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Internal governance

This chapter discusses internal governance. We first present statistics on sample firms' ownership forms and discuss the benefits and costs of each form. It then discusses their internal governance structures, paying special attention to the issues that are unique to private firms. It also discusses governance issues in the context of industrial organisation. The focus then shifts to labour management and the relationship between the owner and the employees.

Ownership forms

Chinese law defines four forms of ownership: sole ownership; partnership; limited liability company; and limited liability shareholding company. Table 7.1 shows the distribution of the forms of ownership taken by the sample firms in 1998. The questionnaire did not distinguish between limited liability and limited liability shareholding companies because they are the same in terms of the liability of shareholders. However, it asked whether a firm was listed in stock markets.

Among all of the 612 firms providing a usable answer, the percentages of sole ownership, partnership, limited liability, and public listing were, respectively, 40 per cent, 30 per cent, 28 per cent, and 0.5 per cent. Compared with the national data, there are more partnerships in the sample.[1] There were regional differences. While Chengdu had a small percentage of sole ownership (25 per cent), the differences among the others' were relatively small. Beijing had the highest percentage of partnerships (38 per cent), Mianyang the lowest. Consistently, Beijing had the smallest percentage of limited liability companies. Chengdu had the highest percentage (59 per cent). Finally, two of the 3 firms that were publicly listed were based in Beijing; the other was in Mianyang.

Different ownership forms have different benefits and costs for a firm. Sole ownership has the disadvantage of unlimited liability, but it also has certain benefits. The current law prohibits a single owner from registering the firm as

Table 7.1 Ownership distribution of sample firms: 1998 (number of firms and %)

	Sole ownership			Partnership		Limited liability company		Publicly listed company	
City	Firms	Count	%	Count	%	Count	%	Count	%
Beijing	341	139	40.8	129	37.8	71	20.8	2	0.6
Shunde	54	25	46.3	12	22.2	17	31.5	–	
Wenzhou	87	30	34.5	26	29.9	31	35.6	–	
Chengdu	51	13	25.5	8	15.7	30	58.8	–	
Mianyang	28	16	57.1	3	10.7	8	28.6	1	3.6
Deyang	51	25	49.0	8	15.7	18	35.3	–	
Total	612	248	40.5	186	30.4	175	28.6	3	0.5

Source: Firm survey.

a limited liability company. Therefore, an owner that did not want to have a partner would be better to register as a sole ownership firm. In addition, sole ownership makes management easier. If the firm is not large, this will be a big advantage for the firm. Sole ownership also has the advantage of not requiring a standard corporate account, which puts it under the state's supervision. This provides certain attractions, including in relation to tax evasion.

However, when the firm becomes large, single-owner management becomes difficult (see the next section for more discussion). In addition, if a firm is not registered as a corporation, it cannot call itself a company. Therefore, being a sole ownership firm may have a negative impact on its reputation. In the sample, however, it seems that the benefits outweighed the costs because many of the sole ownership firms were large (the average of net fixed capital stock of these firms was 15 million yuan).

Partnership firms cannot call themselves companies either, and most of the benefits associated with a sole ownership firm are absent. The only benefit left is that a partnership firm does not need to have standard corporate accounts, providing it certain benefits. Generally, it is envisioned that a firm with several owners will most of the time prefer to register as a limited liability company.[2]

However, the *Law of Corporation* stipulates that a manufacturing firm has to have a total of more than 500,000 yuan of initial capital in order to qualify for a limited liability company. The average original capital value of the partnership firms in the sample was 551 thousand yuan, barely above this limit. In terms of net value, the average was only 159 thousand yuan. Therefore, the existence of many partnership firms in the sample might be a result of the minimum capital required for a limited liability company. This is reflected by the high percentage of such firms in Beijing where firms were much smaller than in the other cities.

The limited liability company is the preferred form of ownership for larger firms not only because it provides owners with protection for their personal wealth, but also because it provides a firm with a clear internal management structure with legal backup. In a partnership, partners have unlimited liability for losses of the firm, but may not have a good idea of each other's personal wealth. So, when a loss occurs, disputes may arise as to who should be responsible for how much of the loss. In a limited liability company, a shareholder's liability stops at the amount of capital invested in the company. So the probability of a dispute is minimised.

In addition, having corporate status can enhance a firm's reputation. These benefits have prompted many firms with a single owner to find a partner to qualify as a limited liability company. Although the law does not set a minimum share for the second owner, in implementation, the share is set to be from 5 per cent to 20 per cent in the four cities covered in the first phase of survey. In some cities such as Shunde, a spouse is qualified as a partner, so a firm gets the corporate status without necessarily losing the sole owner's family's control of the firm. In other cities, such as Beijing, a spouse is not qualified as a partner. In this case, some firms just gave a nominal partner a nominal share, but both parties agreed between themselves that the share is not real. However, the agreement is not legally binding because the shares are not recorded in the legal documentation of the firm's registration. This discrepancy between personal agreement and legal protection has already brought cases in which the second owner sues the first owner to get his share out of the company. In many cases, such disputes could be devastating for the firm.

Internal decision making

Table 7.2 reports the pattern of internal management of the survey firms by ownership, firm size and length of business operation. There are two headings: one distinguishes internal management agencies by the percentage of firms using either manager meetings or Board of Directors meetings, and the other shows the percentage of important decisions made by managers, Board of Directors or others.

The results show that for the ownership forms, Board of Directors controlled most important decisions in a firm. In particular, corporations do not delegate more, but less power to managers. In particular, the Board of Directors controls all the important decisions in the three publicly listed firms. Even the 20 per cent of decisions shown to be controlled by managers, may actually be controlled

Table 7.2 Pattern of internal management (% of valid data)

	Internal management agency (% of firms)		Percentage of important decisions made by		
	Manager meeting	Board of directors	Manager	Board of directors	Others
Total	51.2	65.6	69.0	23.0	8.0
By ownership					
Sole proprietor	62.5	50.0	26.9	65.5	7.7
Partnership	54.8	59.5	20.1	67.6	12.4
Company	45.7	81.4	22.3	71.0	6.7
Publicly listed	–	100.0	–	100.0	–
By size					
<51	62.3	57.4	22.5	67.6	10.0
51–100	41.9	71.0	30.4	61.3	8.3
101–500	51.1	75.6	24.4	67.8	7.8
>500	44.4	77.8	10.1	83.4	6.5
By age					
<3 years	51.0	66.0	23.5	67.4	9.1
3–5 years	40.5	67.6	29.1	65.1	5.8
5–10 years	49.0	71.4	21.2	70.7	8.1
>10 years	69.2	50.0	16.4	76.0	7.6

Source: CEO survey.

Table 7.3 Certified accounting reports by ownership (%)

Ownership	Firm providing report	Reason for not providing the report: Not useful	Not necessary	Expensive	Never consisdered	Other
Sole ownership	24.2	17.8	45.5	3.0	27.7	5.9
Partnership	43.7	6.5	51.6	6.5	27.4	8.1
Company	47.7	5.2	41.4	13.8	25.9	13.8
Publicly listed	33.3	–	100.0	–	–	–

Source: Firm survey.

by owners, because the latter may well be managers themselves. Therefore, delegation in the sample firms is weak. This is consistent with the CEO interviews that found most of the CEOs were themselves owners. In terms of the decision-making process, among the 338 firms covered in the CEO survey, 110 firms have regular manager meetings, 141 firms have regular board meetings, and only 36 firms have both. There are several issues that are related to the internal management in the sample firms.

First, internal financial supervision is slack amongst the sample firms. Amongst 514 respondent firms, only 37 per cent provided to shareholders an annual report certified by an outside accounting agency. (Only 1.2 per cent of the firms said the accounting agency had foreign investment in it). Since the law only requests corporations to provide such a report, this low percentage may be acceptable. Further, it is not a problem for corporate governance, if a manager who fully owns the firms fails to report systematically to shareholders. However, among the 137 corporations that provided an answer, the percentage was only increased to 47 per cent (Table 7.3).

Asked why they did not provide such a report, 25 per cent of the firms without the report said they never considered it, 41 per cent of them thought it was not required, 14 per cent said it was too expensive, and 5 per cent thought the report was of no use. The report might not be of much use to a private firm for most of the time, but in case of an internal dispute, it would be difficult for the parties to resort to law for protection without one. In addition, the lack of formal accounting reports reduces a private firm's credibility when it approaches a bank or other financial intermediary to apply for a loan.

Second, as a firm becomes larger, some of the initial investors cannot keep up with the skills needed to manage the firm. The problem is acute for private firms because many of the initial owners do not have much education and training. A problem then arises as to how to place these people while bringing new people into management teams. One method created by firms is to provide early retirement with generous packages.

Third, for a private owner who wants to have further development of the firm, there is a problem of lack of advanced technical and managerial knowledge. Under these circumstances, some of them have begun to bring in outside experts onto the Board of Directors. Although the number of such firms is still very small, the trend is encouraging. The practice is more common in Wenzhou. After 20 plus years of development, many private firms in Wenzhou have found themselves no room for further development if they do not bring in people with advanced managerial knowledge and skills.

One arrangement is to bring outside experts from Shanghai and other large cities onto the Board of Directors. These new outside directors do not have shares in the firm and their roles are mainly to make strategic decisions for the firm. In the extreme case, the Board of Directors is overwhelmingly staffed with outsiders. In this case, the owners in effect surrender the firm's control to outsiders. In recent economics literature, outside directors have been found to serve in the role of arbitrators for the owners in disputes. This practice is especially common in the high-tech firms in Silicon Valley in the United States.

Box 7.1. Changing ownership and internal governance in private firms

In Wenzhou City, private enterprises have developed quickly and dominate the local economy. Most private firms are owned by a sole owner or a family, and still managed by the owners. However, there are tendencies for ownership and internal governance to change in those firms, which have become large.

TZ is a private firm, which was established in 1990. After only nine years of growth, it became a relatively large company with over 200 million yuan of total capital and over 3000 employees. It had three experiences of internal restructuring. In 1994 it converted from a solely owned small private firm to a company. Several senior managers became owners. In 1997, it further changed into a stock-sharing company, issuing 50 per cent of its shares to over 50 middle level managers. In 1999, it bought the largest parts of the shares of over 10 member firms, and made itself the stockholding company of these firms. Thus it is able to integrate these small factories into a large one.

These changes enabled the company to recruit experienced managers from outside to improve its management, to reduce the management cost, and also to expand its size. In these two years its total capital expanded six times, and its sales expanded 4 times. Its share of the domestic market increased. Its exports increased. Technical innovation in the company accelerated also. The company now allocates 1–2 per cent of its total revenue to research and to the development of new products.

It is interesting to find that in Wenzhou, outside directors serve a more substantial role than just being arbitrators. The owners' surrender of control to outside directors can be seen as an exchange for the latter's expertise.

Instead of bringing in outside directors, an owner can also hire competent managers to compensate for his or her own lack of managerial and other specific knowledge. This practice was common in all the cities. In this case, the owner usually gives the managers shares. This is necessary to solve the incentive problems inherent in delegation. Since the managers control the daily management and thus have a large share of the firms' control rights, it is important for owners to bring in people they can trust, usually long-time friends.

There are also exceptions. For example, a firm in Shunde wanted to list on the Hong Kong stock market by issuing H shares. A person who had expertise in corporate finance was required. The president of the Board of Directors met a person by coincidence whom he hired as the CEO for the firm then gave him shares. The research team found in Wenzhou an owner that delegated all management responsibilities to a manager hired from Shanghai. In Chengdu, an owner of a private firm that had been transformed from a TVE hired a young graduate with a MBA degree as his firm's top manager. The young manager helped to design an new management responsibilites system for the firm.

Finally, a private firm has to solve the incentive problem for ordinary employees as it becomes larger and loses the intimacy of a family-like environment. Many people in China still feel uncomfortable working for a private owner. Even without this sentiment, there can still be an incentive problem, especially for employees with higher education whose contribution to the firm cannot be properly compensated by a fixed wage.

However, simply giving employees the option of buying the firm's shares cannot fully solve the incentive problem. This is because, without being listed on a stock market, the shares are not transferable. As a result, the value of shares to the employees is reduced, and for an employee who wants to leave the firm, the owner is obliged to cash out his shares. Therefore, the option of buying shares is not a perfect solution. In Shunde, the closed shareholding firms that resulted from its privatisation program are gradually concentrating ownership into the hands of a smaller group of employees, notably, the top management. This demonstrates the inability of the share option on its own to solve a private firm's internal incentive problems.

Owners of some large firms have realised that issuing shares in the open market will be necessary if their firms are to solve their internal incentive problems as well as to have further development. In fact, a major reason for a Beijing firm, the largest software firm in China, to go public was to solve its internal incentive problem. The software industry is knowledge intensive, and the incentive problem is acute.

Governance and industrial organisation

Governance issues of firms with subsidiaries are of particular interest because they can provide understanding of private firms' acquisition behaviour, as well as of how they handle the cross-firm delegation problem. Among 582 firms providing a valid entry, 19 per cent had at least one subsidiary. In particular, 28 per cent had one subsidiary, 22 per cent had 2, 27 per cent had 2 to 5, and 24 per cent had more than 5. In addition, 27 firms or 5 per cent had subsidiaries outside mainland China.

Seventeen per cent of firms had upstream (suppliers) and 22 per cent downstream (buyer's) subsidiaries. In general, a majority of firms had industrial connections with their subsidiaries. Twenty three per cent of the firms with subsidiaries described the relationship between themselves and their subsidiaries as vertical integration, 25 per cent described the relationship as horizontal integration, and 14 per cent described it as both (Table 7.4). However, 38 per cent of the firms also said there was no specific industrial connections between themselves and their subsidiaries. The purpose of these firms' plan to set up subsidiaries might be only to disperse risks.

Table 7.4 Industrial organisation (% of firms)

	Vertical integration	Horizontal integration	Both	Neither
Total	22.3	25.0	14.3	38.4
By ownership				
Sole proprietor	28.9	26.3	18.4	26.3
Partnership	22.7	27.3	4.5	45.5
Company	18.0	24.0	16.0	42.0
Publicly listed	–	–	–	100.0
By age of firm				
< 3 years	16.0	32.0	12.0	40.0
3–5 years	12.5	25.0	12.5	50.0
5–10 years	21.7	30.4	21.7	26.1
> 10 years	33.3	20.0	20.0	26.7
By industry				
Primary industries	33.3	13.3	20.0	33.3
Foods and cigarettes	38.5	23.1	15.4	23.1
Garments and other light products	16.0	28.0	12.0	44.0
Chemicals	22.2	22.2	16.7	38.9
Metal and nonmetal manufacturing	–	20.0	–	80.0
Machinery	16.7	41.7	16.7	25.0
Electronics and apparatuses	26.3	21.1	10.5	42.1
Others	–	40.0	20.0	40.0

Source: CEO and firm surveys. Gregory et al., 2000, *IFC Report.*, Figure 3.1, p.27 and Figure 3.2, p.28.

Table 7.4 also shows that except for sole proprietor, other types of firms, namely partnership and company, tended to have more horizontal integration. Looking from the perspective of a firm's years of operation, it seems that the longer the firms operate, the more they tend to vertical rather than to horizontal integration. There are substantial variations across industries. For example, while food and cigarettes, and primary industries have high levels of vertical integration, machinery industry has a high level of horizontal integration.

In addition to firms with subsidiaries, 33 firms reported that they belonged to enterprise conglomerates. The average size of the conglomerates in 1998 was 1,127 employees with a sales volume of 150 million yuan and a profit of 20 million yuan. These figures indicate that the mean size of a conglomerate is that of a medium size SOE. Firms may seek to reduce transaction costs in market transactions by inviting their customers and suppliers to invest in the firm. In the sample, 24 firms had suppliers as their shareholders, 39 had customers, and 8 had financial institutions.

To summarise, there is considerable evidence of sample firms using merger as a means to strengthen their market positions. However, the number of firms that could do so was small. In addition, the conglomerates were also small compared with SOEs.

Employee involvement and labour management

The survey data show that the role of workers is limited in the sample firms' important decision making. This is because few decisions need workers' involvement. In an SOE, there are several kinds of major benefits, such as housing, pension, health insurance, and sometimes wages that need to be distributed among all the employees fairly. In a private firm, either there are no such benefits, or if there are some, the decisions on these issues are largely made and controlled by the owner.[3] The limited role of workers is also related to their weak collective bargaining power in a private firm.

In the 173 firms (27 per cent of the total) providing a usable entry, the average percentage of unionised workers was 60 per cent. However, the firms that did not provide an answer to the question might well have no unionised workers.

Employees in a typical private firm can be divided into two groups, one comprising local people and outside university graduates, and the other rural migrants. The first group of employees generally occupy better positions in the firms and enjoy better wages and benefits. For example, many cities require firms to purchase retirement and health insurance for urban residents, and firms are doing exactly that. Firms need the expertise of outside graduates, so they tend to treat them as locals. As the rural migrants have a high turnover rate and have accrued few skills that cannot be acquired quickly by readily available new workers, it does not make much sense from the firm's perspective to purchase retirement or health insurance for them.

As the reform of SOEs has deepened, many urban workers have lost their jobs. These unemployed workers are willing to lower their asking wages and benefits in order to find new jobs. As a result, they have become competitive in the labour market. For example, a Beijing garment company hired rural migrants in the past. These rural workers had a high turnover rate and had two strikes. The firm began to hire unemployed local workers. Because they had already lost jobs once, these local workers appreciated the work opportunity and worked hard. Apart from being more disciplined; their previous working experience reduced the cost of training for the owner.

As a result, a clear distinction has emerged in the workforce of private firms between locals (and outside graduates) and rural migrants. Members of the latter group not only have less favourable jobs and lower wages, but also are treated differently from the first in housing. Rural workers usually live in firm-provided dormitories within the factory, often 8 to 12 people in one small room. In contrast, local people live in their own houses. Outside college graduates enjoy much better housing provided by the firm, typically two persons in a room. The firm often buys commercial apartments for higher level employees.

Amongst the 338 firms in the CEO survey, only 20 per cent indicated that they had no labour disputes. The percentages of firms choosing the court, union in the factory, government, and direct negotiation to solve labour disputes were, respectively, 21, 41, 25 and 11 (a firm could choose more than one answer). Therefore, labour unions played a significant role in representing the interests of workers.

In addition, the roles of the court and the government were also important. It is noteworthy that a few firms consciously used labour unions and Communist Party organisations to strengthen their management. This is particularly significant in Beijing. Although conforming to the law or public relations may be one aim of setting up a Party organisation,[4] it has real effects on the morale of employees. This is especially helpful for party member employees to justify their working for or even being a capitalist.

In summary, several conclusions can be made regarding the sample firms. First, internal governance of these firms is still in its primitive stage. However, to a large extent, this is consistent with their small size and ownership structure. Second, there are signs that large firms with relatively long periods of operation are beginning to adopt more open governance structures in an effort to improve performance as well as to rectify weaknesses in governance. Third, there is evidence that the sample firms are beginning to use merger as a means to reduce transaction costs in market activities. Last, while the protection of workers, especially rural workers, is insufficient, labour unions have begun to play a significant role in collective bargaining.

Notes

1. This might be due to the respondents' misunderstanding of the question so some companies were recorded as partnership firms. It could also be due to the way the sample has been selected.
2. For people who want to use unlimited liability as a sign of their credibility, partnership may be another choice. In other countries, some specific businesses, such as law firms in the United States, are required to register as unlimited liability firms.
3. There is a *Regulation for Labour Management in Private Enterprises* issued by Ministry of Labour on 21 September 1989, which details requirements for private firms with regard to employment contract, wage levels, insurance and welfare, safety and labour disputes.
4. The *Law of Corporation* requires that a corporation have both a Communist Party organization and a union.