Journal of Corporate Finance 17 (2011) 541–554

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Disproportional ownership structure and pay–performance relationship: Evidence from China's listed firms

Jerry Cao [a], Xiaofei Pan [b], Gary Tian [b,*]

[a] Lee Kong Chian School of Business, Singapore Management University, Singapore
[b] School of Accounting and Finance, University of Wollongong, Australia

ARTICLE INFO

Article history:
Received 2 November 2009
Received in revised form 24 February 2011
Accepted 24 February 2011
Available online 3 March 2011

JEL classification:
G32
G34

Keywords:
Managerial compensation
Firm performance
Ownership structure

ABSTRACT

This paper examines the impact of ownership structure on executive compensation in China's listed firms. We find that the cash flow rights of ultimate controlling shareholders have a positive effect on the pay–performance relationship, while a divergence between control rights and cash flow rights has a significantly negative effect on the pay–performance relationship. We divide our sample based on ultimate controlling shareholders' type into state owned enterprises (SOE), state assets management bureaus (SAMB), and privately controlled firms. We find that in SOE controlled firms cash flow rights have a significant impact on accounting based pay–performance relationship. In privately controlled firms, cash flow rights affect the market based pay–performance relationship. In SAMB controlled firms, CEO pay bears no relationship with either accounting or market based performance. The evidence suggests that CEO pay is inefficient in firms where the state is the controlling shareholder because it is insensitive to market based performance but consistent with the efforts of controlling shareholders to maximize their private benefit.

1. Introduction

In recent years two strands of research on the effect of ownership structure on pay–performance relationships have begun to emerge. The first focuses on the effects of cash flow rights and divergence between control rights and cash flow rights (excess control rights) on CEO pay (Masulis et al., 2009; Barontini and Bozzi, 2010). With US dual-class firms, Masulis et al. (2009) find that the divergence between an insider's control and cash flow rights has a positive effect on CEO pay, while from a sample of Italian listed firms, Barontini and Bozzi (2010) acknowledged that there is a negative effect. The second strand focuses on the effects of an ultimate controlling shareholder's type on the pay–performance relationship, particularly between state and non-state owned firms in transition economies such as China. For example, Kato and Long (2005) find that state ownership weakened the pay–performance relationship. Firth et al. (2006b) find that distinct types of controlling shareholders have different impacts on the use of incentive pay for CEOs, and they provide evidence that CEO pay is weakly related to firm performance in firms whose controlling shareholder is either the central government or a private owner. We extend their research by explicitly examining how a controlling shareholder's type, cash flow rights and excess control rights shape CEO pay and the pay–performance relationship.

Several studies find that the wedge between cash flow and control rights affects firm value (Claessens et al., 2002; Lemmon and Lins, 2003; Laeven and Levine, 2008; Gompers et al., 2010). Indeed through a common practice of ownership concentration and pyramid structure, controlling shareholders in emerging markets can exercise control through voting rights despite having relatively small proportional cash flow rights. These excess control rights give controlling shareholders an incentive to expropriate the wealth of other investors and pursue their own interests, which are often diametrically opposed to those of minority shareholders (Chen et al., 2011). The

* Corresponding author at: School of Accounting and Finance, University of Wollongong, Northfields Avenue, NSW 2522, Australia.
E-mail address: gtian@uow.edu.au (G. Tian).

0929-1199/$ – see front matter. Crown Copyright © 2011 Published by Elsevier B.V. All rights reserved.
doi:10.1016/j.jcorpfin.2011.02.006

issues regarding the expropriation of minority shareholders are especially relevant in economies with weak legal protection or poorer governance standards (La Porta et al., 1999, 2000; Johnson et al., 2000; Peng et al., 2011). Conflicts between the largest shareholders and minority shareholders are particularly severe in transition economies where the ownership is highly concentrated and investors lack legal protection (Shleifer and Vishny, 1997; Lin et al., forthcoming). The general consensus is that a disproportional ownership structure allows for easier expropriation of the wealth of minority shareholders, which results in a firm's lower value. Fan et al. (2011) further suggest that the cost of expropriation may ultimately be born by the controlling shareholders and that they would need to devote substantial resources to their expropriation activities. However, the question of whether the controlling shareholder's excess control rights affect CEO pay remains unexplored in the context of disproportional ownership economy. CEO compensation is essential to provide management incentive, which is not necessarily consistent with the interest of minority shareholders.

Aligning executive interests with those of shareholders is an important governance mechanism (Jensen and Murphy, 1990). In economies with concentrated ownership, the largest shareholders are often in charge of setting CEO compensations. The impact of ownership concentration and excessive control on executive incentives remains contradictory. Murphy (1999) suggested that the largest shareholders have strong incentives to directly monitor managers by relating CEO pay to firm performance. On the other hand, the separation of control and cash flow rights is able to adversely affect the pay–performance relationship, since the largest shareholders extract their private benefits by setting CEO compensation schemes unrelated to the wealth of minority shareholders but to the controlling shareholder's private interest. To help understand these questions, we use the unique Chinese context[1] to examine the effect of ownership structure, specifically cash flow rights and control rights of the ultimate controlling shareholders, on the pay–performance relationship.

China's economic transition follows a path of partial privatization, in which the state retains control over many SOEs by floating only a small percentage of shares to the public. It does this through creating a long principal-agent chain, a significant pyramid structure, and cross-shareholdings of ownership. As a result, the state controlling shareholders have substantial control rights in excess of their cash flow rights. At the same time, many privately controlled firms were also listed in the capital markets in China through initial public offerings (IPOs) along the development of these Chinese markets after 2001.

State controlled and privately controlled firms have different operating objectives due to the nature of their ownership and are also subject to different regulations. It is argued that state controlled firms operate with multiple objectives that vary between maximizing the wealth of shareholders, maintaining urban employment levels, and controlling sensitive industries (Clarke, 2003). Fan et al. (2011) also argued that state ownership, which is often non-tradable or not freely-transferrable, can have a significant impact on managerial incentive schemes. Therefore, it is important to distinguish between state and private-controlled firms because they may intend to use different incentive schemes.

However, due to the complex ownership structure of state controlled firms, it is also important to distinguish among state controlled firms. State controlling shareholders may belong to different state owned entities and government agencies and each of them may have different objectives and therefore desire to adopt different pay schemes. Therefore we classified state controlled firms into two categories based on their ultimate controlling shareholders: state assets management bureaus (SAMBs), and state owned enterprises (SOEs). SAMB is a government agency responsible for managing and controlling state owned assets. In SAMB controlled firms, CEOs work as representatives of the government, so their pay scheme may not be based purely on economic performance. In contrast, the publicized goal for SOE controlled firms is to maximize the firm's value and incentivize management.

Historically, most general managers of state controlled firms worked as bureaucrats and were paid according to the civil service pay scale. Since 1985, China introduced wage reform and other economic reforms in state controlled firms to improve the management compensation scheme. In 2000, the Ministry of Labor announced that CEO payment in state controlled firms should be linked to a firm's economic performance (The Ministry of Labor, 2000). However, this did not provide sufficient incentive as firms still operated under the previous system where profits and wages were being redistributed by the state (Yueh, 2004). With the establishment of two stock exchanges in the early 1990s and the State-Owned Assets Supervision and Administration Commission of the State Council (SASAC) in 2003, many state controlled firms were restructured and listed on the two stock exchanges. Since 2003, many regulations have been promulgated by SASAC to evaluate SOE performance and align this with CEO pay. Specifically, SASAC issued 'Interim regulations on the evaluation of the top executive operating performance' in SOEs affiliated to the central government (SOECGs) in 2003, which clearly stated that the top executive pay should be aligned to total profits and sales and described how to evaluate executive performance.[2] In 2006 and 2010, SASAC updated this regulation by adding some extra rules such as the punishment of top executives when they were underperforming. Obviously, by putting these regulations into practice, SASAC has decreed that profitability should be the primary measure of firm performance to which CEO pay should be linked. Meanwhile, to curtail CEOs from expropriating shareholder wealth through excessive perks, SASAC also promulgated 'Instructions on regulating top executive 'on-job' consumptions in SOECGs' in 2006.[3]

[1] Firth et al. (2006b) suggest that "China's listed firms have unique ownership characteristics where the largest shareholder usually has effective control. Most listed firms have a dominant shareholder that helps shape the strategies and policies of the company. The dominant shareholder can exercise substantial control over a firm by way of board representation as well as through voting rights. In many cases it is the State, local, city, or regional government that has the controlling share stake. In other cases, the controlling shareholder is a SOE (from which the listed firm was carved out) or a private blockholder."

[2] Furthermore, in 2007 and 2008, the SASAC announced two 'supplementary provisions' of this regulation which made further efforts on aligning executive pay to firm performance in SOEs. Meanwhile, in 2004, 2006 and 2009, the SASAC also promulgated the 'Interim regulations on the administration of top executive pay in SOECGs', 'Interim regulations on the evaluation and administration of SOECG performance' and 'Interim regulations on the evaluation and administration of state owned financial institutions firm performance'.

[3] At the local levels, the local SASACs located across the country have also issued regulations based on their local specific characteristics according to the regulations from the central SASAC. For example, Beijing SASAC promulgated 'Interim regulations on the administration of top executive pay in Beijing SOEs in 2004, which has similar effects of relating CEO pay to firm performance.