International Journal of Business and Economic Development
Vol. 1, No. 7; October, 2020. pp 17-25
ISSN 2692-5591 (print), 2692-5583 (online)

Published by International Center for Promoting Knowledge
www.icpknet.org

Corporate Governance in China: Cash Dividends and Tunneling by Non-tradable controlling shareholders

Yan Xiong
Professor of Accounting
College of Business Administration
California State University – Sacramento
6000 J Street, Sacramento, CA 95819

Nancy Tsai
Professor of Information Systems
College of Business Administration
California State University – Sacramento
6000 J Street, Sacramento, CA 95819

Jin Zhang
Professor of Accounting
College of Business Administration
California State University – Sacramento
6000 J Street, Sacramento, CA 95819

I. Introduction

It has been acknowledged in academia that the agency conflict between controlling owners and the minority shareholders are difficult to mitigate through conventional corporate control mechanisms due to the weak legal systems in the emerging market . As a member of the emerging market, this conflict is even more evident in China due to its unique property rights structure. The first objective of this study is to investigate this conflict in a unique setting in the Chinese stock market where the controlling shareholders are prohibited from selling their shares in the open market.

China's economic reform features and ownership diversification of the "state owned enterprises" (hereafter SOEs) by means of issuing a minority portion of the state enterprise ownership to private investors while various layers of governmental agencies and parent state enterprises remain to be the controlling shareholders. However, there is an important constraint on the property rights of the newly listed SOEs. That is, the shares and assets controlled by the government or parent state enterprises are prohibited from being sold to the public while the privately owned shares are traded freely in the capital market. This artificial constraint imposed by the government on the transferability of stock and assets has caused the non-tradable shareholders to explore opportunistic ways to realize the value of their shares (Aharony et al. 2000). This study investigates different opportunistic tactics non-tradable shareholders utilize to realize their interests in the organization. Specifically, this study examines this issue from three different aspects.

First, this study intends to analyze whether non-tradable shareholders have preference for excessive cash dividends. Most listed companies in China are reformed state-owned enterprises in which non-tradable shareholders are either various government agencies or parent state enterprises. They usually control the shareholders general meetings and the board of directors. They have the ability to determine the profit distribution and may therefore expropriate

minority shareholders by distributing excessive cash dividends. Therefore, this study proposes that controlling non-tradable shareholders have preference to distribute excessive cash dividends when there is no open market for them to realize the value of their shares.

Secondly, this study also attempts to analyze whether non-tradable controlling shareholders expropriate from the company and minority shareholders by transferring assets and profits out of firms through related party transactions. This type of dealings is labeled as "tunneling" (Johnson et al. 2000). It is expected that the current corporate governance system in China fails to constrain controlling non-tradable shareholders from engaging in "tunneling" transactions between the listed company and themselves at the expense of the interests of the company and minority shareholders.

Third, this study aims to examine the relationship between excessive cash dividends and "tunneling" related party transactions. Both excessive cash dividends and tunneling are opportunistic techniques used by controlling shareholders to expropriate from minority shareholders. This study investigates whether those two are independent of each other or there is a compensating relationship between them.

The second objective of this study is to compare the level of preference for cash dividends and the level of related party transactions among the three major non-tradable controlling shareholders in listed SOEs: state shareholders, state-owned legal person shareholders, and domestic legal person shareholders. One of the unique features of the ownership structure in China is that shares in a listed company is artificially divided into different categories that have different rights, including state shares, state-owned legal person shares, and domestic legal person shares. State shares are held by the state and its various government agencies; state owned legal personal shares are kept by parent SOEs; while domestic legal person shares are maintained by institutional investors. Because interests and preferences among the three non-tradable controlling shareholders are different, it is expected that the preferences for cash dividends and the level of related party transactions are different among them.

This study contributes to the literature in several ways. First, the empirical evidence provided by this project will help Chinese regulators identify the areas that are likely to be abused by non-tradable shareholders and the differential interests and preferences among the different non-tradable shareholders. Second, this project will enhance the understanding of both domestic and international investors of the fundamental problems related to the non-tradable shares issue. Finally, this project contributes to the academic understanding of the dividend puzzle and related party transactions issues in the accounting and finance literature.

We present a summary of the ownership structure in China, a summary of previous dividends and related transaction literature, and develop our hypotheses in section II. We present our research methods and sample selection in section III; our results in section IV; and our conclusions and limitations in section V.

II. Literature Review and Hypotheses Development

2.1 Ownership Structure in China

The Chinese government started a reform on its state-owned enterprises in the 1980s. This reform features the decentralization of control rights from the state to the enterprise level by means of ownership diversification of SOEs. The reform is intended to improve productivity and economic efficiency in SOEs (Qian 1996). In 1984, 11 SOEs became shareholding enterprises through a process called shareholding transformation. By the late 1980s another handful of SOEs had undergone this transformation. The introduction of corporate form was associated with further ownership diversification in early 1990s. The ownership diversification process involves the issuance a minority portion of state enterprise ownership to private investors while the central and local government or various governmental agencies remain to be the controlling shareholders. More than 1200 companies have diversified their ownership through public listing from 1993 to present.

Due in large part to the side effects of several decades of a highly centralized economy, many SOEs have run into serious financial difficulties. The opportunity to raise capital in stock market provides strong incentives for state enterprise to go public. Due to the restrictions imposed by the government on the numbers of firms and the stated criteria on financial performance for listing, most state enterprises engage in opportunistic reorganization and restructure activities (Aharony et al. 2000). To manipulate their financial performance and increase their public offering size, several SOEs in similar industries are assembled into one corporate group, where the profitable subsidiaries in the group are selected as the new issue. The unprofitable units are retained by the group to become

the parent or holding company of the new issue. As the largest controlling shareholder, the parent or holding company may inject valuable assets to the listed subsidiary to boost its earnings performance. In return, the parent company expects future payoffs.

One of the unique features of the ownership diversification process is that equity in listed company is artificially divided into different categories of shares that have different rights, including state shares, state-owned legal person shares, domestic legal person shares, and public shares. State shares are held by the state and its various ministries, bureaus and regional governments; state owned legal personal shares are kept by parent SOEs; while domestic legal person shares are maintained by institutional investors; public shares are held by individual investors. To maintain its ultimate control over the state interests in SOEs and reduce conflict of interests between legal entities and management, the government prohibits any state shares and legal shares trading while allows the privately owned shares to be traded freely in the newly developed stock markets. The artificial barrier imposed by the government on the transferability of stock has generated a series of incentive and behavioral problems in the Chinese stock market. Next, we discuss whether controlling shareholders would distribute excessive cash dividends and engage in tunneling activities when their interests in the organization could not be realized in an open market.

2.2 Value Realization of Non-transferable Shares

In China, stock is held by three different parties: government, legal persons (i.e., holding companies), and public individual investors. All categories of shareholders are entitled to equal voting right. Since most listed companies in China are restructured state-owned enterprises, the nontransferable shareholders are usually the controlling shareholders in the listed firms. Due to its weak legal system, it has been a well-known fact in China that mangers of listed companies serve as the agents of controlling shareholders and do not act in the interests of the firms and the minority shareholders. The controlling owner is able to influence decision making of boar of directors easily. Moreover, the artificial barrier imposed by the government on the transferability of state shares and legal person shares has caused the controlling nontransferable shareholders to explore other ways to realize the value of their shares. This unique feature of the ownership structure in China has also contributed to the agency conflict among different shareholders. This paper proposes that the controlling nontransferable shareholders have incentives to expropriate minority shareholders by distributing excessive cash dividends and tunneling the listed firms through related party transactions when there is no open market for them to realize the value of their shares. Furthermore, the paper compares the level of preference for cash dividends among the different controlling nontransferable shareholders.

2.2.1 Cash Dividends

Why do firms pay dividends? Many theories have been proposed to solve the dividend puzzle, including the bird in hand fallacy, the clientele hypothesis, the signaling theory, and the agency theory (Balck 1976; Easterbrook 1984; Jensen et al. 1992). While all of these hypotheses have received some empirical support, none have been consistently supported in the empirical literature. The dividend puzzle has remained unexplained for over half a century. The discussion on dividends policy has been mainly focused on why firms pay dividends and whether dividends affect the market value of the shares.

In dividend decisions, the question is about decision-making and controlling power. Controlling the corporation makes it possible to control dividend decisions. So far, very few studies have researched on the roles of controlling shareholders in the dividend decision making process in different situations. The focus of this study is to investigate whether controlling shareholders would distribute excessive cash dividends when their interests in the organization could not be realized in an open market. Additionally, we investigate whether preferences for cash dividends are different among different controlling shareholders. The unique features of the ownership structure in China provide an ideal setting to examine the roles controlling shareholders play in the dividend decision making process.

2.2.2 Related party transaction

Related party transactions have become an increasingly important issue in China™s fledging stock markets. Since 1997, the Ministry of Finance and China Securities Regulatory Commission (CSRC) have issued several accounting rules and regulations regarding related party transactions. According to the 2010 annual reports of all the listed firms, 90% of them are involved in different degrees of related party transactions. Anecdotal evidence

indicates that the current corporate governance system in China fails to constrain controlling shareholders from manipulating earnings and expropriating minority shareholders through related party transactions.

Related party transactions include items such as sales and purchases of products and materials, borrowing and lending, interest, rent, purchase and sales commissions, exchanges of fixed assets. Related party transactions among group members can help reduce transaction costs and enhance the enforcement of property rights and contracts (Kim 2003, Fan and Wang 2007, Jian and Wang 2008). When external financing is scarce and uncertain, a corporate group maximizes the welfare and economic benefits of its entire group by allocating capital among member firms. Due to poorly-developed external financial market, the creation of internal market within corporate groups can enhance resource allocation in developing economies (Khanna and Palepu 1997). There has been more recent research evidence suggesting that comparing with unaffiliated firm, group-affiliated firms have a lower probability of liquidation by banks (Kim 2003).

Formation of corporation can create values for firms that benefit all shareholders, but it can exacerbate the conflicts of interest between controlling shareholders and minority shareholders. The internal markets set up within the complex ownership and control structure of group-affiliated firms may lead to greater agency problems and opportunistic earnings management (Clasessens and Fan 2003). Controlling shareholders can take advantage of these related dealings for opportunistic purposes. Formation of groups may result in misallocation of capital among member firms, with cash flows generated by profitable members being invested in unprofitable ventures, even though this may not be in the interest of outside shareholders. Loans may well be an important mechanism by which stronger group members assist weaker members (Khanna and Yafeh 2000). However, La Porta et al. (2000) find that corporate groups often channel loans at favorable terms from banks they control to member firms.

Based on the stable and long-term relationships developed among group members, firms should have more assurance in the collection of related party loans. As a result, listed companies might offer larger amounts of credits to affiliated firms, and in returns, they should receive reciprocal treatments from them. However, if credit offering is employed as a tool for tunneling, a listed firm that offers generous credits to related parties does not necessarily receive the same credit terms from them. In other words, listed companies would lend more to their controlling owners and other related parties than borrow from them.

Direct lending to controlling owners and their affiliates is one way that controlling owners divert resources for their own benefits. The listed firms in China are particularly susceptible to engaging in tunneling through related party transactions due to the unique features in their corporate structure and weak legal systems.

The second objective of this paper is to see whether controlling shareholders use related party transactions in tunneling from listed firms. One common way for tunneling to occur is to directly loan to related parties by recognizing the other receivables account in the financial report. According to Jian and Wang (2008), related party transactions are a common practice in China due to its corporate structure, economic institutions and legal system. Anecdotal evidence further indicates that the current corporate governance system in China fails to constrain controlling shareholders from expropriating minority shareholders through related party transactions. Johnson et al. (2000) show that firms in developed market also use related party transactions to transfer assets and profits out of firms for the benefit of those who control them. They label this type of dealings as “tunneling.”

2.3. Hypotheses Development

Under the classical dividend irrelevance theory proposed by Miller and Modigliani (1961), dividends do not affect the value of a firm. However, the artificial barrier imposed by the government on the transferability of state shares and legal person shares has caused the controlling nontransferable shareholders to explore other ways to realize the value of their shares. This unique feature of the ownership structure in China has contributed to the agency conflict among different shareholders. Moreover, due to its weak legal system, it has been a well-known fact in China that mangers of listed companies serve as the agents of controlling shareholders and do not act in the interests of the firms and the minority shareholders. The controlling owner is able to influence decision making of boar of directors easily. This paper proposes that the controlling nontransferable shareholders have incentives to expropriate minority shareholders by distributing excessive cash dividends and tunneling the listed firms through related party transactions when there is no open market for them to realize the value of their shares. Furthermore, the paper compares the level of preference for cash dividends among the different controlling nontransferable shareholders. Because interests and preferences among the three non-tradable controlling shareholders are

different, it is expected that the preferences for cash dividends and the level of related party transactions are different among them. Therefore, the first hypothesis compares the level of cash dividends among the three different types of controlling shareholders.

H1: Firms controlled by parent SOEs distribute the lowest level of cash dividends, firm controlled by the state and its various agencies distribute the medium level of cash dividends, while firms controlled by domestic institutional investors distribute the highest level of cash dividends.

The second hypothesis compares the level of related party transactions among the three controlling shareholders.

H2: Firms controlled by parent SOEs engage in the lowest level of tunneling activities, firm controlled by the state and its various agencies engage in the medium level of tunneling activities, while firms controlled by domestic institutional investors engage in the highest level of tunneling activities.

The third hypothesis aims to examine the relationship between excessive cash dividends and "tunneling" related party transactions. Both excessive cash dividends and tunneling are opportunistic techniques used by controlling shareholders to expropriate from minority shareholders. This study investigates whether those two are independent of each other or there is a compensating relationship between them.

H3: The level of tunneling activities is negatively related to the level of cash dividends in a firm.

III. Models and Data Collection

We employ two main models to test hypotheses 1-3.

$$Dit = \alpha 1 + \alpha 2\ RECit + \alpha 3\ LSi + \alpha 4\ SSi + \alpha 5\ DLSi + \alpha 6 Control\ Variables + \epsilon it \quad (1)$$

$$RECit = \alpha\ 1 + \alpha\ 2\ Di, t\text{-}1 + \alpha\ 3\ CAi, t + \alpha\ 4\ TLi,t + \alpha\ 5\ LSi + \alpha\ 6\ SSi + \alpha\ 7\ DLSi + \epsilon it \quad (2)$$

Where:

Dit = cash dividends per share for sample firm i in period t;

RECit = other receivables scaled by total assets for sample firm i in period t;

= beginning balance of current assets scaled by total assets for sample firm i in period t;

= beginning balance of total liability scaled by total assets for sample firm i in period t;

= an indicator variable set to one if the nontradable controlling shareholder is the parent SOE and to zero otherwise;

= an indicator variable set to one if the nontradable controlling shareholder is the state and its various ministries, bureaus and regional governments and to zero otherwise;

= an indicator variable set to one if the nontradable controlling shareholder is domestic institutional investors and to zero;

= Control variables, including total assets per share , total liability per share , stock dividends per share from previous period , cash dividends per share from previous period , a dummy variable for residual income set to one if the residual income (equals to ROE less cost of equity calculated using the CAPM model) is greater than zero and to 0 otherwise.

Data for this study are based on firms listed before 2007 from both of the Chinese stock markets. The financial accounting data from 2007 to 2013 were used to run the two regression models. 530 firms were identified in the A share market prior to 2007. Three financial service firms were excluded from the sample. In addition, 22 firms were excluded from the sample due to a lack of data. The final sample includes 503 firms.

IV. Summary Statistics and Regression Results

Table 1 presents the descriptive statistics of cash dividends and tunneling activities through related party transactions. As predicted earlier, domestic legal person shareholders divert the most resources through related party transactions among the three different types of controlling shareholders. State-owned legal person shareholders are the second and the state shareholders are the least among the three. As the corporate governance system improved, controlling shareholders diversion of resources from the listed firms decreased gradually, from 11.7% in 2009 down to 6.8 % in 2013. The level of cash dividends payment is from high to low in the order of domestic legal person shareholders, stated-owned legal person shareholders, and the state shareholders. Those results are consistent with our predictions in our three hypotheses.

Table 1 The Descriptive Statistics of Cash Dividends and Related Party Transactions

Variables	Controlling Shareholders	2009	2010	2011	2012	2013
REC	Parent SOEs legal person shares	0.083	0.086	0.087	0.068	0.054
	State Shares	0.097	0.118	0.099	0.075	0.077
	Domestic Legal person shares	0.115	0.075	0.136	0.064	0.098
	All Sample	0.117	0.114	0.101	0.074	0.068
Cash Dividends	Parent SOEs legal person shares	0.055	0.043	0.063	0.065	0.066
	State Shares	0.054	0.063	0.071	0.053	0.056
	Domestic Legal person shares	0.106	0.075	0.080	0.118	0.098
	All Sample	0.048	0.043	0.069	0.057	0.053
roe	All	0.101	0.102	0.089	0.100	0.098
The percentage of Cash Dividends	Parent SOE legal person shares	35.11	30.12	54.79	58.9	48.61
	State Shares	35.29	37.5	62.5	50	48.28
	Domestic Legal person shares	47.67	47.06	50	81.82	70
	All Sample	30.54	28.31	59.12	52.64	45.08

Table 2 The results of Model (1) and (2)

Varialbes	Coefficents	5% Significance	1 % SIgnificance	
D_{it}	1123.578	15.41	20.04	None**
$arecno_{i,t}$	461.9434	3.76	6.65	No more than one**

D_{it} = -0.011245-0.241385 $arecno_{i,t}$ -0.024022 $curoa_{it}$ -0.009787 loa_{it} -0.000106 dg_{it} +0.014023 $dgzj_{it}$

(-3.7394) (-6.30339) (-1.9701) (-2.56288) (-0.00545) (2.46481)

+0.031856 df_{it} +0.001787 seo_{it} +0.374281 $D_{i,t-1}$ +0.031453 $dre10_{it}$, adj.R^2=0.450253

(2.99832) (0.92563) (18.2646) (6.63500)

$arecno_{i,t}$ = -0.05657- 4.142767 D_{it} +0.105628 $curoa_{it}$ +0.032556 loa_{it} -0.012079 dg_{it} -0.015425 $dgzj_{it}$

(-7.1333) (-6.30339) (8.37627) (6.68172) (-1.73547) (-2.12493)

-0.009562 df_{it} -0.002236 seo_{it} -0.186841 $D_{i,t-1}$ -0.009532 $dre10_{it}$, adj.R^2=0.591656

(-0.70539) (-0.90808) (-7.14596) (-1.57589)

Notes:
** Significant at 0.05
* Significant at 0.10

Table 3 presents the regression results from models (1) and (2). The focus of this paper is to compare the differences in the levels of cash dividends and tunneling activities among the three different types of controlling shareholders.

Table 3 Regression Results of Model 1 and 2

$$D_{it} = a_1 + a_2 arecno_{i,t} + a_3 dg_i + a_4 dgzj_i + a_5 df_i + a_6 D_{i,t-1} + a_7 dre10_{i,t-1} + \eta_{it} \quad ①$$

$$arecno_{i,t} = a_8 + a_9 D_{i,t-1} + a_{10} curoa_{i,t} + a_{11} loa + a_{12} dg_t + a_{13} dgzj_i + a_{14} df_i + \zeta_{it} \quad ②$$

coefficients		2009	2010	2011	2012	20103	2009-2011	2012-2013
a_1		0.0502 (2.119)[b]	0.0383 (2.206)[b]	0.0792 (5.430)[a]	0.0740 (3.002)[a]	0.0485 (2.984)[a]	0.0518 (4.799)[a]	0.0584 (4.304)[a]
a_2		-0.2241 (-1.428)	-0.1638 (-1.373)	-0.2727 (-2.260)[b]	-0.6949 (-2.724)[a]	-0.3518 (-1.902)[b]	-0.1725 (-2.194)[b]	-0.4926 (-3.345)[a]
a_3		-0.0042 (-0.328)	0.0034 (0.293)	-0.0097 (-0.959)	0.0081 (0.721)	0.0118 (1.008)	-0.0041 (-0.627)	0.0008 (0.066)
a_4		0.0112 (0.639)	0.0245 (1.631)[c]	-0.0055 (-0.396)	-0.0096 (-0.572)	0.0093 (0.549)	0.0094 (1.071)	0.0095 (1.196)
a_5		0.0796 (3.413)[a]	0.0100 (0.423)	0.0150 (0.706)	0.0418 (1.618)	0.0270 (0.927)	0.0348 (2.698)[a]	0.0377 (2.009)[b]
a_6		0.2775 (6.193)[a]	0.3082 (6.124)[a]	0.3035 (5.427)[a]	0.3943 (4.813)[a]	0.3234 (4.562)[a]	0.3001 (10.40)[a]	0.3633 (7.108)[a]
a_7		0.0247 (2.434)[b]	0.0304 (3.204)[a]	0.0272 (2.994)[a]	0.0409 (2.988)[a]	0.0526 (3.597)[a]	0.0256 (4.649)[a]	0.0475 (4.882)[a]
a_8		0.0638 (2.859)[a]	0.0405 (1.870)[c]	0.0519 (2.144)[b]	0.0653 (4.457)[a]	0.0406 (2.728)[a]	0.0494 (3.745)[a]	0.0529 (5.020)[a]
a_9		-0.3250 (-2.288)[b]	-0.5213 (-3.583)[a]	-0.6379 (-4.620)[a]	-0.3834 (-4.681)[a]	-0.4016 (-3.851)[a]	-0.4785 (-5.607)[a]	-0.3923 (-5.936)[a]
a_{10}		0.1269 (4.263)[a]	0.1465 (4.922)[a]	0.1247 (4.480)[a]	0.0429 (2.026)[b]	0.0613 (2.841)[a]	0.1322 (7.888)[a]	0.0526 (3.455)[a]
a_{11}		0.0356 (1.100)	0.0575 (1.844)[c]	0.0561 (1.709)[c]	0.0137 (2.434)[b]	0.0276 (4.727)[a]	0.0511 (2.766)[a]	0.0206 (5.071)[a]
a_{12}		-0.0382 (-2.992)[a]	-0.0304 (-2.151)[b]	-0.0092 (-0.686)	-0.0010 (-0.095)	-0.0060 (-0.542)	-0.0249 (-3.223)[a]	0.0024 (0. 210)
a_{13}		-0.0350 (-1.888)[c]	-0.0073 (0.361)	-0.0039 (-0.214)	-0.0022 (-0.136)	0.0070 (0.432)	-0.0095 (-0.868)	-0.0036 (-0.468)
a_{14}		-0.0036 (-1.121)	-0.0361 (-1.172)	0.0378 (1.402)	0.0141 (0.560)	0.0438 (1.636)	0.0047 (0.280)	0.0289 (1.574)
①Adj. R^2		0.166	0. 195	0.222	0.095	0.159	0.197	0.173
②adj. R^2		0.087	0.111	0.130	0.070	0.058	0.116	0.065
Wald Chi-sq.	$a_3 = a_4$ $a_3 = a_5$	0.725 11.46[a]	1.441 0.071	0.069 1.168	0.873 1.479	0.017 0.237	1.827 7.843[a]	0.437 2.960[c]
	$a_{12} = a_{13}$ $a_{12} = a_{14}$	0.024 1.296	2.750[c] 0.031	0.060 2.591	0.004 0.319	0. 507 3.204[b]	1.510 2.821[c]	0.217 1.590

As far as the preference for cash dividends, the regression results in the both periods show that the domestic legal person shareholders have significantly higher level of cash dividends than the state-owned legal person shareholders. Though the level of cash dividends is higher for the domestic legal person shareholders than the state shareholder, the difference is not statically significant. The results also show that the state shareholders have significantly higher level of cash dividends than the state-owned legal person shareholders in the first period (2009-2011). Therefore, the empirical results presented in the table show support for hypothesis 1, that is, firms controlled by parent SOEs distribute the lowest level of cash dividends, firm controlled by the state and its various agencies distribute the medium level of cash dividends, while firms controlled by domestic institutional investors distribute the highest level of cash dividends.

The regression results show that the level of tunneling activities engaged by the state-owned legal person shareholders are significantly lower than by the other two in the early period from 2009-2011 (is significantly lower than zero). However, the results are not statistically significant in the late period from 2012-2013. Those results show that the state-owned legal person shareholders engage in significantly lower tunneling activities

through related party transactions than the domestic legal person shareholders. Although the results show that the state-owned legal person shareholders engage in lower tunneling activities than the state shareholders, the difference is not statically significant. Hypothesis 2 is supported.

In the table, is significantly less than zero at the 1% significance level, indicating that the payment of cash dividends decreases the tunneling activities through related party transactions. Alpha 2 is significantly less than zero at the 5% significance level from 2011-2013, while it is all negative in the other time periods although it is not statically significant. Those results show support to hypothesis 3.

V. Conclusions and Contributions

China's capital market is experiencing the most important transitional period in its history. The focal point is to solve the non-tradable share issue. By the end of 2004, 64% of shares in listed companies were earmarked as non-tradable. Among these non-tradable shares, 74% were owned by the state. Non-tradable shares have become the most thorny institutional issue in China's capital market and caused significant negative impacts on the development of the market:

- Both domestic and foreign investors lost confidence in the Chinese stock market because of the uncertain expectation over the future of the market;
- It becomes the key obstacle to further integrate Chinese markets with international markets, and to diversify the products in the market;
- There is a serious agency conflict between non-tradable controlling shareholders and minority shareholders;
- The pricing mechanism of the whole stock market is distorted;
- It becomes rather difficult to further promote the reform of SOEs.

To promote the healthy development of the market, the government firmly decided to solve this issue, and laid down the basic principles as follows:

- To conform with the law of market economy ;
- To ensure healthy and steady development of the market;
- To keep as a priority to protect the interest of public shareholders.

This project will make a contribution to these principles in the following ways.

First, the empirical evidence provided by this project will help Chinese regulators identify the areas that are likely to be abused by non-tradable shareholders and the differential interests and preferences among the different non-tradable shareholders.

Second, this project will enhance the understanding of both domestic and international investors of the fundamental problems related to the non-tradable shares issue.
Finally, this project contributes to the academic understanding of the dividend puzzle and related party transactions issues in the accounting and finance literature.

References

Aharony , J., J. Lee and T.J. Wong, 2000, Financial Packaging of IPO firms in China, Journal of Accounting Research, 38 (1), 103-126.

Black, F. 1976. The Dividend Puzzle, Journal of Portfolio Management, Vol2., pp5-8.

Easterbrook, F.H. 1984. Two Agency Cost Explanations of Dividends, American Economic Review, June, pp650-659.

Demsetz, H., K. Lehn, 1985, The Structure of Corporate Ownership: Causes and Consequences, Journal of Political Economy, 93 (Dec.): 1155-1177.

Fan;, J. T.J. Wong and Tianyu Zhang, 2007, Politically connected CEOs, corporate governance, and Post-IPO performance of China's newly partially privatized firms, Journal of Financial Economics, 84, (2), 330-357

Jensen, M.C. and W.H. Meckling. 1992. Simultaneous Determination of Insider Ownership, Debt and Dividend Policies, Journal of Financial and Quantitative Analysis, June, pp247-263.

Jian, J. and T.J. Wang, 2008. Propping Through Related-Party Transactions, Review of Accounting Studies, 15 (1):70-105.

Johnson, S., R. La Porta, F. Lopez-De-Silanes and A. Shleifer, 2000, Tunneling, The American Economic Review 90(2), 22-27.

La Porta, R., F. Lopez-De-Silanes, A. Shleifer, and R. Vishny, 1999. Corporate Ownership around the World, Journal of Finance 54(2): 471-517.

Miller, M.H., and F. Modigliani, 1961, Dividend Policy, Growth, and the Valuation of Shares, Journal of Business, 34: 411-433.

Ohlson, J.A., 1995, Earnings, Book Values, and Dividends in Equity Valuation, Contemporary Accounting Research Vol.11: 661-687.

Qian, Y., 1995, Reforming Corporate Governance and Finance in China, in Masahiko Aoki and Hyung-Ki Kim eds., Corporate Governance in Transitional Economies, Washington DC: World Bank.