

# Taking a Peek Behind the Corporate Finance in China

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## INTRODUCTION

One of the most widely used concepts in corporate finance is the financial structure (Ayturk, 2017; Kowalewski, Stetsyuk & Talavera, 2007). Certain authors (Chi & Young, 2007; Taylor, 2013; Shi & Zhang, 2018), in their specialized publications, consider the terms financial structure, capital structure and capitals' structure to be synonymous. The financial structure takes into account the component of all company capitals and it may be rendered as ratio of own capitals to company debts, as ratio of company's internal to external financing sources, or as ratio of short-term financing to long-term financing (Elston, Chen & Weidinger, 2016).

Howsoever, an enterprise has the possibility to choose from several alternative financial structures (Wan & Yuce, 2007). In addition to the general term of capital structure, there is the term of optimum capital structure represented by the ratio of own capital to borrowed capital which leads to maximizing the shares' market price and which determines a minimization of average weighted cost of the enterprise's capitals.

In this context, a rather controversial issue in corporate finance related to capital structure was presented by Modigliani and Miller in a remarkable specialized work published in 1958. Subsequently, other theories were developed, which had as starting point the theoretical framework set by the two authors. Modigliani and Miller (1958) in their studies related to the manner of selecting enterprise financing, reach a paradoxical conclusion in the sense that various types of financing may be equivalent and then there cannot be an optimum financial structure in order to be able to optimize the capital cost. They explain that the capital cost remains relatively constant in situations in which the company adopts an indebtedness policy benefitting from a low interest because, in such situation, the cost of own capitals may increase due to the existence of risks, associated with the new loans (the shareholders' claims increase). Overall, the average weighted cost will be approximately the same. Moreover, the cost of capitals in the form of dividends cannot be compared to the cost of the other sources of financing.

In the classic western corporate finance theory, investors hold the right to vote in the market. When the incumbent management of the company is inefficient in operation, the original shareholders or the new shareholders acquiring company will acquire sufficient shares to obtain the control of the company and create a new receiver. Although U.S. laws have more legal restrictions on the takeover of compa-

nies in recent years, the takeover market of the company remains largely effective in terms of external regulatory functions.

Although considering the information asymmetry and incomplete contract factors in the western classic corporate finance theory, it is considered that given the information premise, investors are completely rational and the market is effective (Koksall & Orman, 2015).

In China, due to the short development time of capital market, the phenomenon of speculation and stock price manipulation are more and the protection to investors is also weaker. Therefore, investors cannot correctly identify the signal of enterprise quality according to the relevant financial information (Wintoki, Linck & Netter, 2012).

Most of the listed companies, because of the phenomenon of “single domination”, when the incumbent management of the company is not efficient, unless the major shareholder is willing to negotiate the transfer of non-negotiable shares through the OTC, the outsiders are difficult to buy enough outstanding shares to achieve the purpose of taking over the company, that is, the imperfection of the company’s control market is difficult to play the role of external governance (Liu, 2017).

At the same time, Corporate Social Responsibility (CSR) is a useful instrument centered around two main directions: (1) increasing the competitiveness of Romanian companies based on China or foreign capital on the market; and (2) improving the responsibility of local communities, multinational companies, large companies, and SMEs regardless of their capital, whether public or private. The results of empirical studies on CSR communication have indicated that corporations in China are moving more easily from “visible” involvement to “real” involvement, proving a certain degree of progress and maturity when compared to the situation encountered before the economic and financial crisis in 2007. However, there is still a set of challenges such as the difficulty of quantifying the precise budgets allocated to CSR initiatives thus far by companies belonging to international or multinational groups and the inadequate frequency of communication channels selected by companies in transmitting their CSR messages (Morck & Yeung, 2014; Shi & Zhang, 2018; Chen, Li & Xin, 2017).

Later on, Ross, Westerfield & Jaffe (1993) emphasized that the model elaborated by Modigliani and Miller in 1958 is a theoretical version which has no solid empirical basis. Subsequently, Modigliani & Miller, in a specialized paper published in 1963, handled the issue of capital structure in the taxation hypothesis, emphasizing the effect it has on debts and own capitals in an indebted enterprise and in a debt-free enterprise. As well, in case of applying taxation, the enterprise’s financial structure cannot be neutral anymore, because the debt, which is deductible when calculating the taxable profit, the average weighted capital cost in an indebted enterprise is decreased as a result of fiscal savings, and in this case the financial structure indeed influences the company’s value

There are many research achievements in corporate finance field, mainly including: capital cost analysis, financing preference analysis, capital structure decision, the relationship between capital structure and company performance. In the research of capital cost analysis, the capital cost of listed companies in China is mainly calculated by capital asset pricing method in classic corporate finance theory and Modigliani and Miller average cost pricing method. In the research of financing order and capital structure, most of them are empirical studies, and most of them discuss the possible economic influence variables according to the western classic corporate financial model, and then establish the model to conduct the measurement test. In the analysis of the empirical results, the key point is also to judge whether the financial decision-making behaviors of listed companies in China conform to the conclusion of classic corporate finance theory.

This chapter studies the difference between the theoretical premise of western corporate finance and the corporate finance theory in China. The authors construct an econometric model for corporate gov-

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