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Internal corporate governance and the use of IPO over-financing: Evidence from China

Xin Xu [a,*], Yun Xia [b]

[a] School of Accounting, Zhongnan University of Economics and Law, China
[b] School of International Business, Jinan University, China

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ABSTRACT

In this paper, we describe how Shenzhen A-share listed companies used funds raised in over-financed IPOs during the 2006–2010 period. In exploring the relationship between internal corporate governance and the use of funds raised in over-financed IPOs, we find that the use of such funds to engage in severe over-investment behavior is prevalent among listed companies. Reasonable internal corporate governance mechanisms can effectively alleviate over-investment problems listed companies encounter in using funds raised in over-financed IPOs. However, the same individual serving as both chairman and CEO leads to funds raised in over-financed IPOs being over-invested. Moreover, executives driven by high levels of monetary compensation are more likely to use funds raised in such IPOs to engage in over-investment. We find that improving the balance of power between shareholders will help alleviate the over-investment of excess IPO funds. In addition, the over-investment problem is less severe in state-controlled listed companies than in their non-state-controlled listed counterparts. This study provides policy recommendations for Chinese securities regulators to ensure listed companies use funds raised in over-financed IPOs both rationally and effectively.

* Corresponding author.
E-mail address: xuxinfeiji@126.com (X. Xu).

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1. Introduction

Each year since its establishment in 1991, the Chinese capital market has hosted a considerable number of newly listed companies with over-financed IPOs, i.e. those where the amount of funds actually raised is greater than the size of the planned financing. As a phenomenon unique to China's capital market, IPO over-financing has become an important concern for the China Securities Regulatory Commission, China's domestic financial media and scholars alike. In addition, the frequent occurrence of over-financed IPOs in the newly established Growth Enterprises Market indicates that studying and resolving the IPO over-financing problem to enhance resource allocation efficiency in the Chinese capital market and maintain the healthy development of this new market is both important and urgent. Supervising and ensuring the rational use of funds listed companies raise in IPOs to protect the interests of general investors has recently become the focus of Chinese securities regulatory authorities.[1] Existing research fails to provide a clear explanation of how listed companies use funds raised in over-financed IPOs after meeting their established financing needs, whether listed companies misuse or waste such funds and whether they engage in over-investment and other types of behavior against the interests of investors when using the proceeds of over-subscribed IPOs. We consider these issues important and address them in this paper.

The question of how to use funds raised in over-subscribed IPOs in a reasonable and effective manner not only tests the business wisdom of listed company executives, but also examines their professional integrity. We consider that the use and investment of funds raised in over-financed IPOs among Chinese listed companies provide a natural setting for examining the relationship between internal corporate governance mechanisms and corporate investment decisions. It also provides a better environment for testing the effectiveness of internal corporate governance. There are two main reasons for this. First, the use and investment of the funds raised in over-financed IPOs more truly reflect the real motives of executives. The relevant provisions require that funds raised by a listed company through a public offering must be used for specific purposes in accordance with the applicable commitments in the prospectus.[2] However, the use of excess funds raised in such offerings is not subject to this rule. There is no commitment related to an established purpose and investment plan for funds raised in excess of the IPO target, and no problem would arise even if the investments for which such funds were used changed. Because excess funds raised in IPOs are essentially an extra source of finance given to the company by its shareholders when the company goes public, shareholders do not immediately require cash dividends from such capital, which is akin to manna from heaven. Therefore, listed companies can use this portion of additional funds as they wish. In addition, the huge amount of funds raised in over-financed IPOs also induces companies to engage in rapid investment and expansion. After meeting the funding needs of the enterprise's established investments, the listed company's executives are more likely to use funds raised in an over-financed IPO to further their own interests because of agency problems. Hence, the use and investment of excess funds raised in over-financed IPOs are more reflective of the real motives of executives. This provides us with a better opportunity to test the effect of internal corporate governance.

Second, analysis of the ways in which excess funds raised in over-financed IPOs are used may help us distinguish between firms that engage in distinct forms of over-investment. The public financing of enterprise investment projects is approved following rigorous discussion by the board of directors and at the shareholders meeting. In addition, Chinese financings are currently managed through an examination and approval system. The use of project financing funds is subject to stringent scrutiny by the China Securities Regulatory Commission (CSRC). Chinese enterprises are required to submit their prospectus to the issuance examination committee of the CSRC during the listing process. Investment projects are the focus of scrutiny by the CSRC issuance examination committee. In accordance with relevant laws and regulations, such as the Administrative Measures for Initial Public Offerings and Listings and the Interim Measures for the Administration of Initial

[1] For example, the Shenzhen Stock Exchange issued the "Memorandum on information disclosure business in GEM No.1 – the use of funds raised in IPO over-financings" in 2009 in response to the frequent occurrence of IPO over-financing in the newly established Growth Enterprises Market.

[2] It is noteworthy that Chinese listed companies have frequently changed the investment projects to which they are committed and seriously undermined the interests of small shareholders when using money raised through public offerings (Wang et al., 2011; Zhang and Zhai, 2005; Liu and Dai, 2004).