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Financial management in China

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ABSTRACT

This paper introduces the Journal of Multinational Financial Management's special issue on financial management in China. We provide a brief literature review of China's financial management policies, practices, and recent research findings, and describe how papers published in this special issue contribute to this literature. We also make many suggestions for future research.

1. Introduction

China will soon become the largest economy in the world, yet finance scholars in the international academic community still know very little about financial management policies and practices in China. There are several reasons for this lack of knowledge. First, it is only recently (primarily during the past decade) that China has transitioned from a planned economy to a market economy, a transition that is still not complete. Second, and on a related note, many stocks in China used to be primarily state-owned

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and/or nontradable, making studies on China's financial management practices not generalizable to capital-market-oriented economies. Third, China's stock markets are young, as they were opened only in 1990. Fourth, the quality of Chinese financial statements used to be questionable, and many important data items were unavailable until recently. Fifth, and perhaps most importantly, China's economy, along with its regulatory and institutional environment, changes rapidly. Indeed, papers on China's financial markets published in academic journals ten years ago may report findings not even relevant or useful today.

We, the editors of this special issue, both teach modern corporate finance theory in business schools in China. When we describe or illustrate a financial management theory, concept, or practice, all of which are based primarily on Western thought and practices, our Chinese students often respond, "this is not how it is done in China." As we have gotten to learn China's financial management policies and practices, and the regulations that directly affect these policies and practices, we have to come to realize that our students are sometimes right. However, they are also sometimes wrong. In what ways is financial management in China similar to what is practiced in other countries, and in what ways is it different? Shedding some light on this question is the purpose of this special issue.

In our introduction to the special issue, we first briefly review the literature on China's financial management policies and practices.[2] In this way, we try to narrow the gap in the profession's understanding of China's financial management practices. We document both similarities and differences between China and the rest of the developing and developed world. Second, and more importantly, we describe how the papers in this special issue improve our understanding of financial management practices in China. Finally, we make many suggestions for future research.

2. Financial management practices in China

2.1. Capital structure

Capital structure policy is, of course, one of the fundamental policies in financial management. Yet we continue to debate as to which theory determines a firm's capital structure. The three theories most commonly debated today are the classic tradeoff theory (i.e., firms trade off the tax advantage of debt with financial distress costs), the pecking order theory of Myers (1984) and Myers and Majluf (1984) (i.e., because of costs associated with information asymmetry, firms use internal financing before external financing, and if firms use external finance then they choose debt before equity), and more recently, market-timing theory (Baker and Wurgler, 2002) (i.e., firms' capital structures are driven by share valuation, as firms issue/repurchase shares depending on whether those shares are over- or undervalued). Many papers studying data from developed and developing countries find support for one or more of these theories. Which of these theories, if any, explains capital structure for Chinese firms?

Huang and Song (2006) study firm-specific determinants of capital structure in China. They find that large firms with high fixed-asset ratios hold more debt, while firms with high profits carry less debt. Note that these results are found in almost every developed and developing country (see, e.g., Rajan and Zingales (1995) for a literature review of capital structure studies). More to the point, Huang and Song also find a positive relation between the firm's effective tax rates and leverage. This finding, coupled with their finding that firm size (which can be viewed as an inverse proxy for bankruptcy risk) is also positively related to the leverage ratio, suggests that tradeoff theory explains capital structure in China. However, note that their documented negative relation between profitability and the debt ratio is also consistent with a pecking order. That is, profitable Chinese firms appear to use their own internally generated earnings to finance growth before they seek external financing.

The third capital structure theory, market timing, argues that the issuance (repurchases) of stocks when they are over (under) valued explains the capital structures that we observe. A recent paper by Bo et al. (2011) finds that Chinese firms issue seasoned equity offerings (SEOs) when the market overvalues their stocks, suggesting that market timing could very well play an important role in

[2] Our literature review is not thorough, and we apologize to all authors whose papers are not cited.

determining capital structure in China. Currently, however, there is little evidence on the role of repurchases in capital structure determination in China, as repurchases have only recently been allowed. Overall, therefore, even when researchers use Chinese data, they continue to debate as to which theory explains capital structure.

But how are Chinese firms *different* from firms in other countries with respect to their capital structures? Three observations are particularly noteworthy. First, Chinese listed firms appear to maintain lower financial leverage ratios than firms in other developing economies (see, e.g., Fan et al., 2012). Second, Chinese listed firms especially hold low levels of *long*-term debt. Finally, almost all of the debt comes from commercial banks, as China's corporate bond market is still underdeveloped. These three observations are, of course, not mutually exclusive. That is, when firms have only one primary source of debt, they tend to have low debt levels (see, e.g., Faulkender and Petersen, 2006). When firms rely primarily on bank debt, it is usually short-term debt, as it is easy for firms and large lenders (such as banks) to renegotiate rollover terms. Therefore, the important questions that a sample of Chinese firms can help us answer include, first, what effect do these three particular factors have on firms? For example, how do small firms obtain financing? This is an important question, as small firms are well known to be the drivers of a country's economic development and growth. It seems that some small firms are able to obtain financing from rural credit cooperatives (these are similar to credit unions in the U.S.), but as these cooperatives merge to form regional banks, these small firms struggle to find ways to obtain bank loans. China started allowing its Postal Savings Bank (a bank that had traditionally been a savings bank only) to start lending to small and medium-sized enterprises. And recently, China's government has specifically pledged strong financial support of small firms.[3] Another important question we can raise, given Chinese firms' heavy reliance on bank debt, is whether this reliance has drawbacks. For example, Gibson (1995) and Kang and Stulz (2000) find that bank-dependent Japanese firms are unable to finance profitable projects when their banks are experiencing financial difficulties. It would seem that Chinese firms would be similarly vulnerable, but unfortunately it may be hard to obtain a reliable answer to this question without a comparison sample of Chinese firms that do not rely primarily on bank debt. If scholars can obtain a sufficient sample of such firms, then future research should attempt to identify whether there are any drawbacks to Chinese firms' heavy reliance on bank debt.

Chinese firms are well known for having local and national governments as significant owners and controllers, and those that do are commonly referred to as state-owned enterprises (SOEs). What role does the government play in SOEs' capital structures? Banks, which are also significantly owned by the government, prefer to lend primarily to SOEs rather than non-SOEs (Brandt and Li, 2003). Some argue that this represents discrimination in lending. A more rational explanation is that banks view lending to SOEs as being safe given that the government will probably not let any SOEs fail. This implies that SOEs will have higher debt ratios than non-SOEs, but in conducting our own private empirical analyses, we find that SOEs and non-SOEs have similar debt ratios. So how do non-SOEs, which can be large listed firms, obtain financing? Some non-SOEs appear to use foreign debt (Poncet et al., 2010). In a recent paper, Lu et al. (2012) find that some non-SOEs will sometimes own significant shares of banks to form economic bonds with lenders. They find benefits to these ties, as these firms are able to obtain bank debt at low costs. Finally, some non-SOEs might use whatever political connections they have to obtain bank loans (Li et al., 2008).

Zheng and Zhu (2013) look at Chinese banks' lending incentives. Like Li et al. (2008), they also find that Chinese firms with political connections are more easily able to obtain bank debt. Specifically, Zheng and Zhu find a positive relation between past profitability and changes in bank debt. That is, banks lend to profitable firms. This finding is expected. However, when a firm has a politically connected CEO (i.e., a CEO who used to work for the government), the positive relation between profitability and changes in bank debt is less strong. That is, politically connected firms do not have to be as profitable as others to obtain bank loans. They further find that politically connected firms that show an abnormal increase in bank debt subsequently invest less efficiently (i.e., these firms overinvest). Finally, Zheng and Zhu (2013) document negative announcement returns when politically connected

[3] http://ieli.pku.edu.cn/ieli/legalnews/l111013.html.

firms announce increases in bank loans, further suggesting that loans given to politically connected firms reduce the firms' values. Overall, therefore, Zhen and Zhu find two costs to political connections: they lead to suboptimal financing and investing policies. That is, political connections can destroy firm value. We should point out an alternative view. There is every possibility that political connections can enhance firm value. For example, if a firm deserves financing but is unable to obtain it on favorable terms because of information asymmetry, a political connection can reduce the information asymmetry. Currently, most papers point out economic costs of political connections. Future research might attempt to uncover benefits.

What about external equity financing? Despite the fact that China's stock markets are among the largest in the world, external equity financing still lags far behind debt financing (Tong, 2005; Fan et al., 2008). However, this is *not* due to a lack of desire for external financing. Hundreds (and maybe thousands) of firms have applied to conduct initial public offerings (IPOs), but there is a regulatory quota for the number of firms that can go public. Therefore, many Chinese firms go public abroad rather than in mainland China (see Busaba et al., 2012). However, the government seems to be doing a good job in picking which firms go public. The firms that are allowed to go public are the better performing firms (Du and Xu, 2009).

Once firms become listed, they continue to face regulatory hurdles to raise additional equity capital. In China, a firm must meet certain profitability thresholds (e.g., a specific ROE) before it is allowed to issue seasoned equity offerings (SEOs). On the one hand, there may be a benefit to this hurdle. Since the establishment of this regulation, Chinese firms have suffered less from negative abnormal announcement returns when they announce the issuance of SEOs (Chen and Wang, 2007). But on the other hand, it is precisely unprofitable firms that would benefit the most from access to capital markets so they can eventually become profitable. Therefore, it is uncertain whether profitable Chinese firms issue SEOs for the right motivations (e.g., to finance positive net present value projects). For example, as we previously mentioned, Chinese firms seem to be motivated by share overvaluation in their decisions to issue SEOs. Others argue that Chinese firms issue SEOs to expropriate wealth from minority shareholders (e.g., see discussions in Bo et al., 2011).

Dang and Yang (2013) take advantage of unique changes in the regulatory environment in China to compare rights offerings to underwritten equity offerings. In China's recent past, there have been times when the profitability requirement to conduct rights offerings was higher than the requirement to conduct underwritten offerings, but at other times the reverse has been true. They find that when firms choose an offering method simply because they did not qualify for the alternative method, the announcement returns and buy-and-hold returns are lower than when firms had a choice of methods. Their results suggest that China's regulatory requirements for conducting equity offerings reduce information asymmetry, so the regulatory requirements enhance value. However, they wonder to what extent these regulatory requirements encourage firms to manage earnings. Indeed, this is an intriguing question for future research.

2.2. Capital investment

Firms obviously need to make capital investments, either in capital expenditures for fixed-assets investment and/or in research and development for nonfixed-asset investment, to ensure future net operating cash flows. Among the many issues that researchers have studied when it comes to capital investment, we first focus on the following two issues: (1) firms may under- or overinvest (e.g., Myers, 1977; Stulz, 1990) and (2) firms may not be able to make value-enhancing investments if they are financially constrained (Fazzari et al., 1988; Hubbard, 1998).

Regarding the topic of under- and overinvestment, a negative relation between financial leverage and investment is well documented in the U.S., especially for low-growth firms (e.g., McConnell and Servaes, 1995; Lang et al., 1996). There are two classic reasons for this negative relation. First, firms with high leverage may forgo investing in positive NPV projects as the benefits may go primarily to debtholders. Second, debt, in and of itself, is a disciplinary mechanism that discourages overinvestment (Jensen, 1986). For low (high) growth firms, a negative relation between leverage and investment is consistent with high leverage discouraging overinvestment (encouraging underinvestment). However, in China, given that bank debt is the primary source of external finance and given that many

firms are owned and controlled by the government, might we see different results? Firth et al. (2008) find the usual negative relation between leverage and investment, but they find that this relation is *weaker* when firms have low growth prospects and are controlled by the government. Their results suggest that Chinese banks, which are primarily state-owned, are lenient in lending to firms (especially state-owned firms) despite their low growth prospects, reflecting the banks' role as a rescuer of firms in economic distress rather than as a monitor or discipliner. As we mentioned earlier, Zheng and Zhu (2013) also find that that politically connected firms are able to obtain bank debt more easily than other firms, and that these firms use these funds to overinvest.

Regarding the topic of investment and financing constraints, it is generally well known that there is a positive relation between internally generated funds (usually proxied by cash flow or free cash flow) and investment (usually measured by capital expenditures). This positive relation suggests that it is much easier for firms to make capital investments when they are able to generate their own funds (Fazzari et al., 1988). In a recent paper, Firth et al. (2012) find that government-controlled firms have the usual positive cash-flow–investment relation, but they also find that these firms continue to invest when internally generated cash flows are low, and even when these firms have low growth opportunities. This finding is again consistent with the view that state-owned firms overinvest. Their explanation is that state-owned firms prioritize a responsibility to foster government policies (e.g., maintain low unemployment) over a desire to maximize firm value. However, we should caution that the debate continues. Other researchers (most notably, Poncet et al., 2010) using Chinese data find that non-state-owned firms are more financially constrained than state-owned firms (i.e., their negative cash-flow–investment relation is more sensitive). Earlier, we suggested that future research should look for costs to firms with significant bank relations and bank-dependency. But there are obviously also benefits to maintaining bank relations. An interesting area for future research would be to see whether bank-dependent firms are able to overcome financial constraints, as Hoshi et al. (1991) have suggested. They find that bank-dependent Japanese firms do not have to rely on internally generated funds to invest.

Of course, research and development (R&D) expenditures can also lead to subsequent profits. Indeed, Fan et al. (2013) find a positive relation between firms' sales and R&D. That is, a firm's innovations lead to higher sales. Given this finding, we might assume that Chinese firms then rationally invest in R&D, but this is not necessarily the case. Many Chinese firms may not have a strong incentive to invest in R&D given that their competitors may imitate (or outright steal) their ideas, inventions, and innovations. According to anecdotal evidence, Chinese firms have an unfortunate reputation of violating intellectual property rights. Fan et al. (2013) cite earlier studies that find that Chinese firms located in provinces with weak intellectual property rights engage in less R&D. So Fan et al. ask an important follow-up question. How are R&D spillovers affected by the legal environment, and are they correlated with R&D expenditures? Note that R&D spillovers (in which one firm's innovation is used by other firms) are generally beneficial for economic development. When one firm makes a new discovery, it is best for as many firms as possible to use it as well. This way, firms, consumers, and society as a whole benefit. However, such knowledge transfers can be either compensated (e.g., firms pay to adopt the patent) or uncompensated (the ideas or innovations are simply stolen or imitated). If knowledge is transferred in the latter way, then firms may have no incentive to engage in R&D.

Using many different straightforward and also creative ways of measuring intellectual property rights, Fan et al. (2013) find that in regions with weak intellectual property rights, an individual firm's sales are positively and strongly related to R&D expenditures by competitors (i.e., firms from the same industry). In other words, firms benefit when other firms in their industries invest in R&D. They further find that when this spillover is larger, firms engage in less R&D. Therefore, they identify a specific channel (R&D spillovers) through which weak intellectual property rights reduce innovation. When most scholars suggest that China needs further reforms to become a market-driven economy, they usually point to reforms in the financial sector and infrastructure (e.g., banking, and interest rate and exchange rate liberalizations). The paper by Fan et al. (2013) reminds us that China should seriously engage in legal reform as well.

Finally, another form of capital investment (and perhaps the most dramatic in terms of scope) is the acquisition of other firms. The mergers and acquisitions (M&A) market is growing in China. Currently, many Chinese firms are engaging in cross-border acquisitions as they attempt to globalize and to seize

market share. But the domestic M&A activity is heating up as well. Bhabra and Huang (2013) study the wealth effects on Chinese listed firms that acquire other firms, which are mostly local unlisted firms. They find abnormal positive stock returns surrounding M&A announcements and also for the three-year period following the acquisition. Note that many M&A studies do *not* find positive abnormal returns to acquirers (e.g., Jensen and Ruback, 1983; Loughran and Vijh, 1997). However, the recent evidence is mixed (e.g., Moeller et al. (2004) find situations where acquiring firms enjoy wealth gains). What is it about China that allows acquirers to enjoy positive stock returns? The acquisitions that were most value-enhancing to acquirers were ones where the target was an unlisted firm and was purchased with cash (so the ease of negotiations may play a role), and the target is in an industry related to that of the acquirer (so these are not diversifying mergers). Most interestingly, it also turns out that SOEs enjoy the larger positive stock returns than non-SOEs do. Many studies argue that SOEs are not as profitable as private firms (a notable exception is Chen et al., 2009). Bhabra and Huang (2013) show that SOEs do engage in value-maximizing activities. A fruitful area for future research is to see whether acquirers still enjoy abnormal positive stock returns when they start acquiring other *listed* firms.

2.3. Payout policy

Why do firms pay dividends? There are several theories, but the two primary ones are that (1) dividends signal future profitability (e.g., Bhattacharya, 1979; John and Williams, 1985; Miller and Rock, 1985) and (2) dividends reduce the agency cost of free cash flow (Easterbrook, 1984). More important from our paper's perspective is the question, why do *Chinese* firms pay dividends? There is evidence consistent with the second hypothesis. Gul (1999) finds that firms with low investment opportunities pay more dividends, in accord with the notion that dividends reduce cash available for discretionary spending. In a similar vein, Zhang (2008) finds that when managers serve on boards in China, cash dividends are lower, indicating an agency problem, but when ownership concentration is high, the negative relation between managerial membership on boards and cash dividends is weaker, suggesting that large owners use dividends to mitigate the agency problem.

However, the question that we want to raise is how dividend policy in China differs from that in other countries. In China, institutional factors appear to play a key role. Since 2001, listed firms have been required to pay cash dividends for three consecutive years if they wish to conduct rights issues (Huang et al., 2011). Further, given that owners of nontradable shares (who are usually the government) are not able to profit from capital gains on their shares, firms with a high concentration of nontradable shares are more likely to pay larger cash dividends (Huang et al., 2011). An interesting puzzle related to dividends in China is the popularity of stock dividends (Su, 2005). Given that stock dividends do not change shareholders' total stock value, why are they so popular? This is yet another promising topic for future research.

Finally, stock repurchases only recently became allowed in China (Huang et al., 2011), so we have yet to know their determinants and roles in financial management in China. When repurchases become more often used in China, future research should study their motivations and effects. Overall, very little is known about payout policy in China. Perhaps the main reason for this is that China is still in a developing phase in which many of its firms, especially non-SOEs, are still growing. It will be interesting to see, someday in the future, how these firms choose and use payout policy as a financial management tool when they stop growing at a rapid pace.

2.4. Corporate governance

Corporate governance can obviously influence financial management practices, as sound governance can ensure value-maximizing financial management policies. Ding et al. (2013) examine the relation between Chinese firms' stock price informativeness and mutual fund ownership. Mutual funds are well known to be monitors and active shareholders of firms in which they own stock. Therefore, when firms' shares are significantly held by mutual funds, then their stock prices should be more informative. However, for those firms that are also significantly owned by the government, mutual funds may have less power over the firms. The authors find empirical support for both hypotheses. That is, when stock price informativeness is a dependent variable in a regression framework, the mutual

fund independent variable is significantly positive and an interaction term between the mutual fund variable and the government ownership variable is significantly negative. This paper is timely. Very little is known about institutional investors' monitoring and activism in China. The reason is clear. As the paper points out, the large presence of institutional investors in China is a fairly recent phenomenon. Future research could study whether mutual funds in China are simply attracted to firms with high stock price informativeness. That is, are we sure about the direction of causality documented by Ding et al.? Furthermore, if governments mitigate the influence that mutual funds can have over government-dependent firms, then why do mutual funds still own these shares? Do these institutions believe that state-owned firms are good investments? These questions represent future areas of research.

Finally, it is also important to realize that price informativeness can also be linked to corporate investment policy. For example, a paper by Wang et al. (2009) finds little relation between stock market valuation and firm investment because stock prices do not predict Chinese firms' future operating performance. In a similar vein, note that corporate governance may also play a role in accounting informativeness. Specifically, firms with good governance or oversight may produce more accurate financial statements. Matsunaga and Yeung (2008) document that CEOs with financial expertise provide more precise earnings information. That is, CEOs with financial experience are less likely to engage in earnings manipulation. Jiang et al. (2013) find that Chinese firms with CEOs who were previously CFOs, chief accounting officers, or vice-CEOs for finance or accounting engage in less *real* earnings management. The Matsunaga and Yeung study focuses only on accruals-based earnings management. Therefore, Jiang et al. (2013) present important further evidence on the benefits of having CEOs with financial experience. Indeed, Jiang et al. suggest that this may be one reason why more Chinese firms are hiring CEOs with financial backgrounds.

In general, we need more research on corporate governance in China. As China becomes the largest developed market economy in the world, investor confidence is going to play a crucial role. Yet we currently know very little about corporate governance practices in China. One of the reasons is that corporate governance regulations change constantly.

3. Conclusion

The papers in this special issue contribute importantly to our understanding of financial management policies and practices in China. But more research is needed. In our paper, we suggest many topics for future research. The papers published in this issue also raise additional questions that can be addressed by future research. There are many unique institutional and regulatory differences between China and the rest of the world. And, at the same time, many Chinese firms are enjoying tremendous growth and profitability. Therefore, China provides an excellent setting and opportunity for empirical finance research. We hope that our paper and this special issue will motivate some of that future research.

Acknowledgments

We obviously could not have compiled this special issue without a lot of help. However, we also recognize that our colleagues in this profession are busy people and that their time is one our profession's most valuable resources. Therefore, we took the liberty to conduct initial screens for all submitted papers before we decided to send them out for review. As a result, we desk-rejected most submissions for one reason or another, with the most common reason being lack of fit with the special issue. Of those papers that were sent out for review, we acknowledge the following referees, who provided timely, thorough, and thoughtful reports: Xin Chen, Shanghai Jiaotong University; Fuxiu Jiang, Renmin University of China; Dolly King, University of North Carolina at Charlotte; Byron Lee, Renmin University of China; Bingxuan Lin, University of Rhode Island; Qingzhong Ma, Cornell University; Jiaren Pang, Tsinghua University; Oranee Tawatnuntachai, Penn State University at Harrisburg; Carol Wang, Wright State University; Qinghai Wang, Georgia Tech University; Xue Wang, Tulane University; Hao Zhang, Rochester Institute of Technology.

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