0%.

Company 5: overlapping with 5 items, 8% missing 0 items, 0%.

Table 45. Summary of the Overlapping and Missing Items and Percentages on Financial Reporting, Auditing and Internal Control & Compliance
(Source: Author)

| Financial Reporting, Auditing and Internal Control & Compliance | | | | |
|---|-------------------|-----|---------------|-----|
| Sampled Companies | Overlapping Items | | Missing Items | |
| Survey Result | Item Numbers | | Item Numbers | |
| Company 1 | 16 | 24% | 24 | 36% |
| Company 2 | 16 | 24% | 10 | 15% |
| Company 3 | 13 | 20% | 6 | 9% |
| Company 4 | 12 | 18% | 0 | 0% |
| Company 5 | 5 | 8% | 0 | 0% |

The findings show that the five surveyed companies implemented the operation items with different distribution between SBs and ACs. No consistency exists among the listed companies as to the current status. Inter-dynamic relationships in functions will influence the effectiveness of the internal supervisory mechanism. The overlapping items reached 24 per cent in company 1 and 2, which may point towards redundant work in one organisation; the missing outcome reached 36 per cent of items, which may pose a risk to the organisation by omitting oversight of risky items. Both sampled companies' interviewees said that "it remains to be seen how these institutions should work together." The next chapter aims to reveal the co-ordination between the two institutions in terms of organisation.

6.2.7 Conclusion on Operations

The matrix of two case studies' results on the main features is summarised in the table below (Table 46).

A. Independence

SBs: both cases of systems with and without ACs in China reveal that SBs' members lack independence; The CEOs are also Presidents of the BoD; and shareholders possess more than 10% of the company's voting shares. Meanwhile, Case B SB Chair, Mr. Shen, recommends the other two supervisors. It may be assumed that as Chair, Mr. Shen has absolute power of implementing the supervisory functions of the SB in

this sampled machinery Corporation B. Yet, in Case A, Mr. Chao reports that no supervisor receives remuneration.

ACs: Current Chinese regulation only requests that a majority of AC members are independent. In Case B, two thirds of the AC members are independent, yet Mr. Xu concluded: "I think it would be more in line with the consideration of the independence of the AC if all members would be independent directors."

B. Expertise

Case B (with ACs) equipped with 50% (2/4) expertise in accounting or a financial background is better than Case A (without ACs), with 0% such expertise on the SB. It may be concluded that Case B is more concerned with adding expertise of accounting or finance to improve the effective supervisory functions.

Both SB Chairmen stress the importance of compliance. Both Chairmen are also legal experts. Mr. Chao views compliance as a foundation, by which management can maintain a tight connection between management and supervision. This may explain why Chinese regulations specifically points out the legal requirement for the composition of the SB: the Code of CG for Listed Companies in China.

C. Diligence

Case B's SB met four times; and Case A, three times. This suggests that Case B is more active in due diligence.

D. The role of the AC played in China

The role of the AC played in China may be different from the acknowledged international norm. Both companies have different expectation of this role. Therefore, this research further conducts the survey of 330 listed companies in China: answering sub-question 1 by evaluating the common understanding of the listed companies.

The telephone survey found that 92% meet the defined role of overseer, 60% and 23% acted as advisors and trainers respectively to provide extra services with added value to the ACs, but 49 per cent of ACs act as the decision maker through involvement in making important company policies, which seems in conflict with the independent

supervisory functions of AC. This result supports the assertions of Resource Dependency theory.

E. Problems and difficulties of implementing SBs

In Case B, Mr. Wang said that the operation of SB is simple, and had not operated much since its formation. A meeting of Case B's SB is usually about half an hour, and does not investigate deeply into any problem. He indicated the improvements needed as follows:

1. It is not a dedicated supervisory role. Improvement is needed to improve the level of participation. Its membership should be a dedicated position. Currently, it is overseen by stakeholders, and it is difficult to realise its supervisory function.
2. There is a need to enhance professional competence, especially among stakeholder members, who might not be able to understand financial reports.
3. There is justifiable consideration behind having stakeholder members elected by the union, but this leads to problems in terms of independence.
4. The supervisory culture of the enterprise needs to be improved, and an environment conducive to proper supervision formed.

Mr. Shen asserts that the representation of financial and managerial professions among SB members needs to be improved, bringing it into line with international standards.

Mr. Xu acknowledged that the SB had not functioned as expected, for the following three reasons:

1. Because of the different operations in different countries of direct line reporting, in China, the BoD does not require the prior approval of the SB. He therefore believes such a difference in corporate structure may have impacted upon the effectiveness of CG functions.
2. The members of the SB might be wary that they would be shunned by the management and the colleagues if they try too hard. Without the backing of the proper cultural environment, they are rendered powerless.
3. The members of the SB mostly take on the role on a part-time basis, so are reluctant to engage in the actual process of supervision. They probably do not

truly understand the process of supervision, so end up merely reviewing the final reports.

In Case A, both supervisors identify the main weaknesses as follows:

1. The SB members are “part-timers”; their focus is on their paid work, so they cannot fully dedicate to their supervisory roles.
2. Independence will be impacted upon whenever the subject of supervision is the member’s main department: leading to conflicts of interest and loss of independence.

F. Improve the operations of SBs by resolving to establish ACs (Motivation for establishing AC)

Both companies (two systems with and without ACs) face difficulties and problems in implementing SBs. Both resolved to establish ACs to improve the effectiveness of supervisory functions.

In Case A, Mr. Chao points that the AC exists in order to demonstrate the high priority and determination of the top management in implementing supervisory functions.

In Case A, both Ms. Bao and Ms. Jia recognise the benefits of adopting two institutions simultaneously:

1. This suits the Chinese context and can cater for the spirits of both the Three Old Institutions and the Three New Institutions.
2. The SB can perform its supervisory function (being formed by internal staff, more familiar with the functions).
3. The AC’s organisational structure can comply with the international supervisory mechanism.

In Case B, Mr. Wang expects the installation of AC to enhance levels of professionalism and independence, compensating for the weakness of the SB. His company has been transformed from fully state-owned to a semi-state-owned-and-semi-private enterprise, and he recognises it is now under a system of market

economy, so highlights the necessity of introducing the AC to fit in with international practice while suiting China's specific culture simultaneously.

Mr. Shen also expects independent directors to bring in new ideas and the benefits of external links, so enhancing the company.

Mr. Xu focused on the formation of a culture and mindset conducive to the proper operation of AC: distilling a sense of importance regarding auditing functions, and willingness of colleagues to fully co-operate.

Both cases expect the establishment of ACs to solve the problems and difficulties in implementing SBs. Yet there may be further problems after adding in AC. This issue is further explored as the follows:

G. The co-ordination of two institutions in implementing supervisory functions

In Case B, Mr. Shen highlights that "improvements are needed in the understanding of day-to-day operations. Enhancement of this understanding can further pinpoint the source of problems." The SB and the AC are supervisory institutions under different CG models. It is suspected (sub-question 2) that incorporating both into one model will result in functional overlaps and gaps within the two sampled companies. Therefore, this thesis further investigates the day-to-day process of supervisory functions to define the checklist implemented by SBs and ACs; using this defined checklist to survey five listed companies by face to face interview, in order to reveal the overlapping items and percentages. The research results report overlapping items reached 24 per cent in company 1 and 2, which may point towards redundant work in one organisation; the missing outcome reached 36 per cent of items, which may pose a risk to the organisation by omitting oversight of risky items.

H. The process of implementing supervisory functions between two institutions

Overlapping and missing items between SBs and ACs exist in empirical practice in China, such as Company 1 with 24% overlapping and 36% missing items. In Case A, Ms. Jia and Ms. Bao said "it remains to be seen how these institutions should work together." In Case B, Mr. Xu said that "it is important to instil the mindset throughout the organisation." Also in Case B, Mr. Shen lists key supervising functions of the SB

as follows: (1) Resolutions by the BoD after the General Assembly Meeting; (2) Supervising of the making of major decisions by the BoD; (3) Supervising the compliance level of legitimacy of the conduct of the BoD and higher management, supervised by the members of the SB. Mr. Shen once again explains this is because the SB mainly supervises the BoD. Yet there is no vertical reporting line between SBs and ACs. Therefore, this thesis also endeavours to understand the co-ordination of the two institutions in the next phase study.

Table 46. Matrix of the Comparison of Case A (system A – SB alone) and Case B (System B – SBs plus ACs) in China
(Source: Author)

| A. SB-Alone B. SB+AC | Case A (SB alone) | Case B (SB+AC) | Conclusion |
|---|--|---|--|
| SB- members' independence- Comprises solely outside, unrelated members | 0 | 0 | Same (Lack of Ind.) |
| The CEOs are also Presidents of the BoD | Yes | Yes | Same (Lack of Ind.) |
| Shareholders respectively possess more than 10% of the company's voting shares. | 1 | 2 (including state-owned 10%) | Same (Lack of Ind.) though A is better |
| Independence | One is that he did not receive any remuneration nor the other two supervisors acting in the SB; another one is that SB should be independent from the BoD. (Mr. Chao) | The other two supervisors are recommended by Mr. Shen, the chair of the SB. It may be assumed that the Chair of the SBs, Mr. Shen has the absolute power in implementing the supervisory functions of the SBs in this sampled machinery Corporation B. (Mr. Shen) Mr. Xu concluded "I think it would be more in line with the consideration on the independence of the AC if all members would be independent directors." (Mr. Xu) | A is better than B |
| SB-Expertise in Finance | 0 | 2/4(50%) | B is better |

| A. SB-Alone B. SB+AC | Case A (SB alone) | Case B (SB+AC) | Conclusion |
|---|---|---|--|
| SB- Legal Expertise | Mr. Chao said, "I think the manager of an enterprise must be diligent in obeying the law". Mr. Chao's professional background makes him highlight the importance of compliance for he views the compliance is the foundation of management to have the tight connection of the management and supervision. | Mr. Shen also reminds us that SB needs to oversee financial reporting which he admitted that he is not an expert in. So he mentions that this is mainly done by this member with expertise in accounting. His profession is also in legal background the same as the chair of the SB of the sampled chemical Corporation A. That may be the reason he highlights the legitimacy and rationality which should not conflict with legitimacy on the functions and operations of these two institutions. | Both viewpoints may explain the reason why the Chinese regulation especially points out the legal requirement for the member's composition of the SB according to the Code of CG for Listed Companies in China. |
| SB-Number of Members | 3 | 4 | B is better |
| SB-Meeting times per year | 3 | 4 (in addition 2 times of private meetings) | B is better |
| The expectation of the role of independent directors (AC) played in the company | <p>To play the role of consultancies in the BoD;</p> <p>To suggest to the elite organisation in the enterprise on issues of the competence of the latter's operations. (Qian, Z-y.)</p> <p>They assert that the independent directors have the advantage of an external and macroscopic viewpoint, so they can play the advisory role well, whereas the SB is more familiar with the company's internal operations, so it can supervise better. (Ms. Jia)</p> | <p>Mr. Wang identified the functions of the two institutions are different and he differentiated them in these terms: the AC tends to take the viewpoints of the minor and medium stockholders in their advice during the decision-making process of the meetings of the BoD, but the SB tends to take the viewpoints of the major stockholders in their retrospective supervision on the operations of the company. (Mr. Wang)</p> <p>Mr. Shen once more stresses that the AC is a more microscopic viewpoint and the SB is a more macroscopic viewpoint. (Mr. Shen)</p> | Both companies have different expectation for the role of AC played in China. Therefore, this research further conducts the survey 330 listed companies in China to answer this sub-question by survey the common understanding of the listed companies. |

| A. SB-Alone B. SB+AC | Case A (SB alone) | Case B (SB+AC) | Conclusion |
|---|--|--|--|
| <p>Problems and difficulties of implementing supervisory boards</p> | <p>Case A, both supervisors also identify the weakness as the following: The SB members are "part-timers", their focus is on their paid works, so they cannot fully dedicate to their supervisory roles. Independence will be impacted whenever the subject of supervision is the member's main department, there will be conflict of interest and independence is lost.</p> | <p>Case B, Mr. Wang said the operation of SB is simple and do not operate much since its formation. A meeting of the SB is usually about half an hour without investigating deeply into any problem. He indicates the improvements needed as follows: It is not a dedicated role of supervisors. Improvement is needed to improve the level of participation. Its membership should be a dedicated position. Currently, it is overseen by stakeholders, and it is difficult to realise its supervisory function. There is need to enhance professional competence, especially for the stakeholder members, who might not be able to understand financial reports. There is justifiable consideration behind having stakeholder members elected by the union, but there is the issue of independence. Then the supervisory culture of the enterprise needs to be improved, and an environment conducive to proper supervision needs to be formed.</p> <p>Mr. Shen asserts that the weakness of the SB, the financial and management professions of the members of the SB need to be improved to the international standard. Mr. Xu said because the SB has not functioned as expected with three reasons: Because of the different operations in different countries of direct reporting line among China and the other countries. In China, the BoD does not require the prior approval of the SB for its operations is not like French. He therefore thinks such a difference in corporate structure may have affected the effectiveness of the CG functions. The members of the SB might be wary that they would be shunned by the management and the colleagues if they try too hard. Without the backing of the proper cultural environment, they are powerless in supervision. The members of the SB mostly take on the role on a part-time</p> | <p>The co-ordination of SB & AC in terms of function (overlapping and missing items and s)and in terms of organization is therefore raised for study in the next phase.</p> <p>The motivation of setting up ACs is identified.</p> |

| A. SB-Alone B. SB+AC | Case A (SB alone) | Case B (SB+AC) | Conclusion |
|---------------------------------------|--|---|---|
| <p>Motivation for establishing AC</p> | <p>He points out that the existence of the AC in the organisation to reflect the high concern and determination of the top management in implementing the supervisory functions. He intends to take the government's encouragement by installing ACs because he stresses once more to strengthen the supervisory functions by installing dual supervisory systems at the same time. (Mr. Chao) Both supervisors recognise the strength of adopting two institutions simultaneously as the following: This suits the Chinese context and can cater for the spirits of both the Three Old Institutions and the Three New Institutions. The SB can perform its supervisory function (they are formed by internal staffs and more familiar with the functions). The AC's organisational structure can comply with the international supervisory mechanism. (Ms. Bao and Ms. Jia)</p> | <p>Mr. Wang expects the installing of AC can enhance the professional level and independence to compensate the weakness of the SB. He mentioned another reason for his company to install AC. His company has been transformed from full state-owned company to a semi-state-owned-and-semi-private enterprise, and he recognises it is now under the system of market economy, so he highlights that it is necessary to introduce the AC to fit in the international practice but suit to the specific culture of China with the SB simultaneously.</p> <p>Mr. Shen also expects to utilise the resource of the AC consists of independent directors to bring in new ideas and the benefits of external links to enhance the company.</p> <p>Mr. Xu said the focuses on the installation of AC by starting with the formation of a culture and mindset conducive to its proper operation to distil the sense of importance in the auditing functions and willingness of the colleagues in cooperating with auditing departments in enabling their proper operations.</p> | <p>Both companies (two systems with and without ACs) in implementing SBs face difficulties and problems. Both are motivated to establish ACs to improve the effectiveness of implementing supervisory functions.</p> <p>This may explain the reason why the company is willing to install AC in addition to SB.</p> |

| A. SB-Alone B. SB+AC | Case A (SB alone) | Case B (SB+AC) | Conclusion |
|---|---|--|---|
| <p>The co-ordination of two institutions in implementing supervisory functions.</p> | <p>The operation after forming ACs, they said, "it remains to be seen how these institutions should work together." (Ms. Jia and Ms. Bao)</p> | <p>Mr. Shen points out two areas for improvement of co-ordination of two institutions in implementing supervisory functions: The interaction between the two institutions should collect more regularly the operational information of the company. Improvements are needed in the understanding of day-to-day operations. Enhancement in this understanding can further pinpoint the source of problems.</p> <p>Mr. Shen sums up the points to further enhance or perfect supervisory effectiveness and function of SB, first the quality of the members needs to be improved. Secondly, more attentions are needed on the understanding of the process of the operations of the SB. Thirdly, the viewpoint of the SB is somewhat macroscopic; efforts might be needed to deepen and refine its view to be able to identify problems in advance and act as a problem prevention mechanism. (Mr. Shen)</p> <p>Mr. Xu identified the ways to improve the implementation of supervisory functions, by improving the level of supervision on the processes and the level of support the company gives to supervision. He views that it is important to instil the mindset throughout the organisation of the importance of supervision and to improve the quality of the auditing staffs and also to correct the current problem that the members do not really strive to perform properly as this is not their main roles in the company. (Mr. Xu)</p> | <p>Case B Mr. Shen highlights that "improvements are needed in the understanding of day-to-day operations. Enhancement in this understanding can further pinpoint the source of problems." The SB and the AC are the supervisory institutions under different CG models. It is questioned (sub-question 2) that incorporating both into one model will result in functional overlaps and gaps by two sampled companies. Therefore, this thesis further investigates the day-to-day process of supervisory functions to define the checklist implemented by SBs and ACs; furthermore, to base on this defined checklist to survey five listed companies by face to face interview for understanding the overlapping items and percentages.</p> |

| A. SB-Alone B. SB+AC | Case A (SB alone) | Case B (SB+AC) | Conclusion |
|---|--|---|---|
| <p>The process of implementation the supervisory functions between two institutions</p> | <p>By attending the meetings of the BoD to listen to their proposals and resolutions.</p> <p>He also calls for the meeting of the SB once a season over the minimum number of 1 time in every year required by law after the meetings of the BoD .</p> <p>Besides attending or calling the meetings, he also keeps regular contacts with relevant departments to supervise, therefore, involves physically visiting the relevant departments to investigate on-site. (Mr. Chao)</p> <p>(1)read the data before each meeting of the BoD to ensure all data on the financial report are correct, (2) audit before submission all quarterly, biannual and annual reports and all other data that need to be submitted, (3) first contact the relevant department before discussing it in our meetings; (4) attend the meetings of the BoD, during which we also make suggestions and ask questions. (Ms. Bao and Ms. Jia)</p> | <p>Mr. Wang said the operation of SB is simple and does not operate much since its formation. A meeting of the SB is usually about half an hour without investigating deeply into any problem. Currently, The SB supervises mainly by reviewing the reports as the same data available for the BoD before their meetings such as the audit report, the BoD' report, financial report, and the assessment of the performance of the higher management, followed by oral enquiries if necessary. Then the meetings of SB are held after the meetings of the BoD rather than before. Mr. Wang identified the areas for improvement in the current supervisory system by the following points: (Mr. Wang)</p> <p>Furthermore, he points out the key functions of supervising the SB (1) the resolutions by the BoD after the General Assembly Meeting; (2) Supervising of the making of major decisions by the BoD; (3) Supervising the compliance level of legitimacy of the conducts of the BoD and the higher management, supervised by the members of the SB. (Mr. Shen)</p> <p>He points this is because the SB mainly supervises the BoD, and the BoD is the main decision-making institution. So he attends every meeting of the BoD. (Mr. Shen)</p> | <p>The overlapping and missing items between SBs and ACs exist in empirical practice in China. Case B, Mr. Shen once again points the SB mainly supervises the BoD. Yet there is no vertical reporting line between SBs and ACs in organisation currently. Therefore, this thesis also endeavours to understand the co-ordination of two institutions in organisation of key research objective 3 will be revealed in the next phase.</p> |

| A. SB-Alone B. SB+AC | Case A (SB alone) | Case B (SB+AC) | Conclusion |
|-------------------------|-------------------|---|------------|
| | | <p>The weakness are identified as the following: It is not a dedicated role of supervisors. Improvement is needed to improve the level of participation. Its membership should be a dedicated position. Currently, it is overseen by stakeholders, and it is difficult to realise its supervisory function. There is need to enhance professional competence, especially for the stakeholder members, who might not be able to understand financial reports. There is justifiable consideration behind having stakeholder members elected by the union, but there is the issue of independence.</p> <p>Then the supervisory culture of the enterprise needs to be improved, and an environment conducive to proper supervision needs to be formed. (Mr. Wang)</p> <p>Mr. Shen asserts that the weakness of the SB, the financial and management professions of the members of the SB need to be improved to the international standard. because the SB has not functioned as expected with three reasons: Because of the different operations in different countries of direct reporting line among China and the other countries. In China, the BoD does not require the prior approval of the SB for its operations is not like French. He therefore thinks such a difference in corporate structure may have affected the effectiveness of the CG functions.</p> <p>The members of the SB might be wary that they would be shunned by the management and the colleagues if they try too hard. Without the backing of the proper cultural environment, they are powerless in supervision.</p> <p>The members of the SB mostly take on the role on a part-time basis, so they are reluctant in involving themselves in the actual processes of supervision, and probably do not really understand the process of supervision, and ended up reviewing the final reports only.</p> | |

| A. SB-Along B. SB+AC | Case A (SB alone) | Case B (SB+AC) | Conclusion |
|-------------------------|-------------------|---|------------|
| | | <p>Mr. Wang expects the installation of AC to enhance professionalism and independence to compensate for the weakness of the SB. He mentioned another reason for his company to install AC. His company has been transformed from full state-owned company to a semi-state-owned-and-semi-private enterprise, and he recognises it is now under the system of market economy, so he highlights that it is necessary to introduce the AC to fit in the international practice but suit to the specific culture of China with the SB simultaneously.</p> <p>(Mr. Wang)</p> <p>He also expects to utilise the resource of the AC consists of independent directors to bring in new ideas and the benefits of external links to enhance the company.</p> <p>(Mr. Shen)</p> <p>Mr. Xu said the focuses on the installation of AC by starting with the formation of a culture and mindset conducive to its proper operation to distil the sense of importance in the auditing functions and willingness of the colleagues in cooperating with auditing departments in enabling their proper operations.</p> <p>(Mr. Xu)</p> | |

6.3 Co-ordination

6.3.1 Introduction

The system of ACs in addition to SBs is different from the Anglo-American or German model. How will the two systems with or without ACs exist in the future according to framework of legislation and management of government? The first section of this phase aims to answer this question by interviewing the SSE deputy director according to the framework of legislation and management of the SSE; and interview the Manager of the Property Right Management Department of the State-Owned Hangzhou Industrial Assets Management Co. Ltd, to understand the assertions and opinions of the governor.

By the comparison of the SBs and ACs presented in chapter 2, it is found that there is no vertical relationship between the SBs and the ACs. What is the preferred linkage of interactions between the SBs and the ACs in terms of organisation? The second section of this study aims to find the evidence for the constructive interactions between both supervisory institutions, by understanding the preferred linkage of interactions between the SB and AC.

This study of Objective 3 is structured by presenting the interview of two governors of SSE and State-Owned Hangzhou Industrial Assets Management Co. Ltd., then presenting the preferred linkage by surveying 330 listed companies in China.

6.3.2 Interviews of Two Governors

How will the two systems – with or without ACs – exist in the future according to framework of legislation and management of government? Two governors' opinions on the framework of legislation and the management of government now follow.

Shi Donghui (2007): *Interview with Mr. Shi Donghui, Deputy Director of the Shanghai Stock Exchange (SSE), email response on 24th Aug. 2007.* Shanghai. Phone interview and response by email [Response by email recorded as the attached file of Appendix C1]

1. What are the intended purposes of setting up the SB, the independent directors and the AC according to the framework of legislation and management of the SSE?

The SB: because the 'Company Law of the People's Republic of China' was initially based on the German system, the SB was specified. Yet because of some initial misunderstanding, the functions of the SB in Chinese law differ from those of its German counterpart, and its primary function is to supervise the directors and managers. In practice, the Chair of the SB is generally promoted from the internal staff of the company, and most of its members also come from within the company, so it is merely a deliberative body under the control of the BoD.

The independent directors: the BoD is at the core of CG in China as far as the actual power of control is concerned. To ensure the independence of the BoD from the major shareholders, China introduced the system of independent directors from the US system for corporate governance. At least one third of the directors on the BoD should be independent directors.

The AC: the AC is one of the special committees under the BoD. The majority of its members and its Chair should be independent directors, and one of these should be an accounting professional.

2. What are the functions of the SB, the independent directors and the AC according to the framework of legislation and management of the SSE? How do these compare with one another?

The SB: to check the finance of the company; to supervise the directors and managers against any behaviours that might violate laws or regulations or articles of the company; to demand correction when a director or manager does not behave in the interest of the company.

The independent directors: to have the responsibility of being trustworthy and diligent to all shareholders; to safeguard the interest of the company; to protect the

legal rights of medium and small shareholders.

The AC: to recommend the appointment or replacement of external auditors; to oversee the internal auditing system and its implementation; to sustain the communication between the internal auditing department and the external auditor; to audit the company's financial information and its reporting; to audit the company's internal control system.

In practice, the functions of the SB, the independent directors and the AC overlap with one another. The independent directors and the AC are stronger than the SB in their supervisory roles. The power of the SB is superficial and cannot function as intended. Thus some scholars and professionals have suggested abolishing the SB in favour of letting the independent director to perform its supervisory role fully.

3. How the supervisory rights and responsibilities are divided amongst the SB, the independent directors and the AC according to the framework of legislation and management of the SSE? How do these compare with one another?

See above.

4. In practice, what are the interactions and relations amongst the SB, the independent directors and the AC within the framework of legislation and management of the SSE? How do these compare with one another?

See above.

5. Does each member of the SB and the AC have to be an 'independent director' according to the framework of legislation and management of the SSE?

The AC: the majority and the Chair have to be independent directors.

The SB: the members are mainly the union Chair and employee representatives within the company, who act for the interests of the employees and the society to some extent.

6. What is the definition of an 'independent director' according to the framework of legislation and management of the SSE?

An independent director should be independent to the appointing company and its major shareholders, and must not take on any role other than being an independent director in the said listed company.

7. Do members of the AC need to be approved by an overseeing organisation such as the SSE or any specific regulation according to the framework of legislation and management of the SSE?

The appointment of an independent director needs to be approved by the general meeting of shareholders, and the candidate needs to have received relevant professional trainings.

8. According to the current Chinese regulations on the SBs, the independent directors and the ACs, the installation of the AC is not mandatory. Is there any corporation under any special circumstance for which the installation of the AC is mandatory?

Such a scenario has not happened. Currently, two thirds of the companies have installed the AC under the BoD.

9. Is there law or regulations that specify the constitutions, functions and operations of the SB, independent directors and AC according to the framework of legislation and management of the SSE?

The operations of the SB are specified in the ‘Company Law of the People’s Republic of China’ and the operations of the independent directors and the AC are specified in the ‘Code of CG for Listed Companies in China’.

10. In view of the current situation of China and Chinese culture, what in your opinion is the ideal supervisory function? How the company should operate to enable the CG mechanism to function well?

The equity of listed companies in China is concentrated in the hands of major shareholders. The key to supervisory function is to reinforce the changes in the BoD. Specifically, these include: enhancing the independence of the BoD, establishing the self-appraisal system of the BoD, increasing the effectiveness of the operations of the BoD, perfecting the company’s internal control mechanism and supervisory system, improving the overall quality of the directors, and implementing the continued professional development of the directors.

Xu, T-m. (2007). *Interview with Mr. Xu (Xu Tian Min), Manager of the Property Right Management Department of the State-Owned Hangzhou Industrial Assets Management Co. Ltd. (國營杭州資產管理公司), on 25th July 2007. Hangzhou.*

[Video recording in possession of author]

1. How well does the SB of your company perform?

It is not ideal, and its installation seems a mere formality.

2. What is the reason behind this?

Because of historic reasons, in a state owned enterprise such as ours, there is no evidence that the SB is functioning properly. There are 79 investment corporations under our enterprise, most of which has foreign investment, for which the mechanism of the AC applies, yet Company Law in China demands the installation of the SB.

3. Since the SB cannot function in a state owned enterprise, do you think it is necessary to install it?

Yes, it is definitely necessary.

4. It is necessary to install it according to the regulations, but why do you think it cannot function as expected in practice?

The main reason is that many of the members of the SB are internal staff, and it is impossible for internal staffs to supervise independently. Furthermore, they are under those they are supposed to supervise (in their daily role), how can that be done? So the main reason is a lack of independence. The second reason is a lack of expertise. Though the members of the SB enjoy high reputation and social status, the level of their expertise is questionable. Frankly speaking, most members of the SB are not well qualified. Thirdly, though there is specification in the relevant regulations, it is lacking in its implementation.

5. What is your opinion in encouraging the installation of the AC?

I think this is incredible that the regulation puts the AC under the BoD because it is questionable how it can operate independently in practice within such as model. The SB and the BoD are on the same level, so the former can supervise independently. The SB needs to have real power for it to play its role in supervision. If the AC is formed as an internal audit unit under the SB, then the two institutions can have meaningful relation. Yet in the current design, (in addition to the fact that) the AC is under the BoD, and the SB and the AC do not have direct hierarchical relation, yet both play the role of supervision. (That is incredible.)

6. It seems that there is overlap between the functions of the two institutions.

How are these defined?

The function of the supervisory function is to supervise the BoD, whereas function of the BoD and the Management is to execute. The former is the supervisory unit, and the latter the executing unit.

7. How do you think the hierarchical relation between the SB and the AC should be?

I think the AC should report to the SB to form a vertically integrated system that integrates functions as well as human resources, and together they can achieve the supervision within the organisation.

Summary

To review and compare both governors' opinions on the key issues related to this research presented in the table below:

Table 47. Matrix of Two Governors' Interviews
(Source: Author)

| <i>Mr. Shih</i> | <i>Mr. Xu</i> | <i>Same/Difference</i> |
|---|--|---|
| 1. Is the SB functioning well? | | |
| "The power of the SB is superficial and cannot function as intended." | "It is not ideal, and its installation seems a mere formality." | Same |
| 2. What is the reason for the failing effectiveness of SBs? | | |
| "In practice, the Chair of the SB is generally promoted from the internal staff of the company, and most of its members also come from within the company, so it is merely a deliberative body under the control of the BoD." | "The main reason is that many of the members of the SB are internal staff, and it is impossible for internal staff to supervise independently. Furthermore, they are underneath those they are supposed to supervise (in their daily role), how can that be done? So the main reason is a lack of independence." Mr. Xu also highlights most of the supervisors lack expertise and implementation experience in practice. | Independence – Same Lack Expertise – Mr. Xu Lack of Implementation in practice – Mr. Xu |

| <i>Mr. Shih</i> | <i>Mr. Xu</i> | <i>Same/Difference</i> |
|--|---|--|
| 3. Is it necessary for SBs to exist in the future? | | |
| Mr. Shih highlighted "The key to supervisory function is to reinforce the changes in the BoD." Seemingly he expects the installation of ACs to improve the supervisory function. | Mr. Xu still insists it is necessary for the existence of SBs. "Yes, it is definitely necessary. " Mr Xu said "the SB and the BoD are on the same level, so the former can supervise independently. The SB needs to have real power for it to play its role in supervision." | Different Mr. Shih – reinforce BoD Mr. Xu – "Yes, it is definitely necessary. " |
| 4. It seems that there is overlap between the functions of the two institutions. How are these defined? | | |
| "In practice, the functions of the SB, the independent directors and the AC overlap with one another." | "The function of the supervisory function is to supervise the BoD, whereas function of the BoD and the Management is to execute. The former is the supervisory unit, and the latter the executing unit" | Different – Mr. Shih – overlap Mr Xu – no overlap |
| 5. How do you think the hierarchical relationship between the SB and the AC should be? | | |
| Mr. Shih said "the independent directors and the AC are stronger than the SB in their supervisory roles." Mr. Shih mentioned "some scholars and professionals have suggested abolishing the SB in favour of letting the independent director to perform its supervisory role fully." | "I think the AC should report to the SB to form a vertically integrated system that integrates functions as well as human resources, and together they can achieve the supervision within the organisation." | Different – Mr. Shih – AC stronger than SB and mentioned the scholars suggestion "abolishing" SB. Mr. Xu – form a vertically integrated system |

Both governors state the SB is not functioning well:

Mr. Shih stressed: "The power of the SB is superficial and cannot function as intended." And Mr. Xu acknowledged: "It is not ideal, and its installation seems a mere formality."

Both governors also highlighted a key reason failing effectiveness of SBs: lack of independence among the supervisors.

Mr. Shih: "In practice, the Chair of the SB is generally promoted from the internal staff of the company, and most of its members also come from within the company, so it is merely a deliberative body under the control of the BoD."

Mr. Xu: "The main reason is that many of the members of the SB are internal staff, and it is impossible for internal staffs to supervise independently. Furthermore, they

are underneath those they are supposed to supervise (in their daily role), how can that be done? So the main reason is a lack of independence.”

Mr. Xu also highlights that most supervisors lack expertise and experience of implementation in practice.

Though both governors do not regard SBs as effective, Mr. Xu still insists “Yes, it is definitely necessary. “Mr Xu said, “the SB and the BoD are on the same level, so the former can supervise independently. The SB needs to have real power for it to play its role in supervision.” Yet, Mr. Shih highlighted, “the key to supervisory function is to reinforce the changes in the BoD.” Seemingly, he expects the installation of ACs to improve the supervisory function especially in the case of ineffectiveness of SBs.

Companies who add AC may overlap between SBs and ACs. Here, the governors’ opinions on this issue differ. Mr. Shih commented: “In practice, the functions of the SB, the independent directors and the AC overlap with one another.” Yet, Mr. Xu highlighted differences due to their hierarchical relationship. Furthermore, Mr. Xu indicated that, “I think the AC should report to the SB to form a vertically integrated system that integrates functions as well as human resources, and together they can achieve the supervision within the organisation.” But Mr. Shih said, “the independent directors on the AC are stronger than the SB in their supervisory roles.” Mr. Shih also mentioned that “some scholars and professionals have suggested abolishing the SB in favour of letting the independent director to perform its supervisory role fully.”

Obviously, opinions on the co-ordination of the two supervisory institutions are different between the two governors and scholars. Mr. Shih thinks that ACs are stronger than SBs and also mentioned the scholars’ suggestion of “abolishing” SBs. But Mr. Xu merely called for the formation of a vertically integrated system.

To understand the co-ordination between SBs and ACs is therefore set as one of the research objectives in this thesis. The following section presents the evidence, in order to achieve this objective.

6.3.3 The Preferred Linkage of Interactions between ACs and SBs in Organisation

Possible Alternative Organisational Charts

The Current Chinese Governance Structure

In short, the core structure of a modern company involves a linkage of interactions going between stockholders and the stakeholders, through directors and supervisors, then the management, to the general workers. In a Chinese company, stockholders and stakeholders entrust their resources to the BoD as their agent for management, and delegate the tasks of supervising the BoD to the SB of the same hierarchical level. Several committees including the AC are established under the BoD as well as the management. This structure is illustrated in the figure below:

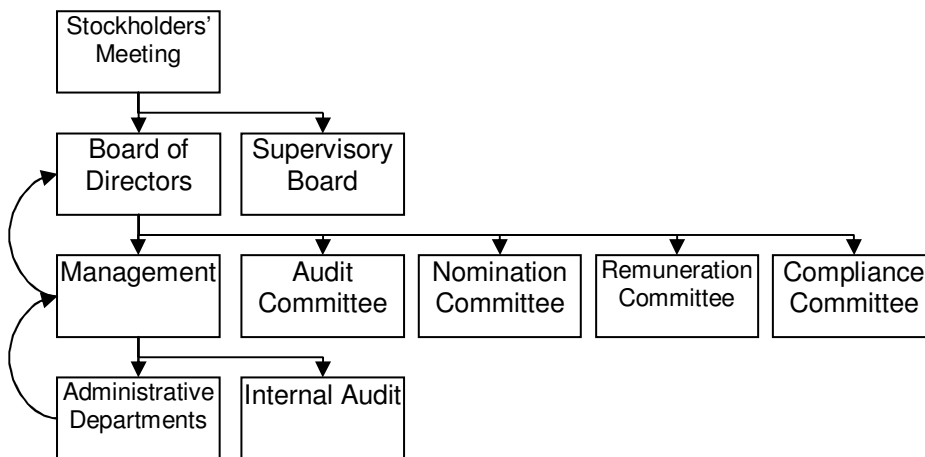


Figure 10. The Current Chinese CG Structure
(Source: Author)

To solve the problems identified with this structure, several modification options are considered below:

Establishing a Vertical Link

This option establishes a vertical link between the SB and the AC, so that the latter is subordinate to the former. In this option, the SB oversees the BoD, and the AC oversees the management. The resulting configuration is illustrated in the figure below:

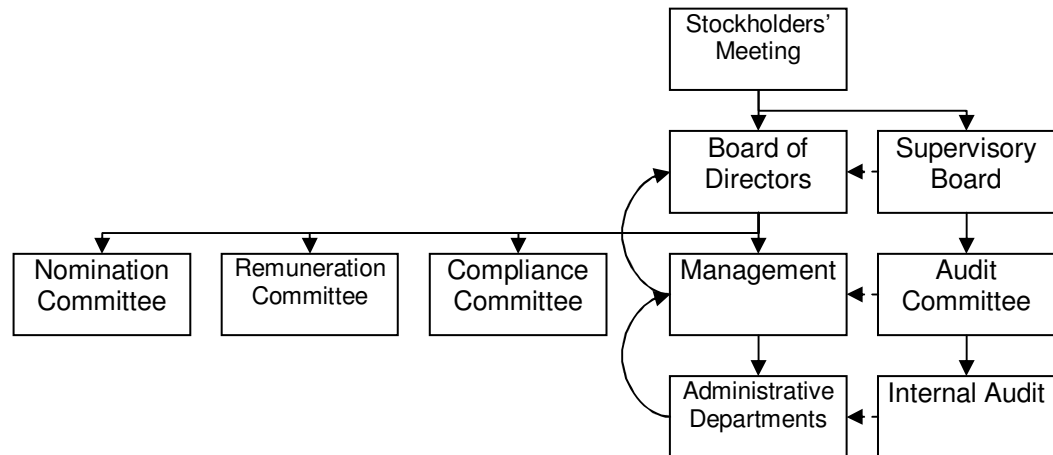


Figure 11. The Resulting Configuration of Establishing a Vertical Link between the SB and the AC
(Source: Author)

In the figure above, a downward arrow represents an administrative relationship between the superior and the subordinate; an upward curved arrow represents information feedback via business guidance and supervision in an administrative relationship; and a dotted arrow represents an oversight relationship. This configuration represents an internal supervisory system, having the organisational structure of two-way accountabilities, twin track reporting and maintaining dual relations.

The specific points of this configuration are:

- It can maintain the independence of the oversight institutions in relation to the overseen;
- It can realise the business guidance and supervision between the oversight institutions and reduce the risk of information asymmetry for the superior oversight unit;
- There is clarity between the levels of oversight and this is useful for determining the reward and punishment of the overseen at each level.

Integrating All Oversight Institutions

This option integrates the SB and AC into one new oversight unit. The resulting configuration is illustrated in the figure below:

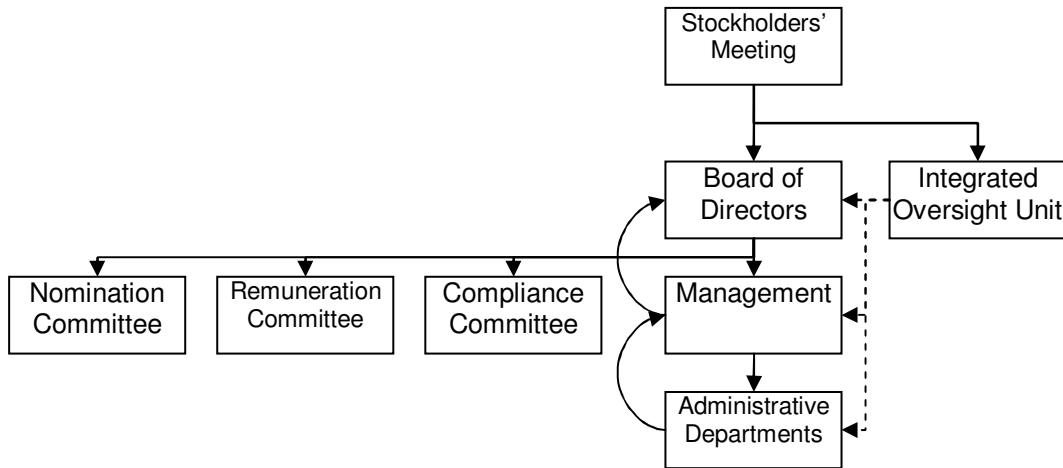


Figure 12. The Resulting Configuration of Integrating All Oversight Institutions
(Source: Author)

The specific points of this configuration are:

- Integration can strengthen oversight functions and save oversight costs;
- Incorporating the regular elements prevents the integrated unit from being incapable of performing daily oversight tasks;
- Having representatives of the stockholders, the stakeholders and other supervisory institutions places the integrated unit at a level not lower than the directors or the senior managers, crucial in preventing the integrated unit from being rendered powerless against the directors and senior managers.

Promoting the AC

This option promotes the AC to the same level as the SB and the BoD. The rationale is that counter balancing the members of the BoD is part of the scope of the functions of the AC. The resulting configuration is illustrated in the figure below:

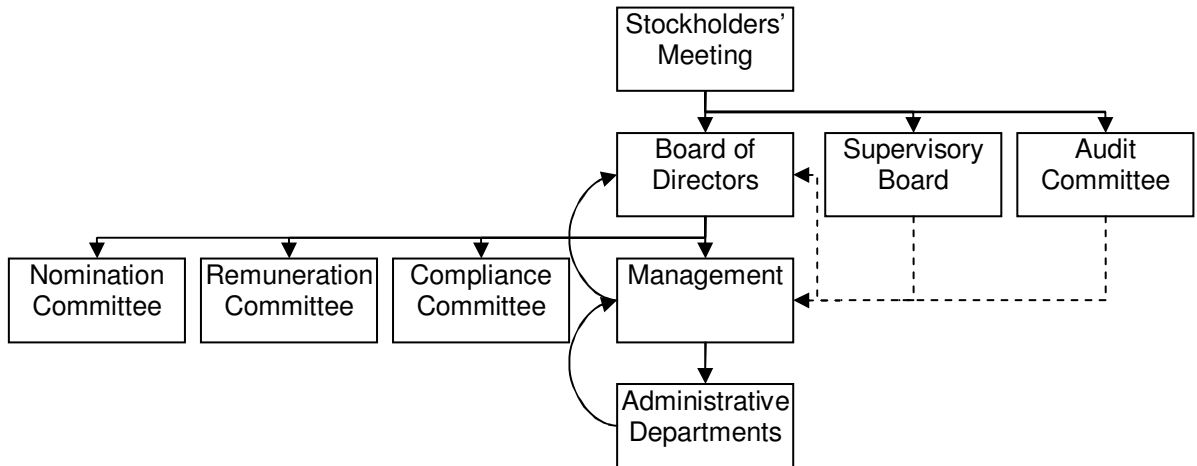


Figure 13. The Resulting Configuration of Promoting the AC
(Source: Author)

The specific points of this configuration are:

- It frees and safeguards the independence of the independent directors by freeing them from the control and interferences of the BoD and enabling it to engage external accountants directly and independently;
- It enables the SB to concentrate on the oversight and restraint of the BoD and the management and reaffirms its role by strengthening its functions.

Abandoning the AC

This option abandons the AC, and allows the SB co-ordinate and co-operate with the Internal Audit instead, each emphasising a separate area of supervision, where the latter can perform daily oversight for the former. The resulting configuration is illustrated in the figure below:

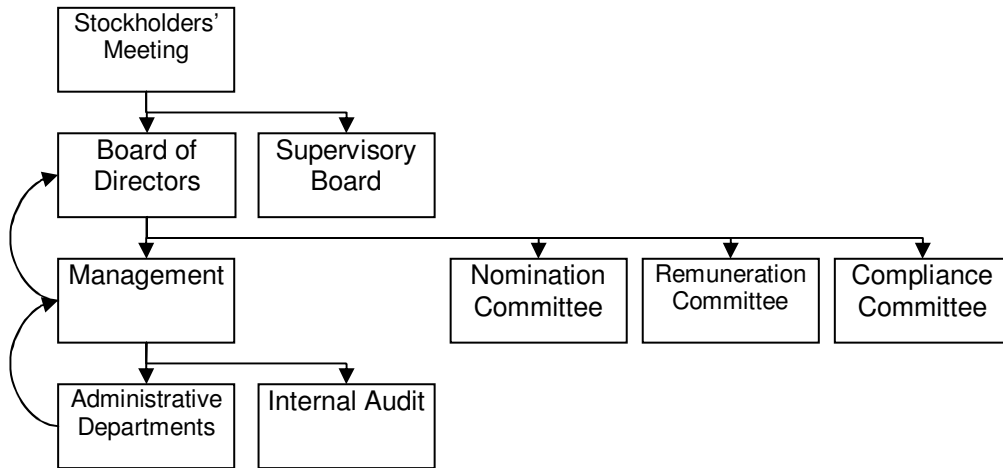


Figure 14. The Resulting Configuration of Abandoning the AC
(Source: Author)

The specific points of this configuration are:

- It reverts to the organisation before the 2002 launch of CG. Listed companies will not face the interaction problem between SB and AC.
- Investors may not have confidence in Chinese listed companies if they lack the internal supervisory mechanism of the prevailing CG models in modern society.

Removing the SB

The fifth option removes the SB. The resulting configuration is illustrated in the figure below:

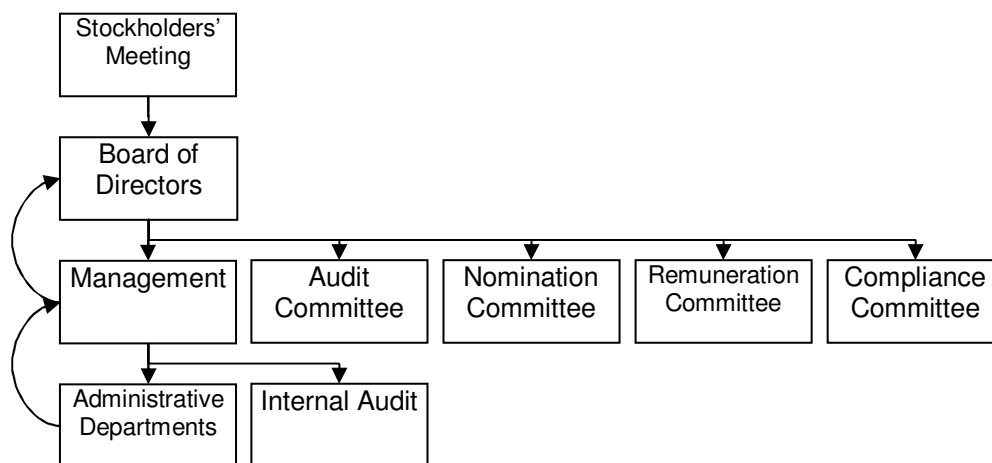


Figure 15. The Resulting Configuration of Removing the SB
(Source: Author)

The specific points of this configuration are:

- It may strengthen investor confidence in listed companies, thanks to the adoption of the “standard” modern CG model, which relies upon AC to perform the overseeing function.
- Chinese listed companies may be reluctant to adapting to this: for they set up SB in 1993, and Chinese governance culture is also distinctive in comparison to Western societies.

6.3.4 Findings on the Preferred Linkage of Interactions between ACs and SBs

The results from the telephone survey on the preferred linkage of interactions between ACs and SBs are presented in the table below:

Table 48. The Results from the Telephone Survey on the Preferred Linkages of Interactions between the SB and the AC
(Source: Author)

| Alternatives | Number of companies | of companies |
|---|---------------------|--------------|
| a. Establishing the vertical link | 5 | 8% (5/61) |
| b. Integrating all oversight institutions | 22 | 36% (22/61) |
| c. Promoting the AC | 13 | 21% (13/61) |
| d. Abandoning the AC | 4 | 7% (4/61) |
| e. Removing the SB | 9 | 15% (9/61) |
| f. Retaining the current status | 8 | 13% (8/61) |

The findings from the telephone surveys reveal that the linkage of interactions in the internal supervisory mechanism that most companies in China prefer are as follows: 36% want to “Integrating all oversight institutions” (figure 12), 21% “Promoting the AC” (figure 13) , 15% “Removing the SB”(figure 15); 13% for “Maintaining the current status” (figure 10); 8% for “Establishing the vertical link” (figure 11); and only 7% for “abandoning the AC” (figure 14).

The preferred interaction linkage between the SB and the AC in organisation is listed and their characteristics analysed according to the order of preference as follows:

Summary

No. 1 Preference: “Integrating all oversight institutions”

This option can establish an independent control system. In the current structure, promotions and relegations of the overseers are controlled by the major managers,

who are supposed to be overseen by the former, thus making the former lose their independence. The modification can eliminate this problem of independence together with the problem of substandard expertise, and can therefore reduce the problem of dereliction of duty or collusion of the overseer: an important measure establishing a protection system for the overseeing auditors and correcting current defects of promotion and relegation, so helping them achieve their role of counterbalance.

No. 2 Preference: “Promoting the AC”

This choice can eliminate the abnormality of self-oversight, as an AC under the BoD is easily fettered by the latter. This prevents the former from being fully functional in supervision, leading to financial scandals such as the case of Enron. Such defects can be rectified by promoting the function of the AC.

No. 3 Preference: “Removing the SB”

The role of SB in China is more symbolic in substance than the expectation in actual practice. Removing the SB may save the agent cost by fully applying AC based on the Anglo-American supervisory mechanism. There is no SB in the Anglo-American CG model, in which independent overseeing functions are performed by independent directors solely. The related regulations are adequate in the US and UK as compared to Chinese regulations, in which applied dual supervisory institutions is peculiar. China may directly benchmark the American and British supervisory regulations in applying this organisation chart.

No. 4 Preference: “Retaining the current status”

No direct reporting or interaction exists between AC and SB. Both can perform the functions as usual. There is no cost of co-ordination to the organisation. The sampled listed company may choose to remove ACs if the AC’s performance is not acceptable, because presently the AC’s establishment is a voluntary choice.

No. 5 Preference: “Establishing the vertical link” – let AC reports to SB directly

This option can integrate the oversight function because there is a complementary relationship between the SB and the AC. Placing the SB at the highest level of the control mechanism in the company, once authorised can exert supervisory power with

a more detached stance. Being a regular institution, it can perform daily supervisory follow-ups. On the other hand, being one of the committees under the BoD and having the mechanism for preventive and strategy supervision, the AC can counterbalance the major stockholders and internal representatives in the BoD, and subsequently improve the operational mechanism of the BoD, as well as being the link between the SB and the Internal Audit, and the backbone of the internal supervisory system.

No. 6 Preference: “Abandoning the AC.”

Since the SB is not effective in the current system, this choice concentrates on strengthening and improving the function of the SB and its co-operation with the Internal Audit in order to realise effective oversight. Co-operative relations can be:

1. Unified: having the Internal Audit under the leadership of and reporting to the SB, incorporating the work of the former into the latter for unified planning and implementation;
2. Controlled: keeping both at their current separate positions, but allowing the SB to supervise the content and quality of the work of the Internal Audit to reduce workload and strengthen the enterprise management system;
3. Collaboration: keeping both at their current positions, but sharing the oversight workloads, having the SB concentrate on supervising the conduct of the directors and the management as well as the corporation’s overall financial balance, leaving the oversight of the business activities and financial balance of the administrative departments to the Internal Audit.

This survey reveals the listed companies’ preference for integrating all in one entity. It shows that their first preference of integration was based on the belief that it can be beneficial in promoting independence, which is the most serious problem facing the effective performance of the supervision of CG in China; and also to solve the hierarchy reporting problems of internal supervisory mechanisms of all supervisory institutions, which may bring about a positive co-ordination of their functions, saving cost and smoothing out supervision.

6.3.5 Conclusion on Co-ordination

China's supervisory mechanism is peculiar in that it integrated the SB of the German CG model and simultaneously adopted the AC of the Anglo-American model. Therefore, how to synchronise these two models has become a particular challenge facing China today. In order to improve the supervisory mechanism of CG in China, this research elaborated on strengthening the relationship between the SB and AC.

This study started by interviewing two governors, whose opinions differed in terms of the co-ordination of the supervisory institutions of the SB and AC. Mr. Xu wants to allow the AC to reports to the SB directly; yet Mr. Shih wants to abolish the SB. It is very apparent that the issue of co-ordinating the SB and AC remains to be resolved in the future.

In terms of organisation, the telephone survey shows that the majority of Chinese companies prefer to integrate the AC and the SB into one unit. Most respondents also confirmed that the two institutions overlap in executing their supervisory functions simultaneously in one organisation. The second preference “Promoting the AC” is in sharp contrast to the least popular choice, “abandoning the AC”, which could be an indication that listed companies have higher expectations on the effective performance of ACs when the latter are integrated into their internal supervisory mechanism. Some would even like to remove the SB so as to enable the AC to play its monitoring functions fully. This may explain why the influence of the SB is not essential in most organisations, and why most companies in China can adopt a sensible approach with or without SBs. The respondents’ third choice – “Removing the SB” – and their fifth choice – “Establishing the vertical link” – could indicate that listed companies have lost their confidence in the effectiveness of SB in China, and therefore, do not expect that SB can lead AC in improving the effective performance of supervision in the future.

There is no direct inter-dynamic relationship between the AC and the SB at present, so it would seem sensible to co-ordinate their relationship. This preference, revealed by surveying 330 listed companies, formed a clear conclusion to the study.

Chapter 7 Conclusion

7.1 Introduction

This research started by studying the difference between SBs and ACs, from which three key research objectives emerged. To achieve these objectives, research theories, literature reviews, and the background behind the internal supervisory mechanism in CG and the security market in China were therefore studied and addressed in Chapters 2 to 4. Research methods were designed and presented in Chapter 5, they guide with which to find the evidence in order to achieve the three key research objectives. Three phases of empirical studies in Chapter 6 specified the effectiveness, the operations of supervisory functions and the co-ordination between ACs and SBs in terms of organisation. The findings from these empirical studies with reference to the related studies in Chapters 2 to 5 are summarised and presented in the final chapter of the Conclusion.

This chapter begins by concluding the relationship between the theory and the research results by checking the research results against the applied theories. The findings are then presented, in order to reveal the answers on which system is more effective and on the contribution of the AC in China. Following this, the findings on promoting the effectiveness of the SB and AC in China respectively, and which suggest the preferred linkage for improving the co-ordination of the two supervisory institutions in China, are also presented. The limitations of this work are discussed in order to provide for more extensive researches in the future; and it is concluded by identifying the original contributions of this thesis.

7.2 Theories and Results

Six theories have been reasoned and relied on in this thesis. The empirical research results check whether these theories conflict or support the applied theories, summarised in the table below.

Table 49. The Relationship between the Applied Theories and Research Results.
(Source: Author)

| No. | The Theory (cf. the chapter on research theories) | The Key Research Results in Relation to the Applied Theories | The Relation between the Theory and Result (Support/Conflict) |
|---|---|--|---|
| Principal theories: shareholder and stakeholder theories | | | |
| 1 | Shareholder | The findings of question 1 and 2 present the establishing of the AC in the monitoring role can contribute to enhance the effectiveness of implementing supervisory functions in China. | Support |
| 2 | Stakeholder | The findings of questions 3-5 all support the continuation of this system of establishing the SB in the future though it proves that SB effectiveness should be enhanced at present. | Support |
| The other approaches: managerial hegemony, political, institutional and resources dependency theories | | | |
| 3 | Managerial Hegemony | The findings of question 1 and 2 prove the contribution of the AC is not only a legal fiction; and the SB is also demanded to continue enhancing the consolidation by the findings of question 3-5. The results conflicts the theory that governing board serves simply as a rubber stamp. | Conflict |
| 4 | Political Model | The findings suggest China should explore its unique CG setting and model. The findings of question 4-5 of co-ordination study provide the suggestions for China's suitable internal supervisory mechanism to suit its political environment. | Support |
| 5 | Institutional Ownership | The findings of section (4.7) suggest an exploration of shareholding structure status by examining top 3 shareholders shareholding %; and also the CEO dual positions with President of the BoD as two variables to test the impact on the effectiveness the supervisory functions. The test results present no significance and the firms after adding in ACs did not decrease these two situations of CEO dual positions; neither did they decentralise the shareholding structures in China. It is therefore concluded that big shareholders can still play an important role even though the AC has joined the BoD in China. | Support |
| 6 | Resource Dependency | The role of the AC played in China is proved to provide the added value as the advisor/consultant and trainer in addition to independent control. | Support |

In addition to the two principal theories of shareholder theory and stakeholder theory, the other approaches such as managerial hegemony theory, political model theory, institutional ownership theory, and resources dependency theory were also discussed in Chapter 3 of this thesis.

Two principal theories:

It has been argued that while shareholder theory forms the basis with which ACs have been introduced into China, acting as a monitor, creating in the existing SBs a high expectation for the impact of ACs on effectiveness, stakeholder theory provides the basis for the key role in supervisory functions that the SB has served in China since 1993, even though ACs were introduced in 2002. The findings for questions 1 and 2 in this study show that establishing the AC in a monitoring role can contribute to the effectiveness of implementing supervisory functions in China; and the findings of questions 3-5 support the continuation of this system in the future, although SB effectiveness needs to be enhanced first. Therefore, it is concluded that both theories of shareholders and stakeholders have empirical validity in terms of the research findings in this thesis.

The other four approaches:

Political model theory and institutional theory are applied to introduce the background – the supervisory mechanism of CG in the West and China - as well as providing an overview of China's political environment in relation to the development of supervisory mechanism of CG, and the relationship between shareholding structures and internal supervisory mechanism. Institutional Ownership theory suggests that when the institutional shareholdings are large it is difficult to switch their invested capital from one firm to another; consequently, they play an important role in the decision making. In this thesis, institutional theory is also employed as part of political model theory to enhance understanding of the background relating to the shareholding structure in China. The findings suggest that China should examine its unique CG setting and model. The findings of questions 4-5 on co-ordination provide suggestions on China's most suitable internal supervisory mechanism. The findings of section (4.7) examine shareholding structure, by looking at the top 3 shareholders percentage, and also instances of dual CEO / President of the BoD positions, as two variables to test impact on the effectiveness of supervisory functions. The test results show no significance, and firms find that adding in ACs does not help to decrease the regularity of dual positions, or to decentralise shareholding structures in China. It is

therefore concluded that big shareholders still can play an important role, even though the AC has joined the BoD in China. These research results are to some extent consistent with interpretations from the political model and institutional theories.

Hung (1998) adds that the governing board of a company serves simply as a rubber stamp. Managerial hegemony theory is founded as the basis with which to study the effectiveness of SBs and ACs in China. The findings of question 1 and 2 prove the contribution of the AC is not a legal fiction; and the SB is also expected to continue enhancing the consolidation, according to the findings of questions 3-5. The results are therefore not consistent with the theory that the governing board serves merely as a rubber stamp or legal fiction.

Resource dependence theory is used to assess whether ACs in China are limited in exercising independent control. The role of the AC played in China is shown to provide added value, as an advisor/consultant and trainer in addition to independent control, results which can be interpreted to some extent as consistent with the theory.

The findings are considered from the perspectives of the applied theories in this thesis. These two principal theories and the other four approaches serve as foundations for appraising the effectiveness, operations and co-ordination of the internal supervisory mechanism. The applied theories guide this thesis to focus on the evaluation of a reliable degree of trust or the impact level of accountability, instead of a mere judgment of “good” or “poor” operations and co-ordination of supervisory functions.

7.3 Findings

7.3.1 Findings on Achieving Key Research Objective One: Effectiveness

Q1: Which system – with or without ACs – has more effective supervisory functions in China?

It is intended to test which group of the companies – with or without ACs – has more effective supervisory functions in terms of improving market response to the earnings (PER), firm size, growth rates of assets, returns on assets and decreasing the debt ratio,

as a proxy (PER) and four control variables to prove whether companies with or without ACs improve their credibility to shareholders.

Answer to Q1: H1 can be proved by testing that Group 2 with ACs has more effective supervisory functions than Group1 without ACs, as proven by the average growth trend of market response to earnings (PER), the firm size (total assets), the debt ratio; and also proven by the comparison between two groups of four control variables of debt ratio, growth rate, return on assets and the firm size. However, the test result of market response to the earnings (PER) in Sample 1 was *** inverse to H1. It may be inferred that the period in which ACs have been built up has not been long enough for them to develop effective supervisory functions. As China announced the regulation encouraging the establishment of ACs in 2002, the longest possible period for its supervisory performance is only five years, and in many cases, considerably less. SBs, on the other hand, have existed since 1993, when they were introduced by the Company Law.

Regardless, the test result on the average growth trend of market response of earnings (PER) shows that Group 2 with AC is better than Group 1 without ACs. These results may help persuade listed companies to implement ACs in the future.

Q2: Will the AC contribute to the effectiveness of the supervisory functions in China?

It is intended to test whether listed companies after implementing ACs can increase their independence, expertise, operations, and decentralize their shareholding structure; as well as decrease the number of dual positions of CEO and President of the BoD.

Answer to Q2: The test results intended to prove H2 show that companies who had implemented ACs are significantly different on 6 out of 17 variables. This illustrates that listed companies that have implemented ACs are different with respect to 6 variables of independence, legal and internal audit expertise and activities and the firm size in relation to market response of earnings (PER). These results suggest the possible contributions of ACs as follows:

Independence: The more directors who receive remunerations will lead to a lower market response to earnings. According to the comparison result intended to prove

H2, listed companies after adding in ACs will decrease the proportion of independent directors receiving remuneration, so improving the effectiveness of supervisory functions.

Expertise: The higher legal expertise on SBs will lead to a higher market value to earnings; and the higher internal audit expertise in SBs will also lead to a higher market value to earnings. According to the comparison of groups, listed companies after adding in ACs increase their percentage of legal and internal audit expertise, so enhancing the effectiveness of supervisory functions in China.

Diligence: The number of supervisors (“Num1sbsize”) in Group 1’s test is contrary ** to the hypothesis: that the bigger the size of SBs, the higher the market response to earnings (inverse *). It shows that the quantity of members of SBs may not be a factor impacting on the quality of supervisory functions. According to the comparison between groups, listed companies after adding in ACs increase the size of SBs but this factor may not impact upon the effectiveness of supervisory functions.

The result for Group 1 for the variable of frequency of SB meeting shows that more active meetings of SBs will result in a higher market response to earnings (***). The diligence of more meeting times in implementing supervisory functions is recognised by shareholders. But according to the comparison result intended to prove H2, companies after adding in AC do not increase meeting times of SBs. The explanation may be that after implementing ACs companies put more focus on strengthening them, rather than SBs, to improve the effectiveness of supervisory functions in China.

Firm size: The test result of the firm size ($\ln_{(Asset)}$) presents ** significance in Group 1 and *** impact in Group 2. Both groups’ test results show that larger firms will enjoy a more stable market response to earnings.

7.3.2 Findings on Achieving Key Research Objective Two: Operations

The findings are summarised from two case studies by interviewing the members of SBs and ACs and considering the studies of regulations and literatures for improving the effectiveness of the supervisory functions in China.

A. Findings on Promoting the Effectiveness of SBs in China

In order to enable the internal supervisory mechanism of CG in China to perform more effectively, ineffectiveness of SBs, insufficient powers and lacklustre legislation are all worth heeding. The findings from the interviews and considerations relating to the study of the regulations and literature are summarised herein:

Lack of Independence of SBs

1. The problem of insider control and lack of external independent supervisors: the independence of members of the SB needs to be strengthened by instituting regulations which take into account the interests of the stakeholders of the company, by preventing the members being influenced by insiders, and setting the appropriate of external independent supervisors.
2. The problem of high concentration of shareholdings and lack of independent supervisors: protecting the interests of small and medium shareholders need to be enhanced by stipulating that SB members should be independent supervisors. This would offer a check and balance against the high concentration of shareholdings in listed companies in China.
3. Problems of voting system and lack of independence: greater attention should also be given to the voting system for the election of shareholders representing supervisors, in order to increase the effective voting power of small shareholders and expand the opportunity for their voice to be heard in the SB.

Lack of Expertise of SBs

1. Lack of expertise: the requirements for professional expertise among SB members need to be regulated and enforced. Currently the Chinese Company Act requires SBs to examine the company's finance, but has no requirement for financial or accounting expertise in the membership; this has resulted in boards lacking the competence needed to meet their responsibilities. Hence the Chinese Company Act should be improved by specifying requirements for financial or accounting expertise in the SB.
2. The problem of dual positions of supervisors: restrictions on the number of supervisory positions a person may concurrently occupy would help ensure that each individual's efforts are concentrated in supervising the company effectively.
3. The party member employee: Due to the existence of company supervisors with

political party status but who lack accounting, financial, legal or auditing expertise, there is a need to reduce the of membership based on political party connections.

Lack of Operations of SBs

1. There is a need for the rights and responsibilities of members of the SB to be enhanced and their operational procedures to be streamlined. As things stand, members have been unable to properly exercise their supervisory duties due to the lack of a clear definition regarding their authority on executive management. The foundation of effective supervision also lies in having rights of access to information. Having independent and unobstructed rights to supervise and review is crucial in assuring the reliability of the supervisory system. Some crucial areas where existing regulations in the Chinese Company Act should be revised include the following:
 - a. The SB's powers with respect to the right to propose the appointment and removal of members of the BoD should be increased, subject to approval by shareholders in a general meeting.
 - b. The ability of the shareholders to impose effective sanctions on SB should be increased, for example through additional regulations on accountability and removal of the collective or individual members whose ineffective oversight or misconduct can cause serious losses to the shareholders.
 - c. Following German measures protecting the right of access to information, similar regulations should be instituted in China to mete out penalties for obstructing or failing to protect the SB's right to information.
 - d. While certain activities may be carried out by the BoD only with the approval of the SB, the rights of supervision with respect to a number of areas of action should be strengthened, such as (1) major operational activities related to the expansion of the company, (2) the opening and closure of subsidiaries, (3) the opening, closure, merger or relocation of major production departments, (4) decisions regarding related companies that can have a significant influence on the parent company itself, (5) large investments, borrowings, loans or economic securities exceeding the amount previously approved, (6) real estate investment, (7) the appointment of plenipotentiaries, (8) major legal proceedings, and (9) major changes pertaining to the employees' wages, benefits and other subsidies. Other points in the German system should also be considered to enhance the functions of

SBs in China.

- e. Currently the Chinese Company Act provides the SBs with the right to take corrective action but there is no specification regarding the approach and extent of such corrections. Hence, this provision should be revised to clarify the scope of SBs' powers.
 - f. Greater attention should be given to the operational procedures of supervision, for example regarding the standards for audits and the principles of operation for the supervision, such as the annual supervision plan, review methodologies, and the frequency and content of regular actions.
2. The lower limit on the size of a SB is set at three members by the Chinese Company Act, but the upper limit is set by the company. Hence, there should be a greater role for the General Meetings of Shareholders to determine the size of the board according to the needs of the company's business.
 3. Currently, the Chinese Company Act only specifies that at least one annual meeting should be held by the SB. The minimum frequency of meeting should be increased to one meeting per quarter and quarterly reports should be submitted to the General Meetings of Shareholders.

In general, while SBs do not participate in the decision making of the company's management, nonetheless their governance function can be enhanced by focusing on examining the company's finances, supervising the regulated activities of directors, and last but not least, overseeing the reporting of information and the legal responsibilities of the directors and managers.

According to two case studies' interviews, both acknowledge the problems and difficulties in implementing the SBs and both expect the establishment of ACs to improve effective supervisory functions in China.

B. Findings on Promoting the Effectiveness of ACs in China:

The research findings indicate that there is still sufficient room for improving the AC's independence and operation. The findings from the interviews and considerations of the related regulations and literature are summarised as follows:.

Lack of Independence:**1: Lack of independence of AC:**

The regulations require only half of AC members to be independent directors. The two case studies illustrate that this number should be increased, and independence strengthened. Since the intention of introducing the AC into the Chinese CG structure is to strengthen checks against internal control by internal individuals, the independence of AC and its members should become the essential prerequisite in order to establish the supervisory function within Corporate Governance.

2. Lack of a mechanism for professional training of members of the AC:

Efforts should be made to guarantee the quality of members of the AC: it is important to establish a mechanism for professional training of AC members, to ensure their professional competence.

3. Lack of operations of ACs:**(1) The laws and regulations governing the AC should be improved.**

As the existing specifications governing AC in China are not clear enough, it is consequently very difficult to push for its smooth implementation. Furthermore, the lack of a well-defined operational guideline or assessment criteria has made it even more difficult, if not, impossible to establish an effective AC. Hence, the implementation and operation of the AC in China should be more concretely specified by laws and regulations.

(2) The overlapping problem of supervisory functions:

The nature and hierarchical relations of the AC and the SB should be specified. The introduction of the AC at a time when the SB still has not become fully functional has inevitably caused conflicts between their overseeing functions within the internal oversight mechanism. Further research findings regarding the co-ordination of the organisation is therefore presented in the next section, to remove the controversy regarding whether the AC should operate directly under the BoD or the SB in an

attempt to integrate the overseeing functions of the two bodies, as well as ensure that their functions are complementary to, rather than overlapping with each other.

(3) A positive interaction between the AC and the internal auditors should be established.

The AC relies on a large amount of information from internal auditing departments to guide the latter and to strengthen its organisational status, so as to guarantee its independence and effectiveness. To ensure the independence of internal auditing departments and the proper operation of the AC, the AC should at least have the power to review the appointments and removals of the Internal Audit managers, and the right to directly question the Internal Audit managers or request the internal auditors to carry out special investigations without the need to first obtain the approval from the management.

(4) Measures complementary to the role of the AC in market disclosure should be established.

The status of the AC should be included in the rules for market disclosure. There should be clear-cut regulations specifying its independence, professional capabilities, shareholding status, and appointments and removals of its members. Other complementary rules should include issues concerning the establishment of training and evaluation systems for independent directors on the AC, and the full publication of information related to the independence and professional capabilities of the members, such as a list of the members of the AC, their independence statements or the reason for not having one, and their certifications in accounting, auditing and securities. These rules are still missing in current Chinese regulations.

(5) The functions and roles of the AC should be established.

Since the AC belongs to the self-regulatory system of a company, its function should be for oversight and consultancy rather than checking on the company's daily affairs. Also, its view should be macroscopic rather than microscopic. Nevertheless, at present it is rather unrealistic to expect ACs in China to assume a role of decision making instead of oversight, since it is the BoD, rather than any of its special committees, which makes the final decisions for the company.

(6) Specific rules defining the rights and responsibilities of the AC should be established.

It is necessary to establish specific and clear-cut rules defining the rights and responsibilities of the AC and penalties or punishments to be meted out should it fail to carry out its responsibilities. Such rules will provide legal protection as well as the necessary restraint on the assertion of its rights and the execution of its functions. For instance, if the right to know is not clearly defined by law, the AC, having most of its members as independent directors external to the company, would not be able to get sufficient and up-to-date information on the company's operation, and thus would have difficulty in effectively overseeing the quality of the financial reporting and the effectiveness of the internal control of the company.

(7) A mechanism for encouraging and restraining members of the AC should be established.

It is indeed a tough challenge for the AC in trying to obtain sufficient information for oversight or to have enough time and energy for it, considering that most independent directors are busy people with substantial social status and reputation. Therefore, a good mechanism is needed to encourage as well as retain members of the AC in executing its overseeing function despite certain restraints.

After implementing ACs, listed companies face co-ordination problems and difficulties of overlapping and missing items in functions between SBs and ACs, according to the survey of five listed companies. According to two case study interviews, better levels of co-ordination may solve the problems of overlapping functions between SBs and ACs in China. The research result proves the problems of overlapping and missing status exist between the SBs and the ACs in China. Looking forward to the future, the coordination between two supervisory institutions in terms of organization is therefore studied and the findings are presented as follows:

7.3.3 Findings on Achieving Key Research Objective Three: Co-ordination

In order to improve the supervisory mechanism of Corporate Governance, the findings after interviewing two governors, as well as research regarding co-ordination between the SB and the AC in terms of their organisation is summarised as follows:

Both governors acknowledge the SB is not functioning well, and highlight the main reason behind its failing: lack of independence. Mr. Xu also highlighted that most supervisors lack expertise and experience of implementation in practice. Though both governors regard SBs as ineffective, Mr. Xu still argues that, “Yes, it is definitely necessary. “ Yet Mr. Shih highlighted, “the key to supervisory function is to reinforce the changes in the BoD.” Seemingly, he expects the installation of ACs to improve the supervisory function.

Companies after implementing AC may face issues of co-ordinating them with SBs. Mr. Shih thinks that ACs are stronger than SBs, and he also referred to some scholars’ suggestion of “abolishing” SBs. But Mr. Xu asserted that a vertically integrated system would be a better idea. Opinions on the co-ordination of the two supervisory institutions differ among the governors and the scholars. Understanding the co-ordination between SBs and ACs was is therefore set as the third research objective in this thesis.

A telephone survey was used to research the linkage in the hierarchy between these two different institutions of internal supervisory mechanism. The order of preference for the interaction linkage between the SB and the AC was as follows: the first preference is “Integrating all three oversight institutions” by combining AC, SB and IA in one entity; the second is “Promoting the AC”; the third is “Removing the SB”; the fourth is “Maintaining the current status”; the fifth is “Establishing a vertical link” – allowing AC report to SB directly- the last is “Abandoning the AC.”

The survey also reveals listed companies’ opinions on their preference to integrate all three in one entity. It shows that choosing integration as their first preference is based on the belief that it can be beneficial in reducing lack of independence, the most serious problem impacting upon the effective performance of supervision of CG in

China, and can also solve hierarchical reporting problems of the internal supervisory mechanism of all the institutions in one organisation. In this way, integration may bring about a positive co-ordination of their functions, to reduce costs and improve the effectiveness of the internal supervisory mechanism.

The second preference, “Promoting the AC” is in sharp contrast to the last choice, “Abandoning the AC”, which could be an indication that listed companies have higher expectations of the effective performance of AC as part of the internal supervisory mechanism. With regard to their third choice, “Removing the SB”, and their fifth choice, “Establishing a vertical link”, both choices could indicate that the listed companies have lost their confidence in the effectiveness of SB in China, and therefore, they do not expect that SB can lead AC in improving the effective performance of supervision in the future.

Given the phenomena of functional overlapping and missing operations, it becomes pertinent to redefine their functions on the basis of division of work in order to promote mutual co-ordination between the SB and the AC. Their functions should be complementary. The two institutions have different requirements for members’ independence, professional literacy and working time. These different characteristics should be considered when allocating their functions because the members’ independence and professional knowledge structure will undoubtedly influence the quality of their monitoring function, while the members’ working time and meeting frequency will influence their participation in, and dedication to, monitoring progress.

The survey indicates an expectation of co-ordinating all the institutions as one as much as it reflects the request for establishing an independent control system to strengthen oversight functions, save oversight costs, enable the supervisors and members of the ACs to execute oversight tasks by avoiding the potential problem of independence, and empower them against the directors and senior managers by establishing a protection system regarding their promotion in status.

If the proposal for modification to improve co-ordination among the institutions of the internal supervisory mechanism and merge them into one entity is carried out, it will eliminate the problems of overlapping or missing functions. At the same time, it will not impact upon the checks and balances between the BoD and the SB in improving

the deficiencies existing in the internal supervisory mechanism of both the German and the Anglo-American CG models. To co-ordinate the organisation of the SB and the AC into one entity will make the co-ordination of their functions much easier. The recommended pattern is an innovative breakthrough, which will remove the limitation and the constraint inherent in the supervisory mechanism of CG in China.

7.4 Limitation and Discussion

There remains room for more discussion and suggestions for more extensive research in the future, for limitations of research framework and data may exist in this thesis.

7.4.1 The Evaluation of “Good” and “Poor” Performance

The AC had already been in place in the United States and United Kingdom long before it was introduced and implemented in China. However, despite their differing periods of existence, comprehensive, systematic regulations and norms govern ACs in these three countries. International regulations and norms for supervision are used as the criteria to examine the performance of the internal supervisory mechanism in China, and for appraising whether the supervisory performance in China has attained international standards. This research is based on the three characteristics of supervision covering independence, expertise and operation as a foundation with which to appraise the respective performance of AC and SB in China. The findings in appraising the performance of the SB in China suggest that in practice it is really not as “good” as expected, and still far below the requirement of international regulations and norms. The AC in China still faces difficulties and problems in how to meet the three indexes of supervision in effectiveness, operations, and co-ordination of supervisory functions. Overall, the performance of the two supervisory institutions of the internal supervisory mechanism in China may be defined as “poor” compared to the regulations of Western countries.

Nevertheless, it is essential to return to the initial points mentioned in the chapter on “The Development of Supervisory Mechanism of CG in the West and China”, in which the four key features of 1) governance culture, 2) legal environments, 3) ownership structure and 4) governance structure are identified as background factors influencing the formation of their respective CG models. These different factors have

also generated peculiar problems faced by the internal supervisory mechanism of CG in the West and China. The potential causes of these problems can be analysed according to the aforementioned four key factors, and then be further illustrated in each model individually. Therefore, in this respect it may seem reasonable to ask whether the appraisal of “good” or “poor” performance is appropriate or suitable, when assessing the performance of the internal supervisory mechanism of CG in China.

7.4.2 How to Define “Standard” Corporate Governance?

In recent years, the Anglo-American CG model has gained a high rating on the GMI ranking. Meanwhile, other studies such as Hansmann and Kraakman (2001) have also asserted that the CG model as practiced in both the US and the UK has been rated as most effective, leading them to refer to the Anglo-American model as the standard CG model. This thesis examined the historical development of the “standard” CG model of the UK and the US to illustrate the development of the supervisory mechanism. The findings suggest that the progress of a supervisory mechanism was a reaction to economic crisis and that, since the criteria for effective quality in the supervisory mechanism have continually increased, it has also become stricter over time. This explains why the “standard” keeps on moving forward: to meet the requirement of effectiveness based on the reaction to the corporate failure to prevent the occurrence of risk impact to both companies and markets.

This thesis studied chronologically the major economic events in more recent years and their impact on the internal supervisory mechanism report, and found that AC in the “standard” CG has not proven to be a perfect system, as was revealed in the Enron scandal of 2001 and the WorldCom scandal of 2002. The surveys by McKinsey (2000 and 2002) indicated that, following the scandals in the US, various Asian governments initiated serious efforts to improve the supervisory mechanism of Corporate Governance. In this context, the relevant question to ask is: will the reformation of the internal supervisory mechanism of CG in emerging markets such as China supersede the current “standard” model and the forerunners of the Western countries? Apparently, there is still scope for future research to continue monitoring the development of supervisory mechanism of CG, especially in terms of its improvement and impact.

7.4.3 The Expansion of the Samples

In this thesis, the samples of telephone surveys of 330 listed companies and the in-depth interviews with the two listed companies in China do not cover all of the listed companies in the country. Moreover, there are gaps in responses between comprehensive and random samples. Though the telephone surveys have covered over 50 per cent of the listed companies with ACs, and over 50 listed companies answered each survey question, it was unrealistic to expect all the sample companies to agree to participate in the survey. The in-depth interview was designed to understand the implementation status, so as to find the problems of the operations and co-ordination between the ACs and SBs. Although this thesis has done its best to balance the trade-off between generalisability and understandability, it still leaves room for further research by expanding the sample size and range.

7.4.4 The Extension of Research Target Area

In addition to it being applied to the Chinese model, the research structure and research design of this thesis can also be applied to study the practices and performance of the internal supervisory mechanism in other areas, such as the Greater China Area which includes Taiwan and Hong-Kong, and the Association of South-east Asian Nations (ASEAN), comprising the ten nations in the region: Vietnam, Thailand, Cambodia, Myanmar, Laos, Brunei, Malaysia, the Philippines, Indonesia and Singapore, which has emerged as potentially the greatest regional economy and market.

7.4.5 The Extension of Research Specification by Industries

This research can be further extended through specification by industries, especially for financial institutions and banks, whose credit is the foundation for them to acquire and retain business. It may be assumed that they have more requirements for internal supervisory mechanisms than other industries, but it is a topic worth studying to discover whether comparison by industries proves the assumption. The lack of internal supervisory mechanisms of financial institutions and banks may result in escalating the financial crisis to national level. More progress on extending this research will contribute to better protecting investors at times of social chaos.

7.5 Research Contributions

The contributions of this thesis' research may be identified as follows:

- (1) This research has illustrated the effectiveness of two systems – SBs alone and the SBs plus ACs – of CG in China. The understanding of the effectiveness between two systems of internal supervisory mechanism of CG in China is proven by the evidence collected from analyzing the quantitative test results of t tests of five proxy variables of effectiveness, and the observation of the growth trend of market response to earnings.
- (2) This research has presented the AC's contributions in improving the characteristics of supervisory functions in China. The evidence is collected from the regression test results of Panel model by comparison of every character's coefficient of independent variable response to market response to earnings (PER-dependent variable) of supervisory functions of the two systems of SBs alone and SBs plus ACs in China.
- (3) This research has gained an understanding about the implementation of SBs and ACs in China. The findings and suggestions for solving the problems arising in implementing the effectiveness of SBs and ACs in China are identified by interviewing the members of two supervisory bodies of two cases and by studying regulations and literature.
- (4) This research has reported the role of ACs played in China. The evidence is collected from the telephone survey, responded to by 65 out of 330 listed companies with ACs. The finding was analysed through the statistics of the roles defined by the regulated main functions of the AC in a listed company, calculated, and then compared to the stipulated functions.
- (5) This research has identified the day-to-day operations of these two institutions' supervisory functions and has reported the overlapping and missing operation percentages and items of supervisory functions between SBs and ACs in China. The operations items are defined through studies of the related regulations and charters; and the overlapping items and

percentages between two supervisory bodies are researched through the survey of five listed companies, with experience in implementing the ACs.

- (6) This research has pointed out the preferred linkage of co-ordination between SBs and ACs in China. The two systems with or without ACs will both exist in the future according to the two governors' assertions and opinions on the framework of legislation and management of government; and the preferred co-ordination is collected from the telephone survey of 330 listed companies, with over 60 responses commenting on interactions between the SB and the AC in organisations.
- (7) This research has gained a better understanding of the regulation gap by comparing the standards between the related international and Chinese regulations.
- (8) This research has gained a better understanding of the gaps in practice by comparing the regulations and standards, and actual practice in China.
- (9) The research results of this thesis may serve as a useful reference point for carrying out similar studies on this topic in the future.

Meanwhile, this research may have made the following contributions to academic works:

- (10) Input the understanding for the effectiveness of ACs

Goodwin and Seow asserted that "Further investigation into the effectiveness of AC is needed" (Goodwin and Seow 2002: 220). Collier concluded that evidence of their effectiveness was very limited and certainly insufficient to support their rapid increase in popularity: describing this as a 'curious phenomenon' (Collier 1996). Spira appeals for research on how AC undertakes its tasks and why its impact cannot be adequately assessed (Spira 2003). Accordingly, further research into CG and AC effectiveness is called for. This thesis has evaluated the effectiveness of two systems – SBs alone and SBs plus ACs in China – by answering research question 1.1; and this thesis has evaluated the contribution of ACs in improving the characteristics of supervisory functions in China by answering research question 1.2. This thesis has achieved

objective one: to understand the effectiveness of SBs and ACs in China. Hence the ACs' performance measures on effectiveness input in this thesis may enrich the literature on academic work.

(11) Input the understanding for the processes associated with the operation of ACs

Turley and Zaman (2004) commented: "There is very little evidence on the processes associated with the operation of ACs". This thesis has replied to their appeal by revealing the process of supervisory functions implemented by the SBs and ACs in China. The evidence is collected from the identification of operations items of supervisory functions, in the form of a checklist. This checklist can contribute to future research to understand the processes associated with the operation of ACs. It has also been used to survey the operation processes of ACs from five Chinese listed companies. The Chinese practice of processes associated with the operation of ACs has been revealed in this thesis.

(12) Input the understanding of the viewpoints of "actors"

Spira (2002) noted that only a few studies have examined the perspectives of actors involved in ACs' processes.

This research was not only based on visits and field surveys arranged through the co-ordination of the Secretary of the BoD of companies in China. (the Secretary of the BoD is in charge of the co-ordination of supervisory functions and related supervisory issues, including the SB and AC in China). This thesis also covers interviews with the real "actors" – the players in the internal supervisory mechanisms in China such as members of the SB and AC. This thesis has replied to Spira's appeal by interviewing two listed companies' members of SBs and ACs. The perceptions of actors involved in ACs' processes in China have been revealed; their viewpoints recorded and summarised in the chapter on the operations. This input could help future research on the related topic.

(13) Input the independent variables for enhancement the attributes of supervision

The analysis in this thesis focuses on the three major attributes most relevant to the likely potential effectiveness of supervisory governance structures in companies:

independence, professional expertise and operations. These are highlighted in the related literature reviewed here such as Klein (2002), Carcello and Neal (2003), Bédard *et al.* (2004), DeFond *et al.* (2005), Turley and Zaman (2007), as well as from relevant regulations in the US and UK (Combined Code, Section 3.1), the Code of CG for Listed Companies in China (CSRC,2002, Section 52) and the Guidelines for Listed Companies on the Establishment of the Institution of Directors in China, which all refer to these factors in setting requirements for supervisory bodies.

These three attributes have become the pillars with which to form the framework of internal supervisory mechanism of CG at present. Thus it has been a challenge to construct other frameworks to build up the effectiveness of supervision, to improve Corporate Governance. This is also an area awaiting future research exploration.

This thesis has input party member employee numbers and shareholding structure, evaluated by the top three shareholders' as two variables to evaluate the AC's contribution to the characteristics of supervisory functions in China. Meanwhile, internal auditors may be transferred from the other departments with special skills in specific operations, but not equipped with a financial or accounting background. The internal audit without experts from a financial or accounting profession is defined as one single variable in this thesis to differentiate from the audit experience defined in the regulation of SEC, Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002.

In addition to the defined three attributes of the literature and regulations, this thesis has also input three independent variables of party-member employees, shareholding structure, and internal audit, which may contribute to future research on evaluating the effectiveness of supervisory functions.

(14) Input the understanding of applying both qualitative and quantitative methods in one thesis

Onwuegbuzie and Leech (2005: 375) encourage all graduate students to learn to utilise both quantitative and qualitative research in order to be pragmatic researchers. They also emphasised that the inclusion of qualitative data can help explain relationships discovered through quantitative data. This thesis applied both qualitative and quantitative methods, which more often than not involves a trade-off between

generalisability and understandability. In this thesis, the quantitative research method is designed to focus on the generalisability of the effectiveness of supervisory functions in China; and the qualitative research method is designed to focus on the understandability of the operations and co-ordination, establishing the factors with which to improve the effectiveness of supervisory functions in China. Not only the consequences of both research methods turn out to be complimentary, but the inclusion of qualitative data can also help explain relationships discovered through quantitative data in this thesis. This thesis's research design on methodology has proved the assertion by Onwuegbuzie and Leech (2005: 375), and could serve as a research model for similar study.

7.6 Concluding Summary

This thesis has explored the effectiveness of SBs and ACs in China and reported that, based on observation of the trend of PER and T-test results that establish that companies with ACs have lower debt ratios and bigger firm sizes, listed companies with ACs are more effective. Results 6 of 17 variables tested also provide statistically significant evidence that the AC contributes to the effectiveness of supervisory functions in China. However, the SBs still cannot be replaced after incorporating ACs into China because listed companies without ACs have more activities as measured by the meeting times of SBs; and listed companies with ACs still increase more the legal and internal audit expertise of SB. The results from the case studies and interviews with the members of SBs and ACs in China echo the results from the quantitative data. Though the actors implementing supervisory functions in China are not satisfied with the effectiveness of SBs they still insist on maintaining the system of the SB in China. It can be foreseen that co-existence of the two institutions of SBs and ACs is unavoidable in the future. Therefore, the evidence provided in this thesis regarding coordination between the SB and the AC in China is of particular relevance.

In order to eliminate the potential problem of independence of the AC's system under the BoD in the US and UK, this thesis has proposed modification to improve co-ordination among the institutions of internal supervision and merge them into one entity. If this proposal can be carried out, it will eliminate the problems of overlapping or missing functions between SBs and ACs in China. At the same time, it will not

detract from the checks and balances between the BoD and the SB in improving the deficiencies existing in the internal supervisory mechanism of both the German and the Anglo-American CG models. To co-ordinate the organisation of the SB and the AC into one entity will make co-ordination of their functions much easier. The recommended pattern would be an innovative breakthrough, which could remove the limitations and the constraints inherent in the supervisory mechanism of CG in China. This suggestion could provide a basis whereby China's internal supervisory mechanism could transcend the AC's system in US and UK and overcome the ineffective problems of current system of SB's in China.

In summary, the findings reported in this thesis, and related comments on the interpretation of those findings and suggestions based upon them, may be of assistance to users such as regulators, supervisors or Boards of Directors in considering what governance structures for internal supervisory functions within companies will be more effective, and the ways to improve the operations of effective supervisory functions in China. The findings from the study of co-ordination between ACs and SBs contribute to suggestions on how the functions of the two institutions should be co-ordinated to avoid redundancies and gaps in internal supervision. Additionally, this research provides practical understanding of the preferred linkage between the two institutions, with a view to proposing how they can improve interaction and co-ordination. Finally, the investigation and results reported in this thesis may offer a basis for continuing research on the effectiveness, operation and coordination of supervisory governance after introduction of an AC, and for studies of other monitoring functions such as audit and internal control.

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Appendix A1 Qian, Z-y., 24th July 2007

Qian, Z-y. 錢之揚 (2007). *Interview with Mr. Qian Zhi Yang (錢之揚), Secretary of the Board of Directors of the Zhejiang Transfar Co., Ltd. (Chuanhua, 傳化公*司), on 24th July 2007. Hangzhou. [Video recording in possession of author]

2007年7月24日訪問傳化公司董秘

1. 請問您認為在您的企業中的成長如何呢？

答：新安化工比傳化化工1986早建立20，上市比傳化化工的上市還早，文化傳承也自有一套體系，自二年前2005年二家公司合併成爲一，經歷文化的整合的過程，由國營轉民營的過程，由黨營企業轉爲民營企業經營的精神。

2. 請問獨立董事在貴公司扮演角色爲何呢？

答：在企業的董事會裡起了顧問的角色，其中的成員，獨立董事具專業指導的職責，一爲對於企業內的精英組織有建議權，如對內部的運作，精英組織是否健康運作；二爲外部的比較，目前的精英組織的運作在行業間是屬於什麼樣的水平。由於獨立董事會爲外部人員故期待其功能可扮演監督企業裡面之監督者的功能。

Appendix A2 Zhao, 23rd July 2007

Zhao, 趙總 (2007). *Interview with Mr. Zhao (趙總), Chair of the SB of Wynca (Zhejiang Xinan Chemical Industrial Group Co., Ltd., 新安公司), a subsidiary of the Zhejiang Transfar Co., Ltd. (Chuanhua, 傳化集團), on 23rd July 2007. Hangzhou.* [Video recording in possession of author]

2007年7月23日訪新安公司監事會主席趙總

1. 傳化集團進步如此之快，請問你的訣竅是什麼？

目前在傳化公司任副總經理並在新安公司任監察人約 1 年，傳化公司自 1986 年成立，2005 年上市，傳化的成長，主因是控制文化，控制文化由人來主導，近來約二年傳化公司向國有企業買下國有企業的新安公司，國有企業員工工作的文化與傳化公司私有化的動力不同，首先轉換其工作文化，帶動其工作動力，並力行公開、公平及公正員工管理的文化；我之前為傳化公司的法律顧問，由管理階層找來任副總經理一職，我是由法律所長轉任經營管理者，我認為企業經營者必須要重視法律，遵守法律是管理的基本，因為管理與控制是相連結的。

2. 自 1993 年採用監察人的制度以來，您的看法如何呢？

答、獨立的監察制度是很重要的，特別我們公司申請上市以來，來自由股東的期待且一年比一年重視，也一年比一年做的進步，雖中國有了監察人又引進獨立董事會的制度，自我任監察人一職以來，我沒有公司的股票也不是公司的利害關係人，我任新安公司的監事並無額外拿監事費，我只領傳化公司的薪水，其他二位新安公司的監事為新安化工公司的員工，也只領本位的薪水，只有每年 5000 元的車馬費，強調董事會與監事會各做各事，由監事會獨立監督董事會，不應由董事會來主導。雖我本人為法律背景，但公司內的審計部門有幾個專業的財會人員，且對外公告的財務資訊皆由外部審計審核後才發佈，傳化公司及新安公司皆委由天健事務所任外部審計。

3. 監事會的運作流程？

答、監事會在董事會之前召開內部的監事會議，我個人會在董事會開會前看他們的經營報告，一年約有 6 – 8 次到新安公司開會，包括董事會及監事會的會議，參與董事會主要目的為參與在董事會中聽取董事們的提議的意見及決議事項；另我一季召開一次的監事會，依規定是只有一年二次以上，通常都是在董事會會議之後召開；另平常我也會與相關部門接觸，因為光由財務數據不能完全看出問題所在，如美國的安隆舞弊倒閉案件，故執行監督工作應走動式拜訪相關部門以實地查證，如財務部及審計部等，強調使用審計部門，財務報表的

審查完全委由外部會計師事務所，而內部審計主要負責監事會敏銳到可能有問題，執行需要查證的部份。因為監督會的監督功能應如同公司裡的雷達系統，應事先偵測到問題，以預防問題的發生而造成公司的損傷，並應該給予空間，在合理可接受的範圍內，例如在法律的規定範圍內，另在管理的權限內，若即將逾越限度，監事會應如雷達偵測發出警訊並要求管控。強調監事會應發揮預防的功能。

4. 請問目前監事會監督財務報告、審計報告或內部控制主要的重點為何？

答：真實性，從數據的分析其合理性，會依據監事會的流程運作。監事會報告由監事會主席簽名後發佈。

5. 請問您對擔任監事一職的角色的觀感如何呢？

答：這是公司文化的議題，我們公司的文化重視“誠心、創新及發展”，故我們不怕問題的發現，我們董事長常說的一句話是“發現問題是我們的智慧，面對問題是我們的態度，承認問題是我們的美德，解決問題是我們的責任”，在此月底我們的董事長要主持會議，開會要每部門檢查問題，若不把問題找出來，這個企業是不會發展的。雖新安公司的歷史較久了，早已有監事會的機制，董事長指派我擔任新安公司的監事一職的角色，目的就是要找出問題，以期預防問題造成損害。

6. 請問現在政府鼓勵設立審計委員會，貴公司是否有計畫想成立呢？

答：我們已在考慮了，估計明年此時妳若再來訪問，我們的審計委員會的組織肯定已經出來了，我們已訂由董事長擔任審計委員會的主席，我是主任。

7. 請問你們為什麼想設立審計委員會呢？

答：一方面我們對審計的工作非常非常的重視，二方面必須要有此組織，此一組織的存在，能起作用的，表示高層領導的執行決心，若果高層領導不重視，此一機制就很難起作用的。

8. 若設立了審計委員會了，其組織和功能與監事會是否雷同或重覆呢？

答：組織上不會重覆的，審計委員會是在董事會底下的，而監事會是與董事會平行的單位，設置了審計委員會，只為讓審計的功能更受重視，使問題更加透明，藉由公眾部門的督促，並因為我們企業成長擴大了，一定要在每個企業裡設置審計功能的單位，在總管理部裡成立審計委員會，一定是必要的。

功能上，由審計委員會的重點在內部審計，而監事會的焦點在董事會。

9. 對於目前的內部監督機制中，你認為是否有何需要改進之處呢？

答：目前政府部門很重視這方面的工作，造假的問題全世界各地都有，對於不實的報告應予嚴懲。

感想：監事會成員無薪水或獎金的激動力使其把工作做好的，因此讓我很好奇想知道，監事會的運作效益為何呢？

Appendix A3 Bao and Jia, 24th July 2007

Bao, 包主任 & Jia, 賈主任 (2007). *Interview with Mr. Bao, 包主任 and Ms. Jia, 賈主任, two members of the SB of Wynca (Zhe Jiang Xinan Chemical Industrial Group Co., Ltd., 新安公司), a subsidiary of the Zhejiang Transfar Co., Ltd. (Chuanhua, 傳化集團), on 24th July 2007. Hangzhou. [Video recording in possession of author]*

2007年7月24日訪問新安公司二位監事會成員包主任及賈主任

包－15年的監事經驗，由國有股代表轉為員工股代表；賈－5年的監事經驗

1. 貴公司正嚮組設立審計委員會，往後會有監事會及審計委員會同時執行監督功能，您認為二會性質是否相似或雷同呢？

答：包監事回答，適合中國的國情，二會職能不一樣，在公司章程裡都會明訂各別的職能。

2. 您認為是否有設立審計委員會的必要性呢？

答：賈主任回答：依據規定上看來，我感覺審計委員會與監事會的職能是會有重疊，但我個人認為組成人員是有不同，監事會主要由內部的職工代表組成的，故其對內部的經營情況比較清楚，而審計委員會主要由外部來的獨立董事組成的，由於其對外部的兼職工作也比較多，故其對外部的環境比較有宏觀的了解，但其對內部的運作不如監事們熟悉，故審計委員會的設立可以彌補監事會對外部整個外部經濟及監控環境的知識與了解，故我個人認為二者可以起互補的作用，二會合作完善監督機制。

3. 依你個人看法，審計委員會設立之後二會的功能實務上應如何分配較好呢？

答：依據以上二會成員組成的不同看來，監事會由內部成員的組成負責對內事務的監督，相較於審計委員會成員由外部獨立董事組成，可由其收集外部發展的資料，以促進監督功能的發展，外部獨立董事對於內部的事務除了有特殊情況才會鑽下去調查，一個從外部來投入，一個從內部的投入，二方若相互溝通的情況，對公司整個監督作用，可以有互補相互相成的功能。

4. 從組織的觀點上來看，監事會與審計委員會各設置在不同的組織裡，二會應如何互動呢？

答：董事會統領經營班子，負責具體的生產經營運作，審計委員會設在董事會之下，為幫助董事會監控是否符合法律規定等，在董事會作決策之前就可以發揮事先的監督作用，再者經營班子是否依據董事會決策之事項運作，報表等是否依規定要求等，由審計委員會負責審查，起事中審查的作用；監事會與董事會為平行的單位，二會未來應如何互動，還有待進一步研究。

5. 請問監事會對監督財務報表、審計報告及內部控制的運作情形？

答：上市公司對財務報表、審計報告及內部控制的規定很多，符合法令是基本的，趕上創新的腳步才能有進步。

6. 請問貴公司如何趕上創新的腳步呢？

答：本公司有明確的企業文化，透明化及不斷的提昇品質，努力打造具國際競爭力，敢於打入國際市場才能有永續經營的發展，“同創共享，新酒暗藏”是本公司的核心文化；“新安是企業”是我們的企業經營理念，過往是國營企業，大家吃大鍋飯，現在已經是民營的企業了，必須要市場化，必須要符合市場需求；“新安是學校”所以員工要不斷的學習，不斷的更新知識；“新安是家庭”大家都像是大家庭應互相尊重互相愛護；“新安是舞台”內部就要互相競爭了，員工到管理崗位就必須要考試競爭，要成為幹部就要有表現，所以新安是大舞台，可以讓員工好好表現的地方，這就促進每位員工的素質的提昇，企業才能競爭力，因為企業的發展，員工是最重要的資產，員工的素質包括業務能力的素質及思想品格的素質，整合來說，員工不但要把自己的工作做好，還要把公司當成像自己的家一樣。

7. 請問你們監事會的運作流程與模式為何呢？

答：賈主任：依據公司法、公司章程及公司監事會職責的要求，我們必須要事先審查公司董事會開會前的資料，看財務報表的數據是否合理，季報、半年報及年報所有需要公告之資料及需提交董事會的，我們監事會於事前都會審核，若果有任何疑問時，會詢問相關部門，之後監事會開會商量，一年開會 3 – 4 次以上，每次開會至少需 3 個小時，查看是否符合我們公司實際運作的情況，之後我們監事會要形成決議的，之後再進入公告；除了我們監事會開會以外，我們也需要列席董事會議的，於董事會開會當中，我們監事們也提出我們的建議或疑問。

8. 請問你們認為貴公司的監事會目前的優、缺點在那裡？

答：包主任：依據公司法的要求，董事會及監事會都是股東大會選舉產生的，監事會有股東代表的監事二名，按股份比例由股東選舉產生，監事會有職工代表的監事，由職工選舉產生，另按照我們公司法的要求，必須要有職工監事，職工監事至少佔監事會成員 $1/3$ 的比例，我本身就是職工代表的監事且是工會代表，代表員工，監事會的目的是為監督董事會，若董事會自己監督自己就失去獨立性。過去中國有老三會及新三會，新三會是股東大會、董事會及監事會，過去國有企業是老三會，黨委會、工會及職工代表大會，現在面對老三會及新三會如何結合的問題，經由選舉產生的代表應對股東及職工負責，雖是兼職未額外拿薪酬，還是應做好職份，因此優點為：因為選舉產生，若未將職責做好，則下次就無機會再被選當監事了；依中國的國情，一來兼顧到老三會及新三會的精神，符合中國的國情，二來設立監事會不可少的，得以執行監督的功能，且公司又設立審計委員會的監督體系，得以有與國際接軌的監督機制。缺點為：目前監事會都是兼職的，則精力會放在主要的工作上，對於監事會的職責則無法全心投入，因為一個人的精力是有限的，若是專職的，其作用可預期發揮的更好；並且當需監督到本位工作時，立場衝突則失去獨立性了，如賈主任主要負責內部審計，當監事會需要監督內部審計部門時，則賈主任就失去了監督的獨立性了。

9. 您認為未來如何提昇監督功能呢？

答：先有了監事會又設有獨立董事組成的審計委員會，獨立董事利點為站的層次較高，可以起了顧問的作用，監事會對公司內部的運作較熟悉，比較能發揮監督的功用，二者互相合作以提昇監督功能。

10. 以中國目前的時局看來，您個人認為如何才能發揮監督機制？

答：老三會與新三會，過去國有企業時對監督的職能實際上沒有起了監督的作用，現在有了企業的改革，國有的企業改制為民營企業及上市公司，改造之後有了新三會與老三會的並用，老三會仍存在而新三會的設立，董事會著重企業的發展，監事會發揮監督功能，監事會有與無是不一樣的，其存在本身就是對

監督功能的重視，無論如何監事會都需針對職責要求進行監督，對董事會及經營高管應該都能起了作用的。另監事會的組織定位若能好好發揮職能，其獨立性就能助其好好發揮其職能；另若能進行過程事中的評價，有了過程的參與，就能避免事後審計的事後的檢討的無奈；若能解決專職的問題，監督人員就有精力參與，若專業上他們不懂，就能聘請專家協助，因此專業化的改進加上專業能力的提昇，才能有助於發揮監督機制。

11. 成立的動力為何？

答：強調合法性，符合規範運作，有其必要性，顯然運作起來對公司會有益處的。

12. 往後成立審計委員會之後，審計委員會及內部審計部門如何連結？

答：內部審計是專職的，審計委員會的領導是獨立董事，監事會又獨立於董事會，往後成立審計委員會之後，在組織上，往後內部審計部門會直屬於審計委員會；在功能上，如何連結及如何操作，應該需要研究。

13. 賈主任主要負責內部審計部門，可否請分享貴單位的內部審計的運作？

答：主要為財務審計，依據查核計畫，查核重點著重合理性及合法性，查核過程若果發現有任何管理或內部控制上的問題，再追蹤，若無，就確認一下，審計報告先給被審單位確認認可其真實性及正確性，再由其回覆改進計畫後，再回覆審計部門，由內部審計部審核整理過後，審計報告直接送給董事長，若果董事長有批示的意見，根據批示意見操作，若無，就依程序請相關的部門的領導落實改進的提議與計畫。於下次審計時檢查其是否落實改進計畫是否有整改掉，若果是重要事項，則訂為三個月後覆核追蹤審計。

感想：在中國的審計委員會的角色與監事會的角色為何呢？

Appendix B1 Wang, F-x., 25th July 2007

Wang, F-x. 王阜西 (2007). *Interview with Mr. Wang Fuxi (王阜西), Secretary of the Board of Directors of the Hangcha Engineering Machinery Co., Ltd. (杭叉公司), on 25th July 2007.* Hangzhou. [Video recording in possession of author]

2007年7月25日訪問杭叉公司董秘

1. 請介紹貴公司的審計委員會？

答:剛成立不到一年,在董事會轄下的一個委員會,依公司章程的規定對整個公司的運作及公司的高管人員進行檢核,對財務方面的監督與監事會目標都是一致的。

2. 二會目標一致,但功能是否有重疊,有否考量到監督成本的問題,另二會如何分工呢？

答:因為本公司於去年底(2006)才剛引進獨立董事,也才剛設立審計委員會,應該說目前未完全依據要求來運作,這半年多來尚未好好體驗發揮審計的功能;而監事會因為每半年都有監督報告公布,而監事會屬於事後監督較多一點,理論上在作方案前可能審計的功能較應多參與審核檢查及於執行方案前討論的功能,如今中國多了一個單位來執行監督的功能,設想可以看得面更寬一些。本公司尚未特別考量監督成本的問題,可能因為尚未真正執行審計委員會的監督功能。而且監事會也不需支付任何成本,目前有二位職工監事,除了本薪之外公司並不給付予監事酬勞的,另一位為國家股東代表派來的,所以他是拿他原來崗位的薪水,公司並不給付予監事酬勞的,本公司只有給付獨立董事執酬,其報酬也需經股東大會的決議每年給予固定的報酬,獨立董事主要參與董事會的,獨立董事多站在外部中小股東的立場考量,在董事會的決策過程中發表意見,而監事會多站在大股東的角度,對於公司的運作執行事後監督後的發表意見是不同的功能。

3. 監事會的運作流程為何呢？

答:運作簡單,自成立後日常運作較少,目前在開會前,對相關的財務報表及審計報告拿來了解後,監事會成員開會討論有無重大問題,除此之外並無每日的日常監督,並不像內部審計部門著重點不同,監事會主要以看文件監督為主,若有疑問以口頭了解情況多一些。

4. 請問你們會提供什麼文件內容給監事們呢？

答: 實際就是董事會開會前的相關資料如:審計報告,董事會的報告,財務預決算,對高管人員的考評等。

5. 請問有監事會的議程嗎？有明文規定監事們應監看何種文件嗎？有召開會前會嗎？

答:有的,監事會議事規則,我會提供一份供你參考,都是依據公司法的規定職責及程序而條列的,監事會都在董事會之後才召開的,並未召開董事會之前召開監事會的會前會,只有董事會召開前十天由董秘(我的工作職責)發給予董事及監事們相關文件。

6. 目前的監督制度有何需改進之處嗎？

答:目前的監事有三主要問題需改進: 1) 不是專職,應改進以提升參與度; 2) 專業程度需加強,以加強專業深入度,特別是職工監事,例如財務報表監督,他們可能無從看起; 3) 應改為專任,目前由員工兼任,很難真的發揮監督功能,職工代表有其用意,有職工會選出來的,但有違獨立性;而審計委員會的專業性有明文要求較專業水準,並且由獨立董事組成,期望可以彌補現在監事會的缺點。

7. 中國有監事會又設立審計委員會,往後組織上應如何安排較好呢？

答:中國有老三會及新三會的歷史背景,目前結合國際潮流的監督機制,是中國特有的國情,老三會包括有職工會、經理會及黨內會,本公司當初是由黨營企業發展而成的企業,當初政治的色彩濃一些,而現在市場經濟體制下,經濟

的色彩愈來愈濃，目前是半政治及半民營企業性質，往後組織上應該要整合起來符合中國特有的文化。

8. 未來在實務上如何提昇監督功能的發揮呢？

答：首先應提升監督人員的專業能力；並且提昇企業內的監督文化，應建立配合監督的環境；獨立性的基本問題應解決要不很難實際發揮功能。

9. 目前的監事會或審計委員會是否有私下開會討會呢？

答：沒有

10. 目前的監事會或審計委員會每次開會會議會持續多久的討會時間呢？

答：監事會每次約為半個小時的時間，最多為1個小時的時間，以大致看看沒問題就以進程序為主，未必能深究問題；審計委員會尚未正式開過會。

Appendix B2 Shen, J-h., 25th July 2007

Shen, J-h. 沈劍華 (2007). *Interview with Mr. Shen Jianhua (沈劍華), Chair of the Board of Directors and Legal Advisor of the Hangcha Engineering Machinery Co., Ltd. (杭叉公司), accompanied by Mr. Wang Fuxi (王阜西), Secretary of the Board of Directors, on 25th July 2007. Hangzhou. [Video recording in possession of author]*

2007年7月25日杭州訪問杭叉公司—監事會主席，同時為該公司法律顧問，董事會秘書長陪同

1. 中國監事會及審計委員會二會同時成立，您對該二會的功能運作的看法為何？

答：我個人擔任監事長的期間還不長，但公司整個改制過程都參與的，目前本公司二會都設立的了，因為公司依據公司法的規定，在合法性這部份是否做到

了，是否公司本身的行為及公司高層領導人的行為，這二個行為是否都符合公司章程等規定了，我感覺審計委員會是比較從微觀的角度著眼，而我個人的角度來講，我的身份除了監事會主席的職任又是職工委員會的主席，故而公司整體的行為及高層管理人員的行為二方面，除了合法性的角度之外又要兼顧合理性，當然合理性應服從於合法性，因為從職公會的角度來看，還要考慮合理性。

2. 有二位職工擔任監事代表，是您所推薦的嗎？

答：對的

3. 監事會及審計委員會二會同時設立，功能可能會有重疊現象，您的見解為何？

答：從個人的角度來看，重疊的比例不高，獨立董事主要還是參與董事會的運作，監事會是與董事會是平行的，是一個獨立的機構，而審計委員會是從微觀的角度來看工作的運行。

4. 每次您召開監事會著重的要點為何呢？

答：第一：股東大會決議之後董事會的執行情況；其次：董事會提議的重大決策，依據公司法，證券法及公司章程等法規嚴格執行監事會職責；第三：通過監事會的成員來考察公司董事會等高層管理在履行職務的過程中是否依據法律等運作。

5. 針對財務報表的審查，監事會目前的審查的專業情形為何，您個人的看法為何？

答：我個人鐵定不是專家，監事會成員當中配備有會計專業的人員，因為監事會仍然要負責監督財務報表的職責，分工上由此位有會計專業人員主要擔任，若他有提出任何問題時，再由其他人員協商處理。

6. 對於稽核包括內部稽核，監事會是否有做任何監督或任何解釋的工作呢？

答：這一方面，董事會的運作上比較成熟吧，從我這一任期以來（第一屆），似乎未明顯提出來任何疑義，因為監事會主要監督對象為董事會，董事會為主要的決議機關。

7. 監事會與在董事會轄下的經理層的互動機率高嗎？

答：不多，而董事會每次的會議，我都會參加。

8. 您個人的職稱為常駐監察人，是否仍擔任公司裡的任何職務呢？

答：尚擔任除了職工會的主席之外，公司雖有聘請外部的法律顧問，但因內部的便利性，實質上仍負責內部法律顧問的職責。

9. 請教問卷填寫是否有任何問題？

答：都已事先填好了。

10. 您個人的觀點，目前監事會的運作的優點及缺點在那裡？

答：我們公司的歷史變遷有一定的過程，本公司由全國營機構改制至釋股給員工成為半國營機構，監事會在優點上來看民主性較高，群眾基礎比較好；另一為是優點也是缺點為成員又是職工又是股東，故監事會成員又有股東推選代表又有職工推選代表，故而與董事會之間並不是單純的監督與被監督的問題，透過交流的過程，在問題受監督的抬面化之前，就比較早的達成共識而未讓問題呈現了或已把問題解決了。

缺點：個人的水平，包括監事會的其他成員，都需要跟得上國際水平，在財務的專業領域及業務經營等都需要不斷進修以跟得上需求。

11. 二會機制及運作在未來是否有需要改進的地方？

答：二者之間的運作，應更經常性的捕獲公司的營運訊息，董事會也很尊重監事會，會把某一新的方案事先知會監事會，需要改進之處，為平常運作方面應

多接觸了解，加強過程的了解，較能接近源頭一些，我個人對審計委員會的運作不太了解，憶測他們可能也會有這一方面的需求，例如獨立董事若要他突然來開會，他也可能無法了解平常的運作與過程，在質量上也得考慮。

12. 您個人期待二會如何互動及配搭呢？

答：審計委員會由獨立董事組成，期待能有不同的聲音，從某種角度來講有不同的聲音是一件好事，若只是一律的聲音那未必是一件好事；另期待獨立董事能帶來與外部連結的好處，因為他們的經歷及接觸面是不同的，應讓其發揮優勢，給公司帶來正面的助益，總而言之期待他們帶來新觀念並帶動與外部的連結的，善用其資源以提昇公司。

13. 監督的標準為何呢？

答：例如監督審查財報依據盈虧的情況，依財報是否依 G A A P，從形事要件到實體要件。

14. 是否參與聘請外部稽核呢？

答：沒有，由董事會決定

15. 請教您個人看法，如何改進才能發揮公司治理的監督機制呢？

答：從某個角度說，進一步提高或完善監督效益或職能，一方面是監事會成員的素質的提昇，二來監事會的運作要更多注重過程的了解，第三，監事會從某個層面來說是比較宏觀的，線條仍是較粗的，在宏觀的粗線條的視角下，能否深入些及細膩些呢？以事先看出問題來以達到預先預防的機制。

Appendix B3 Xu, L.-d., 25th July 2007

Xu, L.-d. (2007). *Interview with Mr. Xu Lida (許立達), Audit Committee member and Chief Financial Officer of the Hangcha Engineering Machinery Co., Ltd. (杭叉公司), accompanied by Wang Fuxi (王阜西), Secretary of the Board of Directors, on 25th July 2007. Hangzhou. [Video recording in possession of author]*

2007年7月25日訪問杭叉公司訪問審計委員會的成員，由財務總監同時擔任，董事會秘書長陪同

1. 貴公司剛成立審計委員會,您個人認為為何需要設立審計委員會呢?

答: 衝突談不上,我感覺國內企業的監事會的發揮應尚未達到理論上應有的標準，可能是因為監事會的功能未達到期望的標準，可能每個國家的運作不同，我們公司與法國的企業有接觸，他們監事會的層次與國內的不同，董事會需向監事會匯報工作，由監事會批准之後董事會才執行，而國內是二會都報告予股東大會，董事會並不需要取得監事會的核准，因為組織上的不同，可能因此影響功能的發揮。

2. 往後貴公司有了監事會又設立審計委員會，如今二會應如何分工比較好呢？

答：國內借鏡英美公司治理的模式引進了審計委員會，理論上就有其用處，目前可能監事會未能發揮預期的作用，一方面是因為國內的文化，形式大於實質，若要執行監督有無環境（文化），若介入太深恐公司管理及同僚排擠，若無提供適當的環境，文化的允許，監督若想監督也監督不了；一方面是因為監事多為兼職，不太願意介入實質的審查，過程介入的少，故而監事會對於太具體的東西可能不了解，最後是看結果，主要原因是沒想要去監督吧。

故而往後應從文化環境著手，管理階層應注重監督的功能，提供監事們需要的資料與文件，而不是防範監事涉入過程。

3. 審計委員會對財務報表的審查，您會側重何要點呢？

答：合法合規，對會計師事務所的評選，以有口碑有品牌的事務所為主。

4. 往後您認為應如何推動審計委員會的功能

答：目前有三位成員，二位為外部的獨立董事，應由該二位獨立董事為主，我是唯一一位內部成員，應由他們來領導，以符合獨立性，因為我本身為財務總監，我個人把關財務報表及其處理過程，我認為沒有問題都依規作業，但其他二位獨立董事可能認為有問題，故應以他們二位為主以 3：2 比例來認奪，目前國內規定以半數以上為獨立董事，若是依國外標準全部是獨立董事，我個人認為比較能符合獨立性的立場。

5. 運作流程應如何較好呢？

答：目前公司有一份審計委員會運作細則，應依其細則的規定來執行，召集人為獨立董事，一季才開會一次，平常似乎無太多的連繫。

董秘補充：召集人會於定期給董秘打電話詢問關心企業裡有無任何事情需要他的支持或幫助的，因為此召集人也在其他的企業裡兼任獨立董事，也會交流他認為應注意的事項，具體的實務作業，尚未明確。

財務總監：我們在今年初（2007）才剛設立審計委員會，推展上尚未到位，

召集人有經驗，我們寄望他來帶領我們指導我們如何運作審計委員會，以往為要上市著董法規合法性較多些以符合證監會的要求。

6. 請您介紹貴公司審計委員會和內部審計部門的關係？

答：本公司最早的內部審計是在總經理轄下，現在已提昇其在董事會轄下，二者雖都是審計的功能，但個別具體的側重面仍是有不同的，內部審計較著重細部，如監督內部控制，審計委員會應側重大局，往後應是審計委員會下設之內部審計單位，以互相配合。我目前主要職務為財務總監應是被審計的單位，但

目前又兼審計委員會的會員，角色較為特殊些。我們公司的內部審計部門目前只有3個人，我認為其功能需要加強，目前制度規定已形成，但往後應著重實務實施方面，首應建立觀念文化的建立，對審計的著重及與審計單位的配合，以助其發揮功效。

7a. 目前面對的執行監督的問題為何？

答：本公司剛開始實施審計委員會，目前執行尚未到位未能反應出問題，因為尚未依規定來做，尚未好好執行發揮。（設立時間不到？年）

7b. 未來做 AC 對執行三種主要功能如財務報表，審計及內部控制有何需改進之處？

答：財務總監答：關鍵的條件，理論上，應從文化上著手建立從上而下注重監督的觀念及提升人員的素質問題；監事及審計委員會的職能發揮，應依據規定的層面著手去執行，執行之後才會知道問題所在；目前實務上，監事關心結果比較多，未能關心過程的監督，而且也未曾想過要去好好的去執行監督職任，因為都不是專職的，故而目前尚未看見過程監督的問題及支持的力度問題。

8a. 是否 AC 有開會前會：應先為 BOD 過濾，如何突破過程審計？

目前並未如此做。

8b. 未來是否有必要如此做呢？

財務總監強調財務數據的重要性，各樣的內控就反應在數據上；而且平時就應做好過程審計，而不是在審計委員會之前才開會前會了解實況。

（電話鈴响，財務總監接聽電話）

董事會秘書長答：

由於本司公財務總監的立場特殊，平時職務就需要了解財務狀況，因同時擔任審計委員會的主席，故而不需在開審計委員會前才需要特意進行了解內控情形。其實財務單位本身平實就有監控的功能。

Appendix C1 Shi, D-h., 24th August 2007

Shi, D-h, (2007). *Interview with Mr. Shi Dong-hui (施東輝), Deputy Director in the Research Center of the Shanghai Stock Exchange (SSE), on 24th Aug. 2007.* Shanghai. [Email response to the telephone interview in procession of author]

2007年8月24日上海電話、電郵訪問上海證交所主任施東輝先生

答复: 請教您

2007/8/24(五) 上午 8:44

寄件者: "dhshi@sse.com.cn" <dhshi@sse.com.cn>檢視聯絡人詳細資料

收件者: "寶珍 李" <lee_pao_chen@yahoo.com.tw>

Message contains attachments 1 個檔案 (34KB) [corporate governance.doc](#)



並未偵測到病毒或受感染。 .exe, .com, .bat, .scr, .pif, .msi 檔案建議不要下載，請先確認檔案來源安全性。(網路安全說明)

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1. 目前中國設立之監事會、獨立董事及審計委員會，上海證交所於立法及管理的設計上，三者同時設立的用意為何呢？

监事会：大陆《公司法》最初学习了德国的公司法律制度，所以设立了监事会制度。但由于当时存在着一些误解，监事会的功能与德国不同，主要是监督董事和管理人员。从实际运作情况来看，监事会主席一般是从公司内部提拔上来

的，监事会成员大部分来自公司内部，监事会只是一个受到董事会控制的议事机构而已。

独立董事：从实际控制权来看，大陆公司治理是以董事会为核心的。为了保证董事会相对于大股东的独立性，参照美国的公司治理制度，大陆引入了独立董事制度。董事会成员中至少三分之一应为独立董事。

审计委员会：审计委员会是董事会下属的专业委员会之一，审计委员会中独立董事应占多数并担任召集人，并且至少有一名独立董事是会计专业人士。

2. 目前中國設立之監事會、獨立董事及審計委員會，上海證交所於立法及管理的設計上，三者之功能各有何異同與特色？

监事会：检查公司财务；对董事、经理执行公司职务时违反法律、法规或公司章程的行为进行监督；当董事和经理的行为损害公司利益时，监事会要求董事和经理予以纠正。

独立董事：对全体股东负有诚信与勤勉义务，维护公司利益，尤其要关注中小股东的合法权益不受损害。

审计委员会：提议聘请或更换外部审计机构；监督公司的内部审计制度及其实施；负责内部审计与外部审计之间的沟通；审核公司的财务信息及其披露；审查公司的内控制度。

实践中，监事会与独立董事和审计委员会的职能有所重叠，独立董事和审计委员会的监督作用要强于监事会。监事会的监督权事实上流于形式，并没有起到应有的作用，因此有一些学者和专业人士主张取消监事会，让独立董事充分发挥作用。

3. 目前中國設立之監事會、獨立董事及審計委員會,上海證交所於立法及管理的設計上,三者-監事或委員與獨立董事的職權及責任如何劃分呢？

见上面的回答。

4. 目前中國設立之監事會、獨立董事及審計委員會,上海證交所於立法及管理的設計上,三者 – 監事及委員與獨立董事彼此之間如何互動呢?

见上面的回答。

5. 目前中國設立之監事會、獨立董事及審計委員會,上海證交所於立法及管理的設計上,是否三者成員皆規定需為【獨立董事】?

审计委员会：独立董事应占多数并担任召集人。

监事会：主要由企业内部的工会主席和职工代表组成，一定程度上代表职工和社会的利益。

6. 目前中國設立之監事會、獨立董事及審計委員會,上海證交所於立法及管理的設計上,【獨立董事】之認定標準為何?

独立董事应独立于所受聘的公司及其主要股东，不得在上市公司担任除独立董事外的其他任何职务。

7. 目前中國設立之監事會、獨立董事及審計委員會,上海證交所於立法及管理的設計上,審計委員會之成員是否需要送主管機關核定,例如依證交法等相關規定授權專案核定呢?

独立董事的聘任需经股东大会表决通过，候选人需参加过相关的专业培训。

8. 目前中國設立之監事會、獨立董事及審計委員會,上海證交所於立法及管理的設計上,審計委員會之成立並非強制性的,是否對特定情況之企業強制其必須設立審計委員會呢?

没有出现过这种情况。目前大约三分之二的公司设立了董事会下属的审计委员会。

9. 目前中國設立之監事會、獨立董事及審計委員會,上海證交所於立法及管理的設計上,對其組成、辦法及運作是否有明定規章辦法得據以要求實施?

监事会的运作由《公司法》规定，独立董事及审计委员会的运作由《上市公司治理准则》规定。

10. 以中國目前的時機及中國文化，請教 您認為理想的”監督功能”為何？應如何運作方能夠發揮公司治理機制？

大陆上市公司的股权高度集中在大股东手里，“监督功能”的关键是加强董事会改革，具体包括：增强董事会的独立性；建立董事会的自我评价体系；加强董事会运作的有效性，完善公司的内部控制机制和监督制衡机制；提高董事的综合素质，对公司董事进行持续的培训和教育。

Appendix C2 Xu, T-m., 25th July 2007

Xu, T-m. (2007). *Interview with Mr. Xu (Xu Tian Min 徐天明), Manager of the Property Right Management Department of the State-Owned Hangzhou Industrial Assets Management Co. Ltd. (國營杭州資產管理公司), on 25th July 2007.*
Hangzhou. [Video recording in possession of author]

2007年7月25日訪問國營杭州資產管理公司徐天明先生

Xu Tian Min – Property Right Management Dept. Manager – Hangzhou Industrial Assets Management Co. Ltd

1. 目前貴公司監事會的功能發揮的如何呢？

答：不盡人意且形同虛設。

2. 爲何呢？

答：因爲背景的關係，國營機構設立監事會看不到功能發揮出來，旗下目前有 79 家投資企業，大多爲中外合資（適用審計委員會的機制），在中國公司法規定之下也需要設有監事會。

3. 完全國營的企業的監事會看不到功能的發揮，您認爲還有設立監事會的需要嗎？

答：有的，且絕對有必要的。

4. 依法規有必要依規設立，但實務上您認爲功能的發揮又不盡人意，是爲何呢？

答：主要原因是好多的監事都是內部人員，內部人員的立場上就不可能獨立性的執行監督功能，且監事多爲下屬人員如何能去監督上層管理呢？第一就是獨立性不夠，第二就是專業性不夠，雖監事成員在社會上頗有聲望及社會地位，但在執行監督功能的專業能力上是令人存疑的，多數監事人員的素質是不夠的。第三，目前在法規上有規定，但實務操作上的履行尚欠缺。

5. 對於鼓勵設立審計委員會的看法爲何呢？

依政府要求審計委員會是在董事轄下的委員會，此模式我認爲有點不可思議，因爲操作上如何能發揮獨立性叫人存疑，因爲立場上監事會與董事會爲平行單位尚能執行獨立性的監督，只是監事會應有實權的，如此執行起監督才能有實效。若把審計委員會當成是公司內的內審機構，且在監事會的權力範圍之內，那麼監督單位互相隸屬，才有意義，而目前把審計委員會放在董事會轄下，而二會又不互相隸屬，而二會同時都執行監督功能。

6. 似乎二會的功能上會有重複之處，而二會功能如何界定呢？

答：本來監事會功能就是來監督董事會的，董事會及經理層功能上本來就是要強勢執行的，一爲監督單位，一爲執行單位。

7. 您認為監事會及審計委員會的隸屬應為何呢？

答：我認為若是由審計委員會直接報告給監事會，則可以達到一條鞭的功效，功能整合及人力資源整合，組織內的監督功能互動達到統合綜效的目的。