

# Lecture 13

公司治理

# Corporate Governance

Dr. Tao Yuan

Nanjing University Business School

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# Corporate Governance



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# Separation of Ownership and Control

- 股权与经营权分离: An important feature of modern corporation is the separation of ownership and control. The shareholders delegate firm daily decisions to managers.
- The owners or shareholders have a lot of money, but little management experience, or they are just lazy to work hard. They thus hire professional managers to help them run the company.
- Principle-agent relationship: Shareholders are the ultimate principles and top managers are the shareholders' agents.

# What is Corporate Governance?



- If a firm takes all positive NPV Projects, it maximizes the firm's value. But do the managers want to maximize value? Humans are by nature selfish. Managers tend to maximize their own benefits, which may not in line with shareholder interests.
  - In this situation, agency cost emerges.
- How do shareholders ensure top managers make the right corporate decisions? How to align the interest between managers and shareholders?
  - Good corporate governance (公司治理) system is in need: a series of arrangements that reduce a firm's agency conflict.
- Agency cost: cost incurred by agency conflict. The design of corporate governance is not free. It has a cost.

# Agency Conflicts (代理冲突)

- Managers and shareholder: When managers do not maximize the value of shareholder, but pursue their own private benefits, agency conflicts arise. This is the major form of agency problems.
- Controlling and minority shareholder: The controlling shareholder may take advantage of their controlling power and expropriate minority shareholders.
- Shareholder and debt holder: Debt holder do not have voting right. Shareholders may make decisions hurt the interest of debt holder.

# Agency Conflicts (代理冲突)

Managers



Shareholders

Agency conflict

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董事兼首席执行官



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吴港平  
独立董事

Kabir MISRA  
独立董事

# Forms of Agency Problem

- Reduced effort: Finding and implementing investment in truly valuable projects is a high-effort, high pressure activity. The CEO may slack off.
- Perks: Managers tend to enjoy lavish office accommodations, schedule meetings at luxury resorts, or buy a private jet using the firm's money.
- Empire building: Managers prefer run large business rather than small one, by taking negative-NPV projects.

# Forms of Agency Problem

- Risk-aversion: Managers mainly hold the shares of the company he works for. Shareholders are wealthier and can invest in other securities.
- Therefore, managers cannot diversify their risk as readily as the shareholders, they may be too risk-averse and pass by risky but positive-NPV projects.
- Entrenching investment: Managers tend to select projects that require or reward their personal skills.

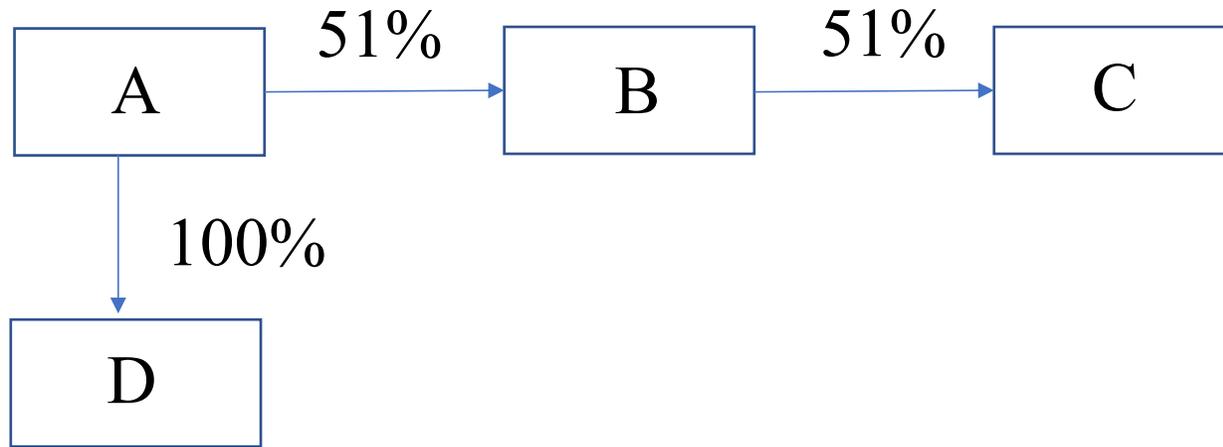
# Cash Flow Right vs. Controlling Right

- **Pyramid ownership structure:** Asia companies usually have multiple layers in the ownership chain. Consider the following ownership chain, company A's control right in C is 100%, while its cash flow right is only  $51\% * 51\% = 26\%$



- **Dual-class shares:** Shares in different classes have unequal voting power. One A-share has ten votes.

# Tunneling of Controlling Shareholder



- Suppose Firm C decides to spend 200 millions to buy 100 million assets from Firm D. Obviously, this is a negative NPV investment and decreases firm value.
- But, it benefits the controlling shareholder A: Firm A lose 26 million in Firm C, but gets 100 million in Firm D. Minority shareholders of C is hurt.

# Corporate Governance Practices

## 萝卜加大棒

- Monitoring: third parties monitor the managers not to do bad thing (大棒).
  - Monitoring can prevent the more obvious agency costs, such as blatant perks. It can confirm that the manager is putting in sufficient time on the job
  - However, monitoring is costly, requiring time and money.
  - Some agency costs cannot be prevented even with thorough monitoring. The managers know more about the firm's prospects. Whether they take negative-NPV projects or not is not observable to shareholders.
- Incentive contract: shareholders design the compensation contract of managers to link their income with shareholder value (萝卜).

# Monitoring Parties



## Internal:

- Board of directors
- Shareholders

## External:

- Auditors
- Lenders
- Takeover threat

# What is the relation between them?

## Managers (职业经理人)

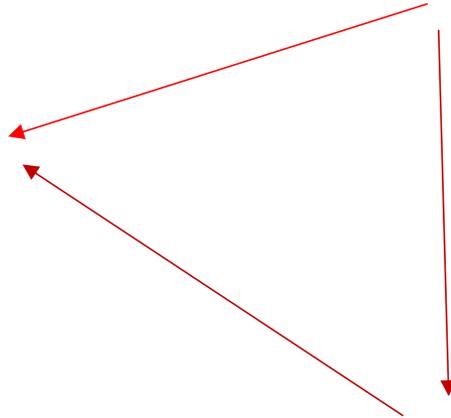
- 高管,
- 总经理, 总裁
- 财务总监, 人力资源总监等

## Shareholders (股东)

- 大股东, 小股东
- 国资委
- 公募、私募、对冲、养老基金
- 个人投资者

## Directors (董事)

- 董事长、董事会主席
- 独立董事
- 执行董事



# Director



- Who actually does the monitoring? The directors! When managers are not up to the job, boards frequently step in. They speak and vote in board meetings (董事会).
- Board members are elected by shareholders to represent their interests. They are responsible to recruit management team.
- Directors are not as busy as CEOs. One director can sit in the board of several companies at the same time.
- The Chairman of the Board (董事长) and CEO (总经理) are different.

# Role of Director

Two major roles played by directors:

- Monitor: Keep an eye on managers, and ensure that they act best in the interests of shareholders.
  
- Advising: provide suggestions and advices in corporate decisions.
  - ▣ Director is a profession, requiring heavy industry expertise, management experience, or personal connections.
  - ▣ Many CEOs become a director after their step-down, but the salary of directors is much lower than CEOs.

# Type of Directors

Two types of directors:

- Inside director (内部董事): directors who are also insiders or managers. Their monitoring duty may be compromised.
- Independent director (独立董事): directors who do not hold position in the company.
  - In the US, the SEC requires above 75% independent directors for listed firms. In China, the requirement is above 1/3.
  - 可能存在“独而不懂”的问题。

# Type of Directors

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独立董事

# Independent Directors

- 2011年11月17日，康美药业因“操纵证券市场”被判赔偿投资者24.59亿元，原董事长马兴田被判12年有期徒刑，11位高管分别判处有期徒刑并处罚金。包括5名曾任或在职的独立董事，需要承担连带责任，合计赔偿金额最高约3.69亿元。
- 月薪1万的独董被罚上亿，冤不冤？

公告日期	证券代码	标题
2021-11-20	300531.SZ	优博讯:关于独立董事辞职的公告
2021-11-20	002267.SZ	陕天然气:独立董事关于董事辞职相关事项的独立意见
2021-11-20	300735.SZ	光弘科技:关于独立董事辞职暨补选独立董事的公告
2021-11-20	600080.SH	金花股份:关于独立董事辞职的公告
2021-11-20	002707.SZ	众信旅游:关于公司独立董事任期届满辞职的公告
2021-11-20	600234.SH	科新发展:关于独立董事辞职的公告
2021-11-19	300674.SZ	宇信科技:关于独立董事辞职的公告
2021-11-19	002655.SZ	共达电声:共达电声股份有限公司独立董事关于董事长辞职的独立意见
2021-11-19	002479.SZ	富春环保:关于公司独立董事辞职及补选独立董事的公告
2021-11-19	000400.SZ	许继电气:独立董事关于公司董事长辞职的核查意见
2021-11-18	300257.SZ	开山股份:关于公司独立董事辞职的公告
2021-11-18	002771.SZ	真视通:关于公司独立董事辞职的公告
2021-11-18	600726.SH	华电能源:关于独立董事辞职的公告
2021-11-18	600710.SH	苏美达:关于独立董事及总经理辞职的公告
2021-11-17	002745.SZ	木林森:关于独立董事辞职的公告
2021-11-17	003031.SZ	中瓷电子:独立董事关于董事长,董事辞职的核查意见
2021-11-17	600739.SH	辽宁成大:关于独立董事辞职的公告

# How shareholders can monitor?

- Shareholder activism: If shareholders believe current managers are not acting in their interest, they may accumulate voting proxies and replace current directors and managers. They vote in shareholder meetings(股东大会).
- Vote on feet: Small shareholders cannot justify the time or money for a proxy battle. However, they may simply sell their shares, which cause a drop in the stock price. The decrease in stock price hurt managers' reputation and personal wealth.

# Auditors

- The job of auditors is to inspect the financial reports prepared by the firm and certify the trustworthiness of a firm's accounting information.
- The organization form of auditing firm is partnership. After auditing, auditors provide four types of opinions:
  - Unqualified opinion: the best results (标准无保留意见)
  - Qualified opinion (带强调事项段的无保留意见)
  - Disclaimer of opinion (保留意见)
  - Adverse opinion: the worst results (否定意见)
- Auditors help monitor managers not to commit financial fraud.

# Lenders

- When a company borrows from a bank, the interests reduce free cash flow and thus reduce the agency costs.
- The bank also tracks the company's assets, earnings, and cash flow. By monitoring to protect its loan, the bank generally protects shareholders' interest.
- Banks also impose covenant restrictions in the loan contracts, which also constrain managers' self-interest activities.
- Recall: banks are more effective in monitoring the issuing company than public bond holders.

# Takeover Threat

- If the management team is not performing well, shareholders may also consider sell the firm.
- When one firm is acquired by another, current management team usually will be dismissed.
- Thus, managers have incentive to run a firm well to avoid being taken over.

# Managerial Compensation

- Because monitoring is necessarily imperfect, compensation plans must be designed to attract competent managers and to give them the right incentives.
- CEO compensation is determined by the compensation committee of the board of directors. Most of them are independent. Managerial compensation is recorded as administrative expense (SG&A).
- CEO compensation is much higher than ordinary employees. Why are CEOs paid so much:
  - Star managers are too rare and their talents are of high values.
  - Poor governance and weak boards allow excessive pay.

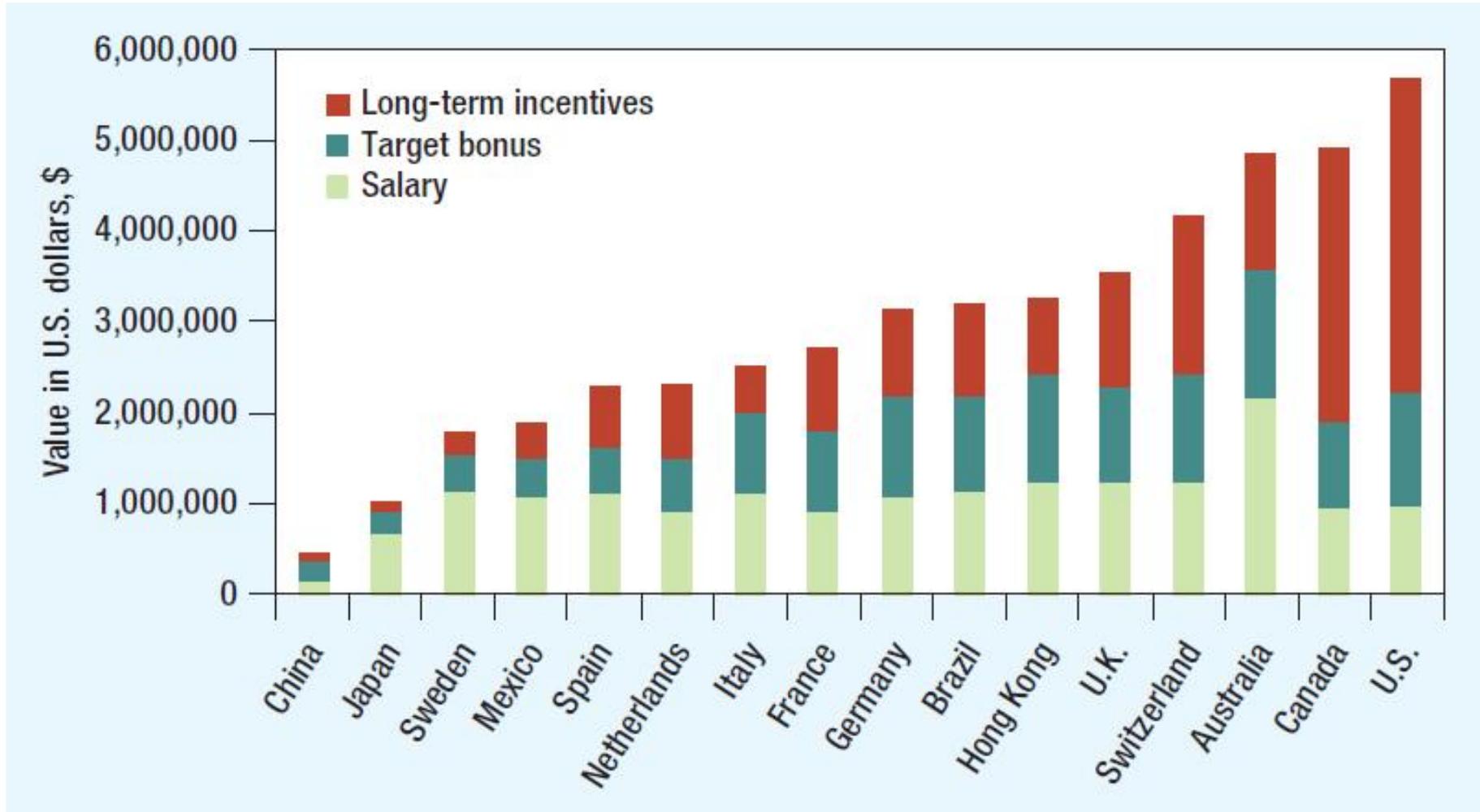
# Incentive Compensation

- The compensation package should encourage managers to maximize shareholder wealth. Because effort is not observable, compensation must be based on output (e.g., stock price, earnings).
- Most companies around the world now link part of their executive pay to the stock price performance. The main composites are:
  - ❑ Fixed cash salary: The part that is not linked with stock price
  - ❑ Stock options: Only when stock price  $>$  strike price, it has positive values
  - ❑ Restricted stock: Stock that must be retrained for several years
  - ❑ Bonus: Shares or cashed awarded only if the company meets an earning target.

# Stock Options

- The options awarded to the managers are call option, giving managers the right to buy their company's shares at the exercise price in the future. The exercise price is usually set equal to stock price at the grant date. Only when the stock price is above the exercise price, the stock option has positive values.
- Vest schedule: the CEO are only allowed to exercise a percentage of their stock options at a time.
- The accounting rules allows companies to value options at the excess of the stock price over the exercise price on the grant date. When stock price = exercise price, the expense is zero.

# CEO Compensation Around The World



# CEO Compensation: Example

2015-8-7 京东(NASDAQ:JD)宣布一项计划，公司董事长兼CEO刘强东在规定的10年内，每年基本工资为1元人民币，且没有现金奖励.刘强东要和奶茶妹妹去喝西北风吗？

Let's look at the compensation disclosed in the 2015 annual report:

May 2015, the board of directors approved a 10-year compensation plan for Mr. Richard Qiangdong Liu, the Company's chairman and chief executive officer. Under this plan, Mr. Liu will receive RMB1.00 per year in cash salary and zero cash bonus during the 10-year period. **He has been granted an option to acquire a total of 26,000,000 Class A ordinary shares of the Company**, representing approximately 0.9% of the Company's total shares outstanding, at an exercise price of \$16.70 per share (or \$33.40 per ADS) under the Company's Share Incentive Plan, subject to a 10-year vesting schedule with 10% of the award vested on each anniversary of the grant date. The Company will not grant any additional equity incentive to Mr. Liu during the 10-year period.

# Bonus



- The CEO's salary is fixed. Stock option and restricted stock are linked with firm stock price. What should the final part, bonus, be link with?
- One choice is to link CEO's bonus to firm accounting profitability.
- However, accounting measures (e.g., earnings, ROA, ROE) may be biased measures of true profitability. Managers may manipulate these measures to increase their bonus. Recall the leverage effect of debt.
- Economic value added (EVA) is used as the benchmark indicator in many cases.

# Economic Value Added

- Economic value added (EVA) take the opportunist cost into consideration and measures the value added for shareholders by management during a given year.
- $$\begin{aligned} \text{EVA} &= \text{income earned} - \text{income required} \\ &= \text{NOPAT} - \text{WACC} * \text{Total capital} \\ &= \text{EBIT} * (1-T) - \text{WACC} * (\text{Debt} + \text{Equity}) \end{aligned}$$
- EVA encourages managers to concentrate on increasing value, not just on increasing earnings.
- 央企考核“一利五率”