Edited by
Douglas Cumming, Michael Firth,
Wenxuan Hou, & Edward Lee

# SUSTAINABLE ENTREPRENEURSHIP IN CHINA

## Ethics, Corporate Governance, and Institutional Reforms

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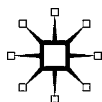

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# *Introduction*

Douglas Cumming, Michael Firth,
Wenxuan Hou, and Edward Lee

China as we know today is an increasingly influential country on the global scene. The phenomenal and impressive economic growth of China has been hailed as one of the greatest achievements in modern history, since it has elevated hundreds of millions of people out of poverty. The surge and success of China's economy has been attributed substantially to the pivotal role played by the private sectors, their ingenuity, innovation, and entrepreneurship.

Chinese entrepreneurship was enabled only after institutional reforms began in the late 1970s from being a centrally planned to a market-oriented economy. Over the past three decades, institutional reforms have continued to promote and expand entrepreneurship in China by improving the business environment. Nevertheless, as Chinese entrepreneurs become increasingly competitive, they also become more reliant on external financial resources to fund their growth opportunities and businesses. To foster sustainable entrepreneurship, further developments in capital markets, corporate governance, and business ethics is necessary to help bolster investor confidence.

A transitional economy like China provides fertile ground to examine how these factors affect economic growth and sustainability. On the one hand, institutional reform and corporate governance assist entrepreneurship by promoting competition. On the

other hand, competition among Chinese entrepreneurs also serves as a catalyst for further regulatory reform and corporate governance improvement. The success of China's economy so far warrants studying these issues to gain insights and inform the development of other emerging economies. This book contains several such interesting studies on this topic.

Chapter 1, by Haß, Müller, and Zhang, "Corporate Fraud and Bank Loan Contracting: Evidence from China" examines the impact of corporate fraud on bank loans. When entrepreneurship becomes increasingly competitive in a country with a weak institutional environment, there is an increased potential for fraudulent activities. Surveying a sample of bank loans provided to Chinese firms from 2001 to 2012, we find evidence that loan financing conditions deteriorate following corporate fraud enforcement. While existing studies on the impact of corporate fraud largely focus on the effect of equity capital acquisition, this study provides interesting findings in the parallel context of debt capital markets.

Chapter 2, by Farag and Mallin, "Corporate Governance and Diversity in Chinese Banks" examines corporate governance issues in Chinese banks, which are an important channel for entrepreneurial finance. Data were collected for 17 Chinese banks over a period of four years, from 2008 to 2012. This study documents the influence of the board of directors, the supervisory board, key subcommittees, and the directors' characteristics on bank stewardship. The main implication is that bank governance can be impeded by a lack of effective monitoring and by state ownership concentration. Given the importance of bank lending decisions to sustainable entrepreneurship, future banking reforms should seek to enhance governance and stewardship.

Chapter 3, by Hua and Chen, "Institutional Logics and Financing Mechanisms: A Comparative Study of Ningbo and Wenzhou Entrepreneurs" compares the financing mechanisms in two Chinese cities from 1978 to 2012. The findings show that community-based business logic makes Ningbo entrepreneurs adopt a balance between formal and informal financing channels, while family and

corporation logic drives Wenzhou entrepreneurs to resort to informal financing more boldly and speculatively. This study also reveals that government policies play a crucial role in affecting entrepreneurial financing. On the whole, an interesting snapshot of the entrepreneurship development underlying China's economic growth today is presented in this chapter.

Chapter 4, by Li, Shi, and Wu, "Transgenerational Succession and Financial Risk Taking of Family Firms: Evidence from China," investigates whether and how transgenerational succession affects the risk-taking behavior of family firms in China. The authors study a sample of 232 family firms publicly listed in China from 2006 to 2011. Findings reveal that succession motivates family firms to take higher financial risks in regions that are more economically developed. Overall, this study sheds light on the sustainability of entrepreneurship when succession plays an important role in continuing performance in family firms.

Chapter 5, by He, "The Qualified Foreign Institutional Investor System and Corporate Governance in China" discusses the introduction and development of foreign institutional investors in China. It provides a review of the relevant literature on the effect of such investors on corporate governance in Chinese firms. The existing literature, based on Western developed economies, suggests that institutional investors play an important role in monitoring firms that they invest in. A further development of the Qualified Foreign Institutional Investor (QFII) system is expected to benefit sustainable entrepreneurship in China, and this may inform similar initiatives in other emerging economies.

Chapter 6, by Bo and Xu, "Accounting Performance Inflated by Private Equity before IPOs: Evidence from Chinese Firms," examines private equity (PE) transactions among Chinese listed firms from 2000 to 2011. It provides evidence that governance of PE is not effective in China, and that PE funds are used to boost short-term accounting performances before listing. The study shows that speculative ventures by PE investors are especially pronounced in small- and medium-sized enterprises. The policy implication that

stems from such evidence is that institutional and regulatory reforms may be needed to help strengthen the governance of PE transactions in emerging economies like China.

Chapter 7, by Yang, Hou, and Qian, "The Split-Share-Structure Reform in China: Past, Procedure and Impact" reviews the literature that describes this reform in China. Taking it at face value, the reform largely affects firms with more restricted shares such as the state-owned enterprises (SOEs). However, given the competitive pressure that SOEs exert against privately controlled firms in China, it is also expected to have indirect implications on the development and sustainability of entrepreneurship.

The studies in this book provide a good starting point to motivate future research on entrepreneurship in China and the governance and financing issues involved in the process. Potential research questions on promoting ethical, sustainable, and socially responsible entrepreneurship can include but are not limited to the following:

- How do institutional reforms attract talent and facilitate this kind of entrepreneurship?
- What kind of regulation encourages venture capital, private equity, and other forms of investment in this kind of entrepreneurship?
- Do corporate governance mechanisms affect capital acquisition of entrepreneurs, and are they different for entrepreneurs in this kind of entrepreneurship?
- Do ethical entrepreneurs and venture capital investment in ethical entrepreneurships perform better?
- What are the appropriate performance metrics for ethical entrepreneurs?
- How do foreign investors perform corporate governance roles for entrepreneurs, and are there differences for entrepreneurs in ethical and sustainable industries?

We hope that the excellent contributions in this book inspire further research in these and related areas.

CHAPTER ONE

# *Corporate Fraud and Bank Loan Contracting: Evidence from China*

Lars Helge Haß, Maximilian A. Müller, and Zhifang Zhang

## 1.1 Introduction

Corporate fraud is pervasive in the Chinese capital market. Nearly one-fifth of the firms in China have been subject to enforcement action by the China Securities Regulatory Commission (CSRC) triggered by a violation of securities laws. Prior literature documents that consequences of corporate fraud being exposed via enforcement actions: among others, firms have experienced a significant loss in market value and stock liquidity (e.g., for China, Chen et al., 2005). While the determinants of the fraud at the firm level and the consequences of it for equity holders have been documented extensively, this chapter investigates the impact of fraud on the cost of debt for Chinese firms. Debt financing represents an important source of corporate finance in China, given that leverage ratios are around 0.5 for the average- and median-listed Chinese firms.

Prior literature also focuses on the consequences from the perspective of equity holders. These papers decompose the negative effect on firm's securities into a wealth effect due to revised cash flow

expectations (e.g., Karpoff et al., 2008) and an information risk effect (e.g., Kravet and Shevlin, 2010). Recent papers use the same line of reasoning to investigate the effects of corporate fraud on bank loan contracting. Graham et al. (2008) predict that revised cash flow expectations translate into higher credit risk estimates, and increased information risk translates into higher monitoring costs for lenders that will be borne by borrowers. Both effects predict an increase in the cost of debt, and for a sample of loans initiated prior to and after a restatement by US-listed firms, Graham et al. (2008) document a relative increase of 10 % in the cost of debt.

We investigate this issue in the context of Chinese firms because of the importance of debt as a source of financing in China and several important institutional features that warrant an investigation of the effect of fraud on the cost of debt. The Chinese banking sector has undergone substantial changes in the past two decades. Chinese banking is dominated by four state-owned banks, which operate in an uncompetitive environment, face much pressure to contribute to political and social stability, and discriminate against firms that are not state owned (Bailey et al., 2011). State-owned banks have been allowed to extend loans to private sector firms only since 1997 (Firth et al., 2009). For these private sector firms, asymmetric information and overall lack of information are problems particularly pervasive in the lender-borrower relationship due to inadequate credit history records to back up loan allocation decisions (Piotroski and Wong, 2013). Two thirds of the enforcement actions by the CSRC are disclosure-related cases. In such a setting, enforcement actions represent valuable signals to adjust prior, relatively uncertain, beliefs about borrowers. At the same time, many state-owned enterprises have been partially privatized, with the government retaining control in some firms. Hence, differences in government financial support across firms (Chen et al., 2010) enable us to identify firms that rely more on debt financing.

To analyze the impact of corporate fraud on the cost of debt, we use the findings of corporate fraud via CSRC enforcement actions to identify changes in the cost of debt of fraudulent firms relative to

nonfraudulent firms. Given the findings of the impact of fraud on the average interest expense for firms in China (Chen et al., 2011), it is important to note that we study data from single-loan contracts initiated prior to and after the enforcement action. Further, closely following the approach in Graham et al. (2008), we control for loan characteristics, such as the size, maturity, and collateralization, and firm characteristics, such as financial health and tangibility of assets, potentially associated with the cost of debt.

We predict and find a relative increase in the cost of debt of about 10–20% in univariate and multivariate analyses. Given an average interest rate of 4 % for all loans initiated prior to the exposure of the fraud and for all loans initiated by nonfraudulent firms, this result indicates an increase of around 40–80 basis points. The magnitude of this estimate is largely consistent not only with the previously mentioned evidence in Graham et al. (2008) but also with the estimates for the increase in the cost of equity capital of 10.8–19.5% reported in Hribar and Jenkins (2004). Because prior papers document that other loan-contracting terms change simultaneously as a response to fraud exposure, such as shortened maturity and more covenant restrictions, the economic effect is likely to be even higher.

Consistent with prior literature, we further document that loans by firms with less tangible assets, lower financial health, and lower state ownership experience a higher cost of debt. Also, loans that are provided against collateral are positively associated with the cost of debt. Given that these variables already capture changes as a response to fraud exposure (e.g., lower financial health), fraud exposure has an effect above and beyond these variables (Graham et al., 2008).

Taken together, fraud exposure via CSRC enforcement actions signal worse and/or more uncertain future expected cash flows, which increase the cost of debt. Hence, we contribute to the literature on the economic consequences of fraud in a Chinese capital market setting, for example, qualified audit opinions, CEO turnover, higher audit fees, and wider bid-ask spreads for fraudulent firms (e.g., Chen et al., 2005). Because debt is an important source of financing for Chinese listed firms and the documented effects of debt are economically significant,

our results should also be of interest to the literature that develops an understanding of debt financing in China (e.g., Firth et al., 2009; Bailey et al., 2011).

The remainder of this chapter is structured as follows. In section 1.2, we describe the related literature and develop our hypothesis. Section 1.3 discusses our research design. Section 1.4 presents information on the sample selection, describes our sample, and presents univariate comparisons. In section 1.5, we present our multivariate analysis. Section 1.6 summarizes and concludes the chapter.

## 1.2 Literature and Hypothesis Development

China's banking sector has been the primary source of financing for China's growing economy (Bailey et al., 2011). Official data indicate that the total value of bank loans is 100 times greater than the value of stocks and corporate bonds (Cai et al., 2008) and that this market is dominated by the four largest state-owned banks. Until 1997, the Chinese banking sector had little latitude and primarily served to channel low-cost capital to state-owned enterprises. The competitiveness of the banking market is influenced by the state ownership of listed firms. Even though Chinese firms have been partially privatized since the mid-1990s, the government has retained sufficient shares to maintain control of many listed firms. As a consequence of the sociopolitical objectives of the government, the government exerts an influence on managerial issues such as asset disposal, mergers and acquisitions, and CEO appointments (Chen et al., 2010). Further, the government provides financial assistance through subsidies and favorable loans, which in turn reduces financial constraints and bankruptcy risk for such firms (e.g., Chen et al., 2008; Wang et al., 2008). Only since 1997, state-owned banks are allowed to extend loans to private sector firms (Firth et al., 2009). For these private sector firms, asymmetric information problems are particularly pervasive in the lender-borrower relationship in China. In such a setting, enforcement actions represent valuable signals to adjust prior, relatively uncertain beliefs about borrowers.

While the role of private enforcement in China is very limited (e.g., Allen et al., 2005; Jiang et al., 2010), the China Securities Regulatory Commission (CSRC) enforces actions via securities laws that prohibit individuals or institutions from making false, seriously misleading presentation or omission, or any other forms of false presentation or inducement, which will lead investors to make investment decisions without knowing the truth (Chen et al., 2005). Apart from regular reviews and random inspections, the CSRC also responds to information and complaints about alleged fraud from external whistleblowers. The results of the CSRC's investigations are made public if wrongdoing is found. Public announcement may take four forms: public criticism, public condemnation, official warning, and monetary fines. These are actions taken against fraudulent behavior. The most frequent violations include nondisclosure or delayed disclosures, false statements, and inflated profits (Chen et al., 2005).

Several papers examine the consequences of corporate fraud from the perspective of equity holders (e.g., Anderson and Yohn, 2002; Hribar and Jenkins, 2004; Palmrose et al., 2004). A corporate fraud usually involves a restatement and, hence, can change expectations that are based on past financial data, that is, an adjustment to the value the firm would have had if its financial statements had never been misreported. Further, fraudulent firms incur legal and reputational costs (Karpoff et al., 2008; Johnson et al., 2014). Chen et al. (2005) and Yang and Xie (2008) investigate the economic consequences of fraud for China. They find that enforcement actions have a negative impact on stock prices with most firms suffering wealth losses of around 1–2% in the five days surrounding the event. Further, fraudulent firms face incur other expenses as they experience a greater rate of auditor change, a much higher incidence of qualified audit opinions, increased CEO turnover, higher audit fees, and wider bid-ask spreads.[1] Taken together, these consequences translate into lower than expected cash flows, which increase default risk and interest rates (e.g., Freixas and Rochet, 1997).

Corporate fraud also increases uncertainty about the reporting quality of a firm's financial statements as evidenced by higher forecast