Global Journal of Management and Business Research: D
Accounting and Auditing
Volume 14 Issue 5 Version 1.0 Year 2014
Type: Double Blind Peer Reviewed International Research Journal
Publisher: Global Journals Inc. (USA)
Online ISSN: 2249-4588 & Print ISSN: 0975-5853

A Theoretical Analysis of the Audit Committee's Role in China

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Abstract- This paper aims to analyze the role of the Audit Committee (AC) in China by employing the following theoretical frameworks: managerial hegemony theory to examine whether ACs in China serve as a mere "rubber stamp"; the origin of agency theory to determine whether ACs are supported by the separation of ownership and control to act as overseers and supervisors; and to use resource dependence theory to assess whether ACs provide added value by acting as consultants and trainers in China. Telephone interviews surveying 330 listed companies in China yielded 61 interviews, and the research results reveal that the AC's role supports both the resource dependency and agency theories but conflicts with managerial hegemony theory.

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GJMBR - D Classification : JEL Code : M42

ATHEORETICALANALYSISOFTHEAUDITCOMMITTEESROLEINCHINA

Strictly as per the compliance and regulations of:

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Abstract- This paper aims to analyze the role of the Audit Committee (AC) in China by employing the following theoretical frameworks: managerial hegemony theory to examine whether ACs in China serve as a mere "rubber stamp"; the origin of agency theory to determine whether ACs are supported by the separation of ownership and control to act as overseers and supervisors; and to use resource dependence theory to assess whether ACs provide added value by acting as consultants and trainers in China. Telephone interviews surveying 330 listed companies in China yielded 61 interviews, and the research results reveal that the AC's role supports both the resource dependency and agency theories but conflicts with managerial hegemony theory.

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I. Introduction

The Sarbanes-Oxley Act (SOX, 2002) was enacted in the United States in response to a series of scandals around the turn of this century perpetrated by Enron and other companies. This act extends the responsibilities and status of the Audit Committee (AC). In 2002, China enacted its own form of Corporate Governance (CG). According to China's "Code of Corporate Governance for Listed Companies", ACs may be established alongside the existing monitoring system of the Supervisory Board (SB). Thus in China, establishing an AC is not legally mandatory but rather voluntary. The willingness to install an AC has increased from 1% (12) in 2000 to 99.86% (2106) in 2010 among listed companies in China (CCER, 2012). Alanezi and Albuloushi (2011) have advised all listed companies and policy makers to require the formation of ACs to increase the level of mandatory disclosure. Firth et al. (2007) noted that China's regulators have endeavored to improve accounting information, transparency, and corporate governance. The Chinese approach to supervisory CG structures in companies combines the AC found in the British and American governance models and the SB found in the German model. This dual-layered governance structure was created to suit China's unique economic, social and political environment.

The implementation of the singular governance structure of the AC on top of the bipolar structure of the SB with dual monitoring institutions in the internal supervisory mechanism in China is explored to highlight the role of the AC in China. This paper aims to explore whether ACs are supported by the separation of ownership and control to act as overseers, as predicted by agency theory. Fama and Jenson (1983) comment that the separation of ownership and control can be a result of efficient forms of economic organization. Agency theory implies a need for supervisory functions, as managers cannot be trusted to act in the interest of shareholders. This research uses shareholder agency theory as a foundation from which to understand the role of the AC as an overseer in China. Managerial hegemony theory is used to evaluate whether in China, the AC merely acts as a "rubber stamp"[1] The above question is answered based on data from surveys conducted through telephone interviews with 61 out of 330 listed companies. The respondent for this survey was the General Secretary of the Bod/SB, whose key function is to organize the BoD and the SB and who has access to confidential data from top management that is normally difficult to access. The general understanding of Chinese listed companies is revealed in the responses, which provide a clear conclusion to this study. The survey indicates that over 95 per cent of sampled companies' ACs can meet the definition of the role of AC as overseers and 92 per cent as supervisors through their actual practice, which supports agency theory. Further, 60 per cent of companies' ACs perform the role of consultants, thereby adding value to the company, and 23 per cent of companies' ACs act as trainers, thereby providing extra service to the company. While both of these roles support the resource. Managerial hegemony theory asserts that the Board of Directors (BoD) is a legal fiction and is dominated by professional management from the organization (Mace 1971; Vance 1983; Lorsch and MacIver 1989). The resource dependency theory suggests that the board serves as a strategic consultant to top managers rather than (or in addition to) exercising independent control (Carpenter and Westphal, 2001). It is hard to refute the expectation that ACs bring benefits to their organizations, for the AC is an invisible asset that may increase the enterprises' reputation, expertise, coordination and connection to earn more resources.

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[1] According to the Merriam-Webster collegiate dictionary, the definition of a *RUBBER STAMP is:* "a mostly powerless yet officially recognized body or person that approves or endorses programs and policies initiated usually by a single specified source."

This paper primarily explores the role that the AC plays in China. The AC is one of the sub-committees of the BoD. Resource dependency theory highlights that the board's role is to expand the outward-looking boundary to enhance a business. This theory will be applied to assess whether the ACs in China contribute added value or provide extra service to the company in addition to executing independent control.

The above question is answered based on data from surveys conducted through telephone interviews with 61 out of 330 listed companies. The respondent for this survey was the General Secretary of the Bod/SB, whose key function is to organize the BoD and the SB and who has access to confidential data from top management that is normally difficult to access. The general understanding of Chinese listed companies is revealed in the responses, which provide a clear conclusion to this study. The survey indicates that over 95 per cent of sampled companies' ACs can meet the definition of the role of AC as overseers and 92 per cent as supervisors through their actual practice, which supports agency theory. Further, 60 per cent of companies' ACs perform the role of consultants, thereby adding value to the company, and 23 per cent of companies' ACs act as trainers, thereby providing extra service to the company. While both of these roles support the resource dependence theory, 49 per cent of companies' ACs act as the decision maker through their involvement in developing important company policies, which appears to be in conflict with the independence of the AC's supervisory function. The findings reveal that the roles the ACs play in China is not merely a legal fiction.

The remainder of this paper is organized as follows: Section II introduces the background and purpose of this research. Section III is based on a study of related literature and regulations regarding the AC and CG to understand the AC's role functions and to raise questions. Section IV describes the theories and develops the hypotheses. Section V presents the empirical findings and analysis results, and Section VI concludes with an assessment of the findings.

II. Background and Purpose

The Corporate Governance (CG) supervisory mechanism in China is rather unique in that it simultaneously established the Audit Committee (ACs) of the board and the Supervisory Board (SB). Initially in 1993, China adopted two-tier boards, with SBs based on the German CG model. However, in 2002, China adopted ACs based on the Anglo-American CG model, thus combining the two models of CG supervisory mechanisms. Xiao et al. (2004) studied the role of the SB in China and found that a two-tier board is fraught with problems. Other studies also found that there is no evidence indicating that the SB can effectively monitor management. Su et al. (2005) found that neither board can perform an effective monitoring function. Liu and Sun's (2005) finding suggests that CG supervisory control mechanisms over management could be further enhanced, particularly through CG reform in China's transitional economy. Since 2002, China has allowed listed companies to choose whether or not to establish an Anglo-American AC system. This system still raises questions regarding the functional positions and responsibilities of the SB and the AC in China.

a) Functions of the SB and the AC in China

Article 126 in China's Corporate Law stipulates that the SB in a Chinese company serves as the internal supervisory unit responsible for supervising the directors' and managers' behavior. China's Corporate Law also defines the system for the SB and provides guidance on how to supervise the organization of internal power as exercised by the company's BoD and the layers of management on behalf of the shareholders. China's "Rules for Listed Companies Governance" establishes five main CG duties for the AC. The duties of the AC and the SB as stipulated in China's Corporate Law are very similar. The SBs oversee the BoDs on behalf of the stakeholders. The AC oversees management on behalf of the BoD and provides balance to the internal directors within the BoD. A comparison of the functions and responsibilities of the SB and the AC is provided in Table 1. From this comparison, it can be observed that there are two functional areas in which the two institutions overlap. First, both are internal supervisory units focusing on financial supervision. This overlap could result in confusion regarding corporate structure and even reduce the effectiveness of the supervision. Second, both are responsible for safeguarding against illegal behavior by directors and managers, such as serious improper transactions, which could trigger conflict in the operations of the two units. The SB and the AC are both supervisory institutions under different CG models. As the function of both institutions is essentially to provide oversight, adding the AC in addition to the SB into the internal supervisory mechanism may enable the AC to provide contributions in addition to its overseeing functions. Given the phenomena of functional overlap, it is therefore appropriate to first clarify the issue concerning *the role the AC plays in China.*

b) An Interactive Model of CG Structure

Cochran and Wartic (1988) asserted that CG solves specific problems by mandating types of interaction between senior executives, shareholders, the BoD and other relevant parties within a company. An interactive model demonstrating the interactions between the political institutions, product markets, capital markets, stakeholders, shareholders, firms, BoDs, SBs, ACs, internal auditors, external auditors, managers and employees is shown in Figure 1: An Interactive Model of CG Structure. The shareholders, BoDs, SBs, ACs internal auditors, managers and employees comprise relationships within the company and interact within the CG structure. Many legal, economic, political, social and other forces are continually involved in these interactions. The interactive model in Figure 1 can help to better understand the impact of CG on the current internal supervisory mechanism and also help to explore possibilities for improving the level of understanding of CG in the future. In terms of its role , the position of the AC in the firm can be identified in Figure 1.

c) The Role of the Audit Committee in Corporate Governance

The World Bank (1993) reported that CG mechanisms consist of both internal and external mechanisms. The internal mechanisms primarily solve relationship and structural problems between stockholders, directors and managers, for example, the internal supervisory mechanism of the AC and the SB and the incentive mechanism of the remuneration committee. The external mechanism impacts and controls the behavior and performance of the company and is primarily comprised of the market and governance powers. Chang (2001) also acknowledges this division: the internal definition indicates the system arrangements relating to the company's functions, the BoD's structures, and the stockholders' powers; the external definition indicates an entire set of legal, cultural and system arrangements relating to the company's control rights and the residual demand rights for allocation. The OECD (1999) defines the structure of CG as involving a series of relationships between the company's managers, the BoD, stockholders and other stakeholders. The position of the stockholders within this series of relationships is defined in the "Principles of CG" issued by the OECD: one role for CG, corporate governance exists to protect the rights of stockholders; in another, the BoD takes responsibility for stockholders. The narrow definition of CG structure defines the shareholders as the target for protection; the broad definition of CG structure defines all stakeholders as this target. This paper aims to discover the role of the AC in the internal supervisory mechanisms for firms in China.

III. Literature and Questions

Corporate governance is the system through which business operations are directed. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders, and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. Therefore, CG also provides the structure through which a company's objectives are set and articulates the means for attaining these objectives and for monitoring performance (Organization for Economic Cooperation and Development 1999; OECD 2004).

Corporate governance defines the procedures used to manage a company and thereby affects the managers in a company (Cohen et al. 2010; Acharya et al. 2011). Cohen et al. (2010) indicated that in many instances, ACs play a passive role in helping to resolve contentious financial reporting issues with management; the respondents indicated that the auditor and management often try to resolve issues before they come to the attention of the AC. The authors note that auditors indicate that management has a major influence over the hiring and termination decisions for external auditors. Acharya et al. (2011) found that corporate governance affects the power balance between managers and the firm and has important implications for the debate on executive pay. Specifically, while better governance may incentivize managers to perform better, it also reduces the firms' ability to attract the best managers. These two effects offset each other and may explain why it has so far proven difficult to find direct evidence that corporate governance increases firm performance. In summary, management has the power to influence firm decisions; an AC may play a passive role in helping management to make better decisions but does not involve itself in creating important company policies. Hence, the following question is raised:

Q1: In China, does the AC involve itself in developing important company policies?

The Blue Ribbon Committee (BRC) (1999: 22) noted that "several recent studies have produced a correlation between AC independence and two desirable outcomes: a higher degree of active oversight and a lower incidence of financial statement fraud." According to the studies by Beasley (1996), Abbott et al. (2004), Klein (2002a), Klein (2002b), Carcello and Neal (2003), Xie et al. (2003), and Bedard et al. (2004), the more independent the ACs are, the better they can exercise their supervisory functions and provide appropriate oversight. It is anticipated that the establishment of the AC will strengthen the oversight of management by the BoD. According to CSRC (2006), the implementation of an AC introduces oversight independently into the decision making process of the BoD rather than having the AC make decisions itself.

It appears that there is no universally accepted definition of an AC to be found in regulations, reports, surveys and research studies. Instead, different definitions are presented such as those in Section 404 of SOX (2002), Klein (2002), Collier (1996), and Braiotta (1981). These definitions state that the AC is a sub-committee of the BoD, and they confine the definition primarily to the composition and the key responsibilities of ACs:

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

These definitions emphasize the composition of the AC through the participation of independent directors with the professional abilities to perform the key responsibilities of financial reporting, audit and internal control. In summary, all definitions of the AC tend to emphasize its responsibility or operations: its primary tasks are to review financial statements, the effectiveness of the company's accounting and internal control system, and the findings of the auditors and to make recommendations on the appointment and remuneration of the external auditor. An AC is set up to oversee, review and monitor the financial reporting process and the audit activities.

The research on the responsibilities of the AC is listed in Table 2: Documentary Source on the Responsibilities of the AC in the American, British and Chinese models. Despite the variations in the specifications for the functions of the AC in the Anglo-American and Chinese models, their common aim of supporting the management targets of the BoD and providing an independent evaluation of operations are upheld. According to the definition of the above regulations and literature, the key function of the AC is to act as an overseer.

An AC is a committee established by the board of directors to oversee the accounting and financial reporting processes of the company and to audit its financial statements (US Securities Exchange Act of 1934 Section 3 (a) (58); SOX Section 404, 2002). The AC's function is to monitor the board of directors to ensure that it operates well. There are various issues associated with ACs, the first being AC effects (He et al. 2009; Chien et al. 2010; Carcello et al. 2011; Ika et al. 2012). Chien et al. (2010) examined AC effects in the largest public hospitals in the US. The authors found that the presence of a committee and the committee's specific qualities of independence, financial expertise, and increased activity positively correlate with a reduced frequency of internal control problems. Ika et al. (2012) indicated that the timeliness of reporting is associated with AC effectiveness. This result suggested that AC effects are likely to reduce financial reporting lead times. In summary, an AC is effective and also improves the financial reporting quality of a company. The AC acts as an overseer to monitor and audit the company's major financial information disclosure. Thus, the following question is raised:

Q2: In China, does the AC monitor and audit the company's major information disclosure as an overseer[2]?

Another area of discussion is the relationship between the AC and earnings management (Carcello et al. 2006; Rahman et al. 2006; Ghosh et al. 2010; Chandrasegaram et al. 2013). Carcello et al. (2006) found that alternate corporate governance mechanisms are an effective substitute for AC financial expertise in constraining earnings management. Ghosh et al. (2010) examined whether board characteristics (composition, size, and structure) and AC characteristics (composition, size, activity, expertise, ownership, and tenure) were associated with earnings management before and after the promulgation of the SOX Act. The authors found that boards and ACs were unsuccessful in constraining corporate earnings management during the post-SOX Act period. The role of the AC is to supervise matters related to transactions, which raises the following question:

Q3: In China, does the AC supervise matters related to transactions?

In practice, it can be observed that the internal governance of a firm may not be as strong as the formal structures suggest. This weakness may impact the quality of the accounting information. The effects must be discussed in the context of three issues: independence, expertise, and diligence. First, there is a relationship between independence and the effects of the AC (Zhang, Y et al. 2007; He et al. 2009; Al-Najjar 2011; Cohen et al. 2011; Sarkar and Sarkar 2012). Al-Najjar (2011) found that ACs are more independent when firms have large boards and more insider ownership. These findings indicate that corporate governance could be considered an effective internal tool to achieve greater audit independence. Sarkar and Sarkar (2012) examined AC independence in India. They determined that strengthening auditor independence and enhancing the powers, functions, and independence of the AC will be crucial for the governance of Indian companies. A highly perceived "independence quotient" for a company's auditing process can be reassuring to outside shareholders, helping to reduce the risk premium when raising capital and thereby providing a strong business case for strengthening auditor and AC independence. In summary, independence is an important factor influencing the effects of an AC. Corporate governance could be more effective if the AC is more independent. The independence of the AC is viewed as the key to oversight and supervisory characteristics.

One issue with ACs is their characteristics (Goodwin et al. 2006; Barua et al. 2010; Li and Richard

[2] According to Merriam-Webster's collegiate dictionary, the definition of *OVERSEER* is : "a person who watches and directs the work of other people to be sure that a job is done correctly".

2012; Iyer et al. 2013). Goodwin et al. (2006) examined whether the existence of an AC, AC characteristics, and the use of internal audits are associated with higher external audit fees. The authors found that the existence of an AC, more frequent committee meetings, and increased use of internal audits are related to higher audit fees. These findings are consistent with an increased demand for higher quality auditing by ACs and by firms that make greater use of internal audits. In addition, Barua et al. (2010) indicated that the internal audit budget is positively related to the number of AC meetings. Iyer et al. (2013) examined the characteristics of AC financial experts. The authors found that professional accounting certification and AC experience are valued positively by the board of directors when designating an AC member as a financial expert. Otherwise, as Barua et al. (2010) have indicated, the internal audit budget is negatively related to the presence of an auditing expert on the committee and the average tenure of AC members. In summary, these examples show that the AC can provide added value to the company, which raises the following question:

Q4: In China, does the AC provide added value to the company?

There is a relationship between expertise and the effects of an AC (Zhang et al. 2007; Krishnan and Visvanathan 2008; Krishnan and Lee 2009). Zhang et al. (2007) found that firms are more likely to be identified with an internal control weakness if their ACs have less financial expertise or, more specifically, have less accounting and non-accounting financial expertise. Krishnan and Visvanathan (2008) found that the AC's financial experts can effectively perform their monitoring function and promote conservative accounting only when they are on boards that are characterized by strong governance. Their findings were consistent with the notion that accounting expertise contributes to improved monitoring by the members of the AC, which in turn enhances multiple attributes of financial reporting quality. In summary, expertise is an important factor influencing the ability of an AC to provide added value to the company.

There is a relationship between diligence and the effects of an AC (Raghunandan and Rama 2007; Stewart and Munro 2007; Sharma and Lee 2009; Yin et al. 2012). Raghunandan and Rama (2007) note that prior researchers found that the number of AC meetings is associated with many "good" outcomes related to financial reporting. The authors found that AC meetings are more frequent for firms that are larger, have greater levels of outsider block-holdings, or are in industries prone to securities litigation. Stewart and Munro (2007) found that the frequency of committee meetings and the auditor's attendance at such meetings are significantly associated with a reduction in perceived audit risk. In summary, diligence is an important factor influencing the effects of the AC's role in providing extra services to the company. The following question is raised:

Q5: In China, does the AC provide extra services to the company?

IV. Theory and Hypothesis

The theories related to the AC within the CG of the company can benefit every party concerned. Because the theory is applied with a certain purpose in certain conditions, it is not an all- powerful theory and cannot be applied in every condition, nor can it be worked out in every environment (Wang, 2005). Moreover, because the theory is developed in certain conditions by a human being, it has its limitations. Nevertheless, the theory can have a critical influence when there are problems to be solved. In addition to Agency Theory, Managerial Hegemony Theory and Resource Dependency Theory are also studied and analyzed as related to the role of AC.

a) Agency Theory

Jensen and Meckling (1976) refer to the moral hazards arising from conflicts of interest in the relationship between owners and managers: a basic assumption underlying agency theory is that managers are inclined to act opportunistically to further their own interests before shareholders' interests and that there are agency costs associated with keeping the managers' interests aligned with those of the owners. Fama and Jensen (1983) further noted that CG research should focus on agency problems and on how to reduce agents' costs. Shleifer and Veshny (1997), however, stated that the problem lies in that most future contingencies are too hard to describe and foresee, and as a result, complete contracts are technically unfeasible. Meanwhile, a basic conclusion of agency theory is that the value of a firm cannot be maximized because managers possess discretions that allow them to expropriate value to themselves. These authors therefore emphasized that CG should be established to safeguard financial capital from investors and lenders and to protect the returns on investment from that capital. In other words, these authors maintained that the core task of CG is to ensure the capital suppliers' interests. The shareholder model as applied in the UK and the US shows that when shareholder wealth is maximized, social wealth will be maximized as well.

The agency theory suggests that when the executives of enterprises are also the owners, they have the right to ask for the enterprise's entire surplus and are therefore motivated to work hard. When the executives of enterprises are not the owners, it can give rise to proxy shareholder problems. The harder the agent works, the higher the agent's fee. The larger the income of the enterprise, the more profits the owner will make, wherein the agent may become discontent, causing an inevitable conflict of interest. The shareholder's proxy theory suggests that because the agent has more information than the shareholder does, there is an information asymmetry that may affect the shareholder's rights. The relationships between the agent, the shareholders and the executives can be defined as a contract and, because of the incompleteness of the contract, problems under agency theory are unavoidable. Vafeas and Theodorou (1998) indicated that because managers are under pressure to produce immediate results, they tend to ignore investments that could have long payback periods. Shareholder's proxy theory noted the following four basic problems (Jensen and Meckling, 1976):

1. Because executives pursue their own interests, there is no reason or evidence indicating that they are unselfish or that they are naturally willing to maintain unanimity with the shareholder's interests.
2. There may be information asymmetry – no one can have complete information because information is distributed among individuals, but it is likely that those inside the company (such as the BoD) will gain access to more information than those outside (such as shareholders).
3. The risk of moral problems and reverse choice may exist. It is assumed that because agents are prone to opportunism, the agent post will be neglected in the course of acting for, incurring damage to and encroaching on the shareholders' interests.
4. Because the market environment is full of uncertainty, it is difficult to judge whether the agent's behavior indicates his hard work.

Shareholder proxy problems not only exist between shareholders and managers but also between minority and large shareholders, also known as 'control shareholders' (Shleifer and Vishny, 1997). Normally, minority shareholders lack a strong interest in participating in shareholder meetings. Therefore, a problem may arise as to who is going to control supervision with respect to shareholders and managers, which explains why it is more difficult to protect the interests of shareholders. Control by the larger shareholders might deprive minority shareholders of their utilities in much the same way that managers might deprive shareholders of their utilities. These two types of agency problems are often interlinked. The mechanism of CG must therefore be designed to solve these two types of agency problems and to determine which mechanism can act as a security measure to protect minority shareholders from being taken advantage of by larger ones. In other words, the CG mechanism is mandated to protect the external body of shareholders from encroachment by internal management and controlling shareholders.

Because the interests of shareholders and managers are usually inconsistent, the CG mechanism is also designed to alleviate the proxy problems between them. The essence of CG is to protect shareholder's interests from being infringed upon, and at its core is a set of rules and systems to provide protection for shareholders and to guarantee that shareholders receive fair repayment from their investment. The supervisory mechanism of CG provides checks and balances on the managers on behalf of owners. Shareholder's proxy theory is particularly focused on the internal supervisory mechanism within the company, with a view to analyzing the internal structure and the internal relationships within the enterprise, which are not controlled by market strength. In essence, the internal supervisory mechanism is a type of internal agreement, in that shareholders hold the decision-making power to change the management team's membership or the corporate structure and to potentially disband the company. The aim is to design a good mechanism using the power of checks and balances to maximize the company's value.

Modern enterprises regard combining internal management levels as the foundation for expanding business on a large scale, and therefore they consider the division of the rights of control between ownership and management to be essential. The difficulty lies in balancing the ownership rights between owners (shareholders) and managers; if any imbalance in interests and information inconsistency is not managed through an effective CG mechanism, problems will further escalate to involve potential agency problems. Eisenhardt (1989) assumes that because managers are opportunistic, intent on gaining self satisfaction instead of maximizing profit on behalf of the principal, there is potential conflict of interest in terms of risk sharing between the enterprises and agents. Furthermore, she argues that agency theory has clear implications for the monitoring and control role of the BoD, whereas implications regarding the BoD's strategic role are not definite. Zahra and Peace (1989) highlighted the importance of the BoD's role in establishing guidelines for being implemented and effective control. Fama (1983) stated that the BoD should be viewed as the ultimate internal monitor of the set of contracts called a firm. Hill (1995) concluded that agency theory does have implications for the strategic role of the BoD in terms of corporate control. McNulty and Pettigrew (1999, page 50) noted, "little has been said by agency theorists about strategy as a means of control over managers."

It is generally acknowledged that the British and the American CG models fall under the category of the shareholders' model (Wang 2005). China adopted the form of AC found in the British and American CG systems. The question has arisen as to whether the ACs in China can act as overseers and supervisors to strengthen internal supervisory mechanisms and thereby safeguard the interests of all shareholders, particularly small shareholders as indicated in Q2-3. It is hypothesized that the role that the ACs play in China as overseers and supervisors lends support to Agency

Theory. On the contrary, the Q1 role as decision makers runs counter to this theory.

b) Resource Dependency Theory

Pettigrew (1992) argued that both sociology and management doctrines are employed to form resource dependency theory. This theory is based on the concept of cooptation, focusing in particular on the attempts by BoDs to create appropriate linkages with the external environment to expand the enterprise. Pfeffer and Salancik (1978) added that when an organization appoints an individual to its board, it expects that as a board member, the individual will come to support the organization, will concern himself with its problems, will favorably present it to others, and will try to aid it. The BoD is the key cooperative mechanism through which the organization links to the external environment to access important resources and to buffer itself against adverse environmental change (Pfeffer and Salancik (1978), Pearce and Zahra (1991), Goodstein, Gautam et al. (1994)).

Ingley and Van der Walt (2001) defined a "resource" as the connection to a nation's elite, industrial intelligence and competitors, market or capital. Further, inter-organizational linkages such as the appointment of outside directors can also be used to manage environmental contingencies (Muth and Donaldson 1998). Price (1963) and Zald (1967) asserted that the board is viewed as a helper to the organization by influencing other constituencies on behalf of the focal organization. The professions and communities of the directors can provide resources within organizations. Overall, resource linkages by means of the board are aimed at maximizing its performance (Zald 1969; Pfeffer 1972; Pfeffer and Salancik 1978).

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

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

Criticisms have been raised about resource dependence theory, for example, the theory focuses on the role of boards in potentially obtaining resources and ignores how they could be involved in exploiting resources (Finkelstein and Hambrick 1996; Hung 1998). Therefore, it is suggested that the board serves as a strategic consultant to top managers rather than (or in addition to) exercising independent control (Carpenter and Westphal 2001). Overall, the shortcomings of resource dependence theory center upon several board activities: providing advice (Lorsch and MacIver 1989; Westphal 1999); monitoring (Fama 1980; Bainbridge 1993; Johnson *et al.*, 1996); and strategizing (Lorsch and MacIver 1989; Kesner and Johnson 1990) It is hard to refute the expectation that the members of ACs will bring benefits to their organizations, for the AC is an invisible asset that could improve the enterprises' reputation, expertise, coordination and connection, allowing it to earn more resources. The AC is one of the sub-committees under the BoD. Resource dependency theory emphasizes that the role of the board expands the outward-looking boundary to enhance a business. It may therefore be asked whether the AC's contribution in China brings added value or provides extra service to the company, as indicated in Q4-5, in addition to executing its independent control. It is hypothesized that the role the AC plays in China, as indicated in Q4-5, lends support to the Resource Dependency Theory.

c) Managerial Hegemony Theory

Managerial hegemony theory primarily asserts that the BoD is a legal fiction and is dominated by professional management in the organization (Mace 1971; Vance 1983; Lorsch and MacIver 1989). Drucker (1974) asserted that the BoD is an important ceremonial and legal fiction. Most boards only perform effectively during a period of crisis (Mace 1971; Clendenin 1972). Hung (1998) added that the governing board of a company serves primarily as a "rubber stamp". Whisler (1984) and Lorsch and MacIver (1989) stated that directors are constrained from setting strategies, although they would often like to become involved. Ingley and van der Walt (2001) proved that, in practice, boards are not involved in establishing strategies. It may that boards lack, in relative terms at least, the required knowledge of the organization (Hung 1998).

Some points explaining managerial hegemony theory are described as follows:

1. Given the assumption of the separation of ownership and control (Berle and Means 1932; Jensen and Meckling 1976), a state of diffuse

ownership could perhaps lead to relative weakness in shareholder control, thereby giving management a relatively stronger foothold over the board's control of the company.

2. Given the nature of information asymmetry between non-executive directors and management, management clearly holds an advantage in terms of in-house information. A board principally composed of non-executive directors would be deemed more passive regarding the activities and information within the company than management.
3. Internal directors rely on the chief executive officer (CEO) for compensation and career advancement and invariably report to him in practice. Under this circumstance, it is unavoidable that internal directors support the CEO at board level, which reduces the effectiveness of the BoD by shifting the balance of power against external directors. Moreover, management may escalate its influence to control the board.
4. Managers can also use retained earnings to determine financial investment independently (Mizruchi 1983; Byrd Parrino *et al.* 1998), allowing them to reduce board control.
5. In most instances, management handpicks board members (Pfeffer 1972); therefore, the board directors are deemed to be in the control of management by virtue of the selection process.

Similarly, Herman (1981) also said that the board only plays a superficial review and approval role, similar to a "rubber stamp" function. Some studies have refuted the managerial hegemony theory. For instance, Zeitlin (1974) argued that the growth of ownership by large shareholders and interlocking directorships considerably reduced the ability of management to control boards. Mizruchi (1983) argued strongly that the board has ultimate control over management through their designated right to hire or fire the CEO. Therefore, Stiles and Taylor (2001) concluded that empirical support for hegemony theory has its limitations, emphasizing its dependence on the definition of the term "control".

It is hypothesized that the role the AC plays in China is not consistent with Managerial Hegemony Theory. The five questions raised above were all designed to prove this hypothesis.

V. Design and Method

a) Questionnaire Design

Survey research by telephone can be defined in this case as personal face-to-face interviews arranged in advance by telephone (Frey, 1989). This research adopts the telephone survey method because it facilitates the collection of quality data in an efficient and timely manner. Lavrakas (1993) describes telephone surveys as most closely approaching the level of unbiased standardization that is the goal of all good surveys. The survey questionnaire should be designed as a call sheet in advance. This survey is aimed to explore Q1-5, and Appendix A: Call Sheet – Survey by Telephone Interview is designed accordingly. Following up on the developed questions, the five functional roles being explored for the AC are therefore called the Decision Maker, Overseer, Supervisor[3] , Consultant and Trainer.

Skillful interviewing is important because a sudden anxiety may surface during the conversation, resulting in the respondent hanging up the telephone (Frey, 1989). Therefore, an initial feeling of trust on the part of the respondent can motivate him or her to answer confidential questions without hesitation. Establishing this trust is critical to avert higher refusal rates and to obtain accurate information. However, because of the limitation on the complexity and length of the questions raised in a telephone interview, questionnaires should be designed to be no longer than 30 minutes to avoid respondent fatigue (Lavrakas, 1993). Fully structured questions were designed for the telephone interview to gain a sufficient understanding of the role the AC plays in China (Appendix A).

b) Sampling

Sampling was via random selection from over 50% of the listed companies with ACs in China. The sample frame consists of 635 companies; from among these, 330 companies were contacted in 2009. The respondent in a sampling unit was identified as the General Secretary of the BoD, whose key function is to organize the BoD/SB, including the AC's business, and the coordinator of the ACs/SBs for the related institutions. Telephone numbers for the sample frame were retrieved from the records on the information website for Chinese listed companies. For a total of 330 of the 635 listed companies, the General Secretary of the BoD was contacted, and over 61 responded to every survey question. The remaining 269 of the 330 listed companies rejected the survey. The major reason for rejecting the survey could be assumed to revolve around the probability of leaking confidential information. Some companies suspected that the interviewer could be a potential investor seeking to obtain first-hand information about their supervisory performance, while others went as far as suspecting the interviewer to be an undercover agent from the Security Exchange Commission or another related Chinese government agency. A total of 305 out of 635

[3] According to Merriam-Webster's collegiate dictionary, the definition of *SUPERVISOR* is : "a person who supervises someone or something. Supervise: to be in charge of (someone or something) or to watch and direct (someone or something)."
According to Merriam-Webster's collegiate dictionary, the definition of "*SUPERVISOR*": "not only covers "*OVERSEER*", to watch and direct, but also means to be in charge of someone or something.

companies were called, but no one at the level of the General Secretary of BoD could be contacted. Various types of excuses were made to avoid the telephone interview: for example, no one answered the phone call; the wrong telephone number was used, or the General Secretary of the BoD was either not in the office or too busy to answer the call. Nevertheless, these 305 listed companies may be considered as having the potential to cooperate and to respond to related questions in similar research in the future.

Despite several challenges, in this research, telephone surveys with 635 companies were smoothly conducted, 330 companies received the phone call and 61 (5%) of these were willing to respond to the survey questions. The samples are categorized according to the Shanghai Stock Exchange and CCER database; the CSRC definition is described; and the sample industries in this research are shown on Table 3: Industry Statistics, Share type and Listed Year of Research Samples.

The summary of the respondent's background, company information and the industry classification is listed. A total of 61 listed companies accepted the telephone interview; though the response rate is only 5% (61/330), given the high level of the information, a refusal to respond could be assumed to revolve around the probability of leaking confidential information. Meanwhile, confidential data and top management are both difficult to access. The respondents' are all confirmed as holding the position of the General Secretary of the BoD/SB. The respondents must be reported and recognized by the SSE in China at a high management level, which is normally equal to a VP or manager, depending on the individual company's definition. The listed year for the sample firms is between 1990 to 2004, so these companies have conducted supervisory functions for at least 5 years. In terms of share type, 61 firms have A shares and 7 firms have A+B share. The research samples cover almost every categorization of industry except Z: No Associated. In this research, the manufacturing industry occupies 50% of the sample companies, reflecting the industry allocation in China.

c) Contacting Procedure

The procedures for contacting respondents are outlined in the following six steps:

First step: send emails featuring the biography of the interviewer and emphasizing the sincere desire to have a positive mutual interaction with the responding company and to share experience and exchange knowledge regarding the subject matter.

Second step: send out fully structured questionnaires by email to achieve the following two objectives: 1) obtain a voluntary response by email and 2) introduce the interviewer to gain the respondent's trust and confidence and to inform them in advance that the interviewer would call over the subsequent days. This information allows the respondents ample time to prepare answers to the survey should they be willing to respond.

Third step: call the companies that received advance emails. An average number of sampled companies was called each day so that every batch of sampled companies was called within the target day.

Fourth step: complete follow-up calls if the respondents were not contacted; the calling procedure is repeated as in the original call.

Fifth step: a call sheet (Appendix A) with a questionnaire for each number was prepared for use by the interviewer as the working paper for this research. The interview was solely executed by the author with the interview wording standardized principally as the call sheet. The working papers were collected to calculate the statistical number for each question as evidence of this research once the sample calls were completed.

Sixth step: the telephone interview was conducted in Chinese. Accurate translation was checked by four levels of review: first by a peer review in Chinese and English, second by the supervisor in English, third by the panel team in English, and a final review by internal and external examiners in English.

VI. Result and Analysis

From the responses, the statistics on the roles that the AC plays in China were calculated and analyzed as indicated in Table 4. The analytical steps proceeded as follows:

First, based on the literature, the possible roles that the AC could play under the CG system in China are identified and questions are summarized (A); the next step is to analyze the characteristics of the AC that may impact its role (B); the third step, based on the literature, is to define the relationship between the AC's role and its characteristics (C); step four applies the three previously mentioned theories as the basis of an analysis to examine the designed questions: the role that the AC plays in China (D-E); the final step is based on the previous four steps and analyzes whether the results support or conflict with the theories (F-G).

The results from these analytical steps are summarized as follows:

1. A total of 95% of ACs in China act as an overseer by monitoring and auditing the company's major information disclosure; this role supports Agency Theory but is not in congruence with Managerial Hegemony Theory (Table 4: G2).
2. A total of 92% of ACs in China supervise matters related to transactions by providing professional opinions on related transactions, which is the extended function of ACs included in the broad

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definition of this role. This finding supports Agency Theory but runs counter to Managerial Hegemony Theory (Table 4: G3).

3. A total of 60% of ACs in China act as consultants to provide added value to the company by diagnosing and providing solutions to any problems facing the company during its development stage. This role supports Resource Dependency Theory but conflicts with Managerial Hegemony Theory (Table 4: G4).
4. A total of 49% of ACs in China act as decision makers by involving themselves in developing important company policies, which appears to be in conflict with the independent supervisory function of the AC. This role is in conflict with both Agency Theory and Managerial Hegemony Theory (Table 4: G1).
5. A total of 23% of ACs in China act as trainers and provide extra service to the company by providing professional training to the middle and senior level management of the company. This role supports Resource Dependency Theory but contradicts Managerial Hegemony Theory (Table 4: G5).

VII. Conclusion

To implement an AC under the dual layer governance structure existing in China impacts the original practice and diverges from its internationally recognized role. The AC in China remains at a rudimentary and experimental stage, experiencing a process of innovation as well as trial and error. Therefore, the AC in every company in China still appears to be in the process of exploring practices suitable to its unique CG setting and model. These findings are considered from the perspectives of the applied theories to reveal the degree of the AC's contribution in China, rather than providing a mere judgement of "good" or "poor" implementation of supervisory functions. The results support Agency Theory in that ACs in China play the role of a financial overseer (95%) and provide professional opinions on transactions in a supervisory role (92%). However, the findings run counter to the independence of overseers as decision makers (49%); they also run counter to the theory of Managerial Hegemony because they prove that the AC is not just a legal fiction in China, as some have alleged. Meanwhile, the AC in China is not limited to exercising independent control.

The AC provides added value and extra services, acting as a trainer (23%) and a consultant (60%) in addition to independent control of overseers and supervisors in the actual creation and disclosure of financial statements, which support the theory of Resource Dependency.

Different CG theories tend to have their specific value, but every theory also has its inherent limitations. Thus, it stands to reason that at a particular time period and under certain conditions, a country might need a particular CG theory to suit its needs. Perhaps this reasoning was why Stiles and Taylor (2001) noted that no single perspective adequately explains this strategic role, though the managerial, the agency and the resource dependence theories provide insight. These authors therefore summarized the view that one theory alone does not illuminate the entire spectrum of board endeavors, which receives strong support from an examination of these theory's shortcomings. It is not simply a matter of selecting between agency theory, managerial hegemony theory or resource dependence theory. Rather, each theory has a unique contribution to make to promote our better understanding regarding the corporate governance debate (Kiel and Nicholson, 2003).

In summary, the findings based on agency theory, managerial hegemony theory and resource dependence theory as reported in this paper and other related comments on the interpretation of those findings and suggestions based upon them are useful as a reference for users such as regulators, supervisors or Boards of Directors when considering what role ACs should play in companies in China. The findings in this research can also be effective for improving the supervisory functions and for avoiding redundancies and gaps in internal supervision with a view to proposing how managers and owners can improve interaction and coordination with SBs in China. Finally, the investigation and the results reported in this paper may offer a basis for continuing research on the effectiveness, operation and coordination of supervisory governance after the introduction of an AC, as well as for studies of other monitoring functions such as audit and internal control.

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