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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.