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RECENT DEVELOPMENTS IN CORPORATE SUSTAINABILITY REPORTING IN CHINA

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Abstract

Sustainability reports contain important information for the stakeholders. The aim of this paper is to present an overview of recent developments in the area of sustainability reporting in China. The paper presents useful insights into sustainability reporting in China and helps to better navigate the future trends in sustainability reporting practices. The sustainability reporting rules in China should not rely on a basis of broad standards but on legally enforced binding rules.

Keywords: China, Corporate Social Responsibility, Corporate Governance, Sustainability Reporting, Communication, Global Reporting Initiative

1. Introduction

Significant information with regard to the company activities are communicated through sustainability reports. These reports have become an integral part of a corporate governance framework of a country as cultural, social and environmental factors start playing a more and more important role in addition to the economic performance of companies. This paper will lay its focus on sustainability reporting in China. The country has been chosen as the object to study for quite obvious reasons: China is going through a major transition since quite a few years. Transition implies changes of various important aspects one wants to keep track of. Furthermore, China is nowadays one of the most important economies in the world and there has been a spate of recent scandals involving bad reporting practices (Jackson, 2011). Although there is only very limited regulatory guidance on sustainability reporting in most countries including China (Manetti and Becatti, 2009), projects such as the GRI (Global Reporting Initiative) and IIRC (International Integrated Reporting Council) try to overcome this gap. With the establishment of GRI and the advent of the twenty-first century, the first formal guideline on sustainability reporting was released and later on was revised multiple times. GRI's sustainability reporting guideline (G4 from 2013 is the most recent standard) has become the most widely adopted non-financial reporting guideline among businesses (Brown, *et al.* 2009).

In this paper we like to give a brief overview of the most important components of sustainability reporting in China and discuss some of the most pressing issues and implications within the broader corporate governance area. The overall goal is to describe the main features, one has to be aware of and China might do different than other countries. We will present discuss sustainability reporting in China in section 2, with a focus on executive compensation

and board reporting. In section 3 we will discuss the advantages and disadvantages of legal sustainability reporting rules versus broader standards. Section 4 concludes.

2. Corporate Sustainability Reporting in China

Since half a century, diverse stakeholders, including governments, employees, media, and the broader public, are increasingly concerned with organizations' commitment to (corporate) governance standards, environmental issues, social investment, and community involvement. The United Nations in the 1980s convened the World Commission on Environment and Development, also known as Brundtland Commission (1983), to address some of these issues. Having initially primarily been understood as environmental sustainability (Crane and Matten 2007) the concept was developed further and now embraces environmental, social, and economic sustainability.

Although sustainability communication remains as vague and ambiguous as the entire sustainability concept (Braendle and Noll 2005), the prominence of sustainability and its reporting in China has developed substantially. An organization's communication approach varies and depends on the organization's institutional background, size, business unit in charge. In addition, the sustainability communication channels also distinguish from the annual report being employed to non-financial reporting to corporate websites.

In order to find out, which stance exactly Chinese companies take to communicate their sustainability initiatives, we present the understanding of the sustainability concept and sustainability communication approach in the Chinese institutional context. There are some studies investigating the sustainability movement of Chinese companies (Graafl and Zhang 2014).

The Chinese legal environment in regard to corporate governance and sustainability reporting is mainly formed by the China Securities Regulatory Commission (CSRC), the Shenzhen and Shanghai stock exchanges, the Chinese Corporate Governance Code and the company law established by the government (Jiang and Kim, 2015).

The Code of Corporate Governance for Listed Companies in China accounts to the regulatory provisions (OECD, 2011). Chapter six covers the stakeholders. The last chapter with real content is the seventh chapter. It outlines the information disclosure and transparency. The obligation towards the code on behalf of the companies is either to comply or to explain deviations (Weil Gotshal & Manges LLP, 2014). Jiang and Kim (2015) provided one of the latest critical analysis of this code. Summarized, their conclusion is, that the language is very broad and vague and that the points are rather guiding principles than real regulations. However, there are some parts, which are very precise and explicit in their statements like the explanations of specialized committees in chapter 3. The CSRC is the authority to investigate and penalize violations of the relevant laws and regulations (China Securities Regulatory Commission, 2015).

There are a number of studies elaborating on the strength of the legal environment in China. Allen *et al.* (2005) analyze various components of a legal system and discovered, that the creditor and shareholder rights in China are below the average of the sample. Moreover, the observed sample shows a weak enforcement of law paired with a poor corruption index. On top of that, Allen *et al.* (2005) observed only a small legal labor force to provide legal protection and advice and a limited role of professional auditing. Consequently, they come to the conclusion, that the Chinese legal framework is weak. Pistor and Xu (2005) made the same finding, whereas they mainly focused on public and private law enforcement. Both aspects are weakly developed. However, the data used by Allen *et al.* (2005) and Pistor and Xu (2005) is fairly old in regard to the year 2016. A timespan longer than a decade is in a fast changing country like China a long time and leaves room for many changes. According to Pistor and Xu (2005), the legal environment is beginning to change in China. A newer insight is provided by Zou *et al.* (2008). They confirm the existence of a weak legal framework in China, especially for investors. Again, the most recent research in this direction was done by Jiang and Kim (2015) by reviewing various literature. They attest China, for instance, low fines and sanctions in the case of violations against the securities regulations and company laws. Overall, they evaluate the legal system in China as weak, as well as the other cited works. On the other hand, they also

state, that the system is changing in a fast pace and are expecting a strong legal environment in the near future. To overcome problems implicated by the weak legal framework, connections and networks, especially with politicians, are required. Chinese are custom to their own important kind of networking, namely “Guanxi”, with its own rules and formalities, one has to be aware of (Gu *et al.* 2008).

2.1. Executive Remuneration Reporting

Executive Remuneration is one of the most vividly discussed issues in China. Unlike in Western economies, compensation based on stock options remains very low in China, which can be attributed to the fact that this kind of remuneration was legalized only in the last years according to Kato and Long (2006). Jiang and Kim (2015) provide data on top management remuneration in China for the years 1999 to 2012, in which a drastic increase in management remuneration can be observed. The authors emphasize the fact that at the beginning of the observed time frame, top managers of non-publicly owned companies had a higher compensation than those of SOE, even though the size of the two kinds of firms would have suggested otherwise. The authors explain this with the fact, that managers of SOEs are mostly government employees rather than professional managers. This pay disparity reversed in the observed years, which is explained by the fact that many SOE went public in these years, and the CSRC encouraged firms to implement more effective pay-performance schemes.

Rampling *et al.* (2013) provide evidence that return on assets is significantly positive correlated with CEO remuneration of Chinese firms, whereas no such correlation can be observed between stock returns and remuneration. State ownership tends to decrease the level of remuneration, while foreign ownership tends to increase it. Moreover, the size of the Board is negatively correlated with the level of CEO remuneration, and firms with boards with a high proportion of executive members tend to use non-performance related remuneration schemes.

In order to understand the logic of executive remuneration, the concept of “guanxi” has to be introduced, i.e. the importance of interpersonal connections that serve as a form of social currency. It provides managers with access to scarce information, resources, or influence.” According to this logic, relationships are being evaluated by how close the other person is to oneself in a social context. When the other person is being considered as part of the “extended family”, unconditional loyalty is being granted. Total strangers are being treated with 'discretion and caution'. Individuals can improve their “guanxi” by mutual favors and perks.

Regarding the structure of executive remuneration, where in Western countries a clear differentiation between base salary and incentive-based bonuses can be taken, in China the logic of incentive schemes shows a more elaborated approach. Firth *et al.* (2007) show that perks constitute an important remuneration component. They identify two functions of perks: To provide incentives to managers as well as to establish an environment of appreciation that facilitates work. This complex system of mutual appreciation by the exchange of perks and favors is defined by the term “guanxi”. The authors show empirically that the value of perks granted to executives of large Chinese companies is positively correlated with current and future firm performance. Whether this “guanxi” approach of incentive payment is an effective alternative to performance incentives and bonuses based on hard facts cannot be ascertained with certainty since data on remuneration is not transparent enough to enable a empirically solid statement.

Realizing the importance of “guanxi” is perceived as a crucial requirement for corporate decision making in the Asian context and of critical influence for the success of firms in China according to Marquis and Qian (2014).

Kato and Long (2006) found evidence for a high pay-performance sensitivity for Chinese public listed companies compared from data from Western countries. The pay-performance sensitivity of executives is especially high when profits are negative.

2.2. Board of Directors Reporting

The board of directors of a company limited by shares is the operational implementation organ (OECD, 2011) and should have between 5 and 19 directors and, depending on certain requirements, representatives of the staff and working force (China Securities Regulatory Commission, 2005). Further shall the board of directors consist of one third of independent directors since the year 2003 (China Securities Regulatory Commission, 2001; Jiang and Kim, 2015). The board has the authority among other responsibilities to setup a management system, to appoint and dismiss managers and special committees, like an auditing or a remuneration committee, all in accordance to the general shareholder meeting (OECD, 2011).

Chen *et al.* (2006) and Jiang and Kim (2015) share the opinion, that the person with the most power and influence within a Chinese company, besides the controlling shareholders, is not the CEO. Both papers are explaining that the actual position in charge is very often the chairman. Chen *et al.* (2006) are simply stating that the chairman, in contrast to the most western concepts, is usually a full-time executive and holds a significant amount of power. Unfortunately, they do not elaborate further in this direction in contrast to Jiang and Kim (2015). First they mention that the top manager is in many cases not referred to as CEO but as the general manager, as apparently some literature is not aware of. Secondly, they differentiate the assumption that the chairman is the actual person in charge between state-owned enterprises (SOE) and non-SOEs. Another important component of the board of directors, besides the board chair is the independent directors. An independent director is not allowed to be related to the management of the company, to own more than one percent of the shares, to be one of the top ten shareholders or to have a business relation with the company itself (Jiang and Kim, 2015). The boards in China have on average nine directors during the year 2012. Observing the number of independent directors over a longer time span, we discover that Chinese companies only fulfill the regulatory requirements and usually do not top them. It is therefore not surprising that for the year 2012 on average only around three independent directors were appointed to the Chinese boards of directors (Jiang and Kim, 2015). Being independent of the management allows the directors to speak openly about problems without worrying about getting on the bad side of the management (Donald 2006). Though, Jiang and Kim (2015) explain, that the independent directors in China do not solely serve this classical idea of monitoring the management. Instead, they mainly should monitor controlling shareholders on behalf of the minority shareholders, since China's share market is dominated by concentrated ownership and controlling shareholders.

The supervisory board of a company limited by share must consist of at least three members and has the duty to evaluate and oversee the board of directors and the management. It must include representatives of the shareholders and at least one third of the members must be democratic elected representatives of the staff and workers. Though, different regulations exist for SOEs (China Securities Regulatory Commission, 2005). The literature doubts the effectiveness of Chinese supervisory boards in monitoring the directors and management for various reasons (Dahya *et al.* 2002, 2003; Xiao *et al.* 2004); the supervisory board has an inferior position within the corporate governance framework or better said a lack of legal power and responsibilities, is therefore not taken seriously by the board of directors and the management, shows a lack of independence and technical incompetence, may have a shortage on information and a lack of incentives. This is even worse for state owned companies, due to a strong influence through personal control, as for example article number 71 in the Companies Law shows. It should be added, that the above stated sources are relatively old. It can be possible, that significant changes were made in regard to the supervisory board and thus the position strengthened. Recent research in this direction could maybe show interesting results and insightful conclusions in hindsight to the corporate governance development in China.

Banks and debt are also not suited to moderate good corporate governance in China. Chinese banks are highly influenced and controlled by the government; state-owned banks are predominant (Bailey *et al.* 2011; Claessens and Fan, 2002). Jiang and Kim (2015) describing the first problem, which arises through this matter, with a fitting question: "... why would a state-

owned institution monitor another state-owned institution?" Both sides belong to the same owner, so there is no reason to distrust or to monitor. Another problem is, that the state pursues its own political goals and might put them before economical aspects. These goals might push the government to instruct a bank to help a nearly bankrupt SOE with cheap loans and a low interest rate to ultimately prevent unemployment (Bai *et al.* 2000). Logically the government insures the banks if they have to hand out bad loans (Bailey *et al.* 2011). This backup and control by the state leaves the banks with even less incentives to monitor the debtors. This situation is also the main reason amongst other causes, why debt hardly promotes good corporate governance (Jiang and Kim, 2015).

In China, around 50% of publicly listed companies can be regarded as being controlled by the government according to a study by Bai *et al.* (2004). Jiang and Kim (2015) note that in 2012, 57.28% of A-shares are under the control of the state or legal persons.

State-owned companies are being controlled by the State-Owned Assets Supervision and Administration Commission (SASAC). This agency acts on directive of the central government. Among the institution's responsibilities are the appointments of top executives, setting executive compensation and restructuring state-owned companies (Jiang and Kim, 2015). According to these authors, Chinese institutional investors include mutual funds, QFIIs (Qualified Foreign Institutional Investors), insurance firms, supplementary pensions, securities companies, social insurance funds, and trust companies. In the years 2003-2011, the amount of shares owned by mutual funds has increased tenfold. Although, the amount of total shares being controlled by mutual funds still remains relatively low at 0.067% in 2011.

According to Jiang and Kim (2015), state ownership plays a crucial role for the remuneration of executives. In Chinese state-owned enterprises, the wage gap between workers and managers is generally being regulated implicitly or explicitly. Therefore, there exists an upper bound to the monetary remuneration of top executives. Moreover, in general, managers of SOEs are government officials that only stay on their post for a limited amount of time. Upon meeting their requirements, they generally are being promoted to a higher position. The authors emphasize the fact that this constitutes merely a different kind of incentive scheme, where monetary compensation is not the most important instrument.

Jiang and Kim (2015) state that the debt ratio of Chinese PLCs of around 50% in 2002-2012 is relatively high compared to other developed countries. The authors argue that debt can serve as a governance mechanism, since it gives an incentive to generate enough cash flow to be able to pay back the debt. The authors concede that this factor might be largely offset by the generous government aids to firms in financial trouble that make bankruptcies rare and eliminate the managers' incentive of financial conservativeness. Furthermore, the authors argue that being mostly state-owned firms, Chinese banks in general do not monitor strictly compared to banks in other developed countries. State ownership constitutes a form of ownership concentration. Holding the majority of the shares, the state can exert power over other investors: Wu *et al.* (2011) established a model, in which corporate divestiture decreases the possibility of majority shareholders to expropriate minority shareholders. In their sample of Chinese PLCs they find evidence supporting their hypothesis: With the existence of ownership concentration, the amount corporate divestiture decreases. Jiang and Kim (2015) observe that there is a negative relation between firm value and state ownership for Chinese firms. They argue that this effect cannot be attributed exclusively to corruption, but rather to the fact that often the state as the owner of an enterprise pursues different goals than just value maximization: Employment and business cycle policy might influence decision making away from profit maximization.

3. Legal Reporting Rules vs. Broad Standards for China

The question remains, if sustainability reporting rules should be mandatory to companies or not. In this discussion from the law and economics literature, legal reporting rules are commands in a simple and clear way. Broad standards, on the other hand, are fuzzy and unclear. Legal reporting rules and standards can be differentiated by the level of complexity. Legal reporting rules are based on a command-like system of "tell and do".

An incomplete sustainability report leading to a liability for the management is a reporting rule whereas a norm for the management foster transparency without defining transparency is a standard. Broad standards are basic reference points.

Compared to legal reporting rules, broad standards may have lower initial specification costs. On the other hand, broad standards have higher enforcement and compliance costs. Disseminating a broad sustainability standard such as promoting all stakeholders is easy and does not generate any cost at all. But applying this standard in a practical report would generate significant costs. Table 1 illustrates pros and cons of legal reporting rules and standards.

Table 1. Pros and cons of legal reporting rules and broad standards

	Legal Reporting Rules	Broad Standards
Pros	<ul style="list-style-type: none"> - Clear and simple - Reduced monitoring and enforcement costs 	<ul style="list-style-type: none"> - Low initial costs - Adaptation possible
Cons	<ul style="list-style-type: none"> - High initial costs - Over/ under complexity 	<ul style="list-style-type: none"> - Unclear, interpretation necessary - High enforcement and compliance costs

5. Conclusion

In this paper we gave a short review of issues of sustainability reporting in China. We laid our focus mainly on the specific features in this country based on the broader corporate governance research. We portrayed sustainability reporting in areas such as compensation and board of directors, with special regards to Chinese peculiarities regarding the roles of the CEO and the chairman of the board. To know about the relatively strong position of the chairman and the weakness of the supervisory board seem of great importance for business people who want to familiarize themselves with Chinese idiosyncrasies. Regarding executive remuneration, we stated that the low level of fixed payment and the high importance of perks can be attributed to the Chinese business culture as well as the strong importance of the state. Further, we discussed the advantages and disadvantages of legal sustainability reporting rules versus broader standards.

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