Reputation, Accounting Information and Debt Contracts in Chinese Family Firms*

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Abstract

This paper provides evidence to show that in the presence of imperfect formal institutions there is both a substitutional and a complementary relationship between accounting information and reputation, an informal institution. Empirical results using a sample of family firms listed in the Chinese A-share stock market from 2004 to 2007 show that in China, where the legal environment is far from perfect, the complementary relationship between reputation and accounting information is more pronounced than is the substitutional relationship. Thus, the aggregate effect is that a better reputation improves the usefulness of accounting information in debt contracts. Besides the aggregate effect, this paper also provides evidence of the substitutional and complementary relationships between reputation and accounting separately.

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1. Introduction

Coase (1937) shows that the costs of entering into and executing contracts and managing organizations, and these costs that are neglected by traditional microeconomic theory, can be employed to interpret the reasons for a firm's existence. He then extends these costs to form the concept of "transaction costs." In a world of positive transaction costs, the contracting parties will try to minimize (given constraints) contracting costs. Positive accounting theory (PAT), as formulated by Watts and Zimmerman and other researchers, views accounting as part of a set of efficient contracts that are agreed by the firm and its stakeholders (see Watts and Zimmerman (1986) for a summary of related PAT literature from the 1970s). The three major hypotheses proposed by PAT, namely, the bonus plan, debt contract and political cost hypotheses, are all based on the assumption that accounting information can reduce contracting costs. A natural question that arises is: What is the relationship between accounting information and the other institutional arrangements that can also reduce these costs?

The prior literature, much of which constitutes cross-country studies, has examined the relationship between accounting information and the other formal institutional arrangements that can also reduce contracting costs, such as legal origin, legal enforcement and public policies. Transaction cost economics, as established by Williamson (1979), however, argues that in reality the most common way to solve contract disputes is not through a formal institution, but rather through the informal institutions that are formed by repeated games among the transaction parties and are known as "private order" institutions. Informal institutions can also remedy some of the defects of formal institutions (Lin, 1994), and it is thus meaningful to examine them. Because of data collection difficulties (Sun *et al.*, 2005) and the problems of omitted variables and measurement bias (Gul, 2006), it is difficult for cross-country studies to examine the effects of informal institutions and the relationship between these institutions and accounting information. At the same time, informal institutions guarantee the self-enforcement of contracts and thus do not rely on any third party outside the contracting relationship such as the courts. In the face of imperfect formal institutions, transactions are more reliant on informal institutions. Hence, I expect it to be easier to observe the way in which informal institutions aid the enforcement of contracts. China, an emerging market, provides a unique setting for such an investigation.

Sun *et al.* (2006) show that the usefulness of accounting information in debt contracts is less pronounced in state-owned enterprises (SOEs) than in non-SOEs. After ruling out alternative explanations, they conclude that the government's reputation serves as guarantee that SOEs will repay their bank loans, thereby weakening the usefulness of accounting information. Reputation is a self-enforcing informal institution (Klein *et al.*, 1978; Williamson, 1979). It serves to render the present value of future gains when the contract is honored greater than that of current gains when it is breached. Reputation thus gives the contracting parties the incentive to honor the contract.