CHANGES IN THE USE OF PROCEEDS FROM RIGHTS ISSUES: EVIDENCE FROM CHINESE LISTED FIRMS

Xuelian Li[a], Hong Bo[b*], and Zhongnan Huang[b]

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Abstract

We examine whether the ownership structure accounts for the changes in the use of proceeds from rights issues based on a sample of 550 Chinese listed firms during 1998-2001. We find that the changes in the use of proceeds from rights issues have nothing to do with the firm's future profitability, suggesting that Chinese managers change the use of the raised capital on the ground of other factors rather than the shareholders' value. We find that ownership structure matters for the changes in the use of proceeds from rights issues. Evidence indicates that insiders in the state-controlled listed firms in China, including top managers, members of the board of directors, and members of the supervisory board exploit not only outside minority shareholders but also the controlling shareholder, i.e. the state, by manipulating the use of proceeds from rights issues. Our study adds value to the standard corporate governance theories by providing evidence on the rights issues behaviour of the controlling shareholder, managers and other insiders in

[a] Department of Finance, NanKai University, China.
[b] Department of Financial & Management Studies, SOAS, University of London.
[*] Correspondence: Department of Financial & Management Studies, SOAS, University of London, Thornhaugh Street, Russell Square, London WC1 0XG. Tel: +44 20 78984528; Fax: +44 20 78984809; Email: hb22@soas.ac.uk

the state-controlled listed firms in China, which is in contrast to firms in mature market economies. Out results are consistent with one unique feature of Chinese corporate governance, i.e. the monitoring on the managers from both inside and outside the firm is very weak, in particularly, in the state-controlled listed firms. Policy implications can be drawn regarding the necessity of further privatizing and liquidating the state- and the state-related shares in Chinese listed firms.

Key worlds: Proceeds from Rights issues, the ownership structure, China

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Introduction

The agency conflicts between managers and shareholders exist whenever ownership and management is separated (Jensen, 1986). A good corporate governance arrangement, however, can to some extend reduce the agency conflicts between managers and shareholders. For example, a relatively concentrated ownership structure may enable the controlling shareholder to closely monitor the management (Shleifer and Vishny, 1986). However, having a highly concentrated ownership structure and hence a too powerful controlling shareholder may result in another type of agency conflicts, i.e. the conflicts between the controlling shareholder and outside minority shareholders. La Porta, et al., (2000) argue that in an economy where the protection of outside investors' rights is poor, large shareholders may exploit outside minority shareholders.

China has a low score in protecting outside minority investors (Allen, Qian and Qian, 2005). Evidence shows that Chinese large shareholders exploit outside minority investors, for example, through tunnelling (e.g. Liu and Lu, 2004; Jiang, Yue, and Lee, 2005; Lee, 2006). In the Chinese context, however, managers are often in a stronger position than the largest shareholder as far as the control rights are concerned. This is particularly true in the state-controlled listed firms. By the state-controlled listed firms we mean the firms in which the state is the ultimate controlling shareholder. The state in this paper refers to either the central government, or local governments, or the former SOEs of the listed firms. The former SOEs must invest over 50% total assets of the newly listed

firms for the listed firm to maintain the status of the state-owned. Most Chinese listed firms were carved from former State-Owned Enterprises (SOEs). When the carved firms went to Initial Public Offering (IPO), the state was guaranteed to hold the majority share of the listed firms. Moreover, the state shares are not tradable. Therefore, even after more than a decade privatization of SOEs, many Chinese listed firms are still heavily intervened by the government through both the state ownership and the selection and appointment of top managers. This unique Chinese corporate governance arrangement implies that the state being the controlling shareholder is not able to effectively monitor the managers. Because the controlling shareholder of this type represents the ultimate owner of the firm, namely the public, the actual principal of a large proportion of the firm's assets is missing, which results in that the controlling shareholder looses effective control over the firm. Although the selection and the appointment of top managers for the state-controlled listed firms can to some extend control the managers, once the managers are appointed, the state as the controlling shareholder will rely on the managers for routine corporate decision-makings. Therefore, as compared to a standard corporation, the controlling shareholder who is the state in Chinese listed firms is in general not able to effectively monitor managers as far as the routine corporate decisions are concerned, which leaves the Chinese managers in the state-controlled listed firms with too much discretion in allocating resources.

Generally speaking, the disciplinary mechanisms for the Chinese managers are different from that in mature market economies. In a standard modern corporation, managers are disciplined by the managerial labour market, the board of directors, the threat of takeover, and product market competition (Shleifer and Vishny, 1989). Except

for product market competition, other disciplinary mechanisms are still missing or underdeveloped in China. Both the managerial labour market and the corporate takeover market are not yet developed in China. In addition, both the supervisory board and the board of directors of Chinese listed firms are very weak in monitoring managers (Allen, Qian and Qian, forthcoming). It is widely accepted that directors and members in the supervisory board in Chinese listed firms are often 'captured' by top managers and become part of the group of insiders.

In addition to the weak managerial monitoring mechanisms, the Chinese managerial ownership is too low to play an effective role in corporate governance. If Chinese managers have very little assets tied to firms, then the managers have strong motivation to manipulate the use of the firm's resources in order to obtain private benefits of control. Agency costs between managers and the controlling shareholder and the conflicts between insiders and outside shareholders must be very high under this circumstance.

Allen, Qian and Qian (forthcoming) point out that the ineffective regulation in the Chinese stock markets leaves Chinese managers with a lot of loopholes to behave opportunistically. As they state: "Once listed, managers in firms with severer agency problems do not have incentive to manage assets to grow, but rather to rely on the external capital market to raise funds (mainly through mergers and acquisitions, and seasoned offerings of securities) to pursue private benefit". Allen, Qian and Qian (forthcoming) also acknowledge that the data available to test the above statement is very limited, so that case studies are often used to provide evidence.

In this paper, we explore whether agency conflicts between managers and the controlling shareholder and the conflicts between insiders and outside shareholders can explain the changes in the use of proceeds from rights issues. We examine a unique phenomenon accompanying the rights issues practice for Chinese listed firms, i.e. many firms have broken their promises to outsider individual investors and changed the use of proceeds from rights issues. In theory the managers may change the use of the raised capital because of the changes in the operating environment, such as the changes in demand and supply conditions, the changes in competition, etc. Besides these external factors, the managers may be motivated by their private interests when they decide to change the use of the raised capital. In a standard corporation where the monitoring mechanisms for managers are complete and mature, the managers may be more likely to act in the interests of ordinary shareholders. However, in China corporate mechanisms are incomplete and weak, in particular in the state-controlled listed firms the controlling shareholder is not able to effectively monitor the managers, therefore the managers have strong motivation to manipulate the use of the proceeds from rights issue towards their own private benefits of control.

We test the aforementioned conjecture based on 550 firms that experienced rights issues in the Chinese domestic stock markets in the period 1998-2001. After controlling for some external factors that may affect the changes in the use of the raised capital, we find that the ownership structure matters: (a) the largest shareholder who is not the state does not benefit from the changes in the use of the raised capital. To the contrary, it has prevented the changes in the use of the raised capital. (b) the largest shareholder being the state is not able to prevent the changes in the use of the raised capital. Also the state

despite being the controlling shareholder does not directly benefit from the changes in the use of the capital. (c) In the state-controlled firms (the state is the controlling shareholder) managerial ownership is positively associated with changes in the use of the raised capital. Moreover, the ownership ratio of insiders (including top managers, members of the board of directors and members of the supervisory board) is also positively associated with changes in the use of the raised capital. However, in the non-state-controlled firms (the controlling shareholder is not the state) both the managerial ownership and the insider ownership are negatively associated with the changes in the use of the raised capital. This evidence suggests that the state being the controlling shareholder is likely to induce the changes in the use of the raised capital due to the lack of effective monitoring on the managers and other insiders. In sum, in the state-controlled listed firms in China the managers and other insiders exploit not only outside minority shareholders but also the controlling shareholder, i.e. the state.

In addition, we obtain clear-cut evidence that the changes in the use of proceeds from rights issues have nothing to do with the firm's future profitability, suggesting that Chinese managers change the use of the raised capital on the ground of other factors rather than the shareholders' value.

The contributions of our study are threefold. Firstly, we use a newly hand-collected unique dataset to provide direct evidence on the exploitation of shareholders by Chinese managers and other insiders in the state-controlled listed firms. As noticed by Allen, Qian and Qian (forthcoming) most existing evidence on how Chinese managers exploit outside minority investors is supported by case studies due to data restriction. Formal econometric analyses on this topic are scant. We fill in the gap in this respect.

Secondly, formal exploratory studies on the rights issue behaviour of Chinese listed firms is lacking in the literatures. Among very few studies on rights issues in China, the subject of research has been mainly on whether or not the firm issues rights and what the impacts of rights issues have on the firm's other corporate decisions (e.g. Lee and Song, 2003; Chen, Chen and Chen, 2005; Su, 2005). In our study, the focus of research is the changes in the use of proceeds from rights issues. More specifically, we check whether the ownership structure accounts for the changes in the use of the raised capital. We emphasize whether or not firms use the raised capital as they originally promised to outside individual investors. Thirdly, among very few studies on rights issues of Chinese listed firms, the controlling shareholder as a whole is often blamed to be the source of distortions (e.g. Lee and Song, 2003, 2006; Su, 2005). Here in our study we provide some new evidence that the largest shareholder, no matter it is the state or not, does not directly benefit from the changes in the use of the raised capital. To the contrary, when the largest shareholder is not the state, it could actually prevent the changes in the use of the raised capital from deviating from shareholders' value. Our evidence suggests that the Chinese managers and other insiders in the state-controlled listed firms manipulate the use of proceeds from rights issues. This result is consistent with one unique feature of Chinese corporate governance, i.e. the monitoring on the managers from both inside and outside the firm is very weak, in particularly in the state-controlled listed firms.

The remaining of the paper is organised as follows. Section 2 provides some background on the practice of rights issues in China. Empirical analyses are in Section 3. Section 4 concludes.

The Practice of Rights Issues in China

A typical Chinese listed firm after its Initial Public Offering (IPO) can further raise equity capital by means of Seasoned Equity Offerings (SEOs), which refer to all kinds of equity issues after IPO, including rights issues, public offerings, private placement and others. Although all these SEOs methods are available in Chinese stock markets, rights issues and public offerings are often used by Chinese listed firms. Figure 1 and Figure 2 demonstrate that rights issues dominated public offering before 2001. In a rights issue, the existing shareholders are granted with the priority to subscribe the new shares. Given that our sample period covers 1998-2001 during which rights issues dominate, in this section, we provide a background on the practice of rights issues in China.

(Insert Figure1 and Figure 2 about here)

On the face of it, the process of issuing rights is not very different from that in mature market economies. Board of Directors chooses the investment projects and decides the amount of capital needs to be raised via rights issues. The rights issue proposal is then discussed and voted in the shareholders' general meeting. If the proposal is proved by the shareholders' meeting, then underwriters will take care of the matters concerning the number and the price of new shares based on the agreed proposal. In the meantime, underwriters will advise the firm about how to further improve its performance in order to be qualified for the issue by meeting the requirements on accounting performance set by the China Securities Regulatory Commission (CSRC). On the other hand, underwriters also provide the CSRC with their opinions about the firm's competitive advantages in the industry. If the CSRC approves the issue application, then the firm and the stock exchange could arrange the time for new shares to go public. It is worth mentioning that

underwriters were introduced to the rights issues practice only after 1998, before which the CSRC was functioning as an underwriter in Chinese stock markets.

In China, the CSRC administers rights issues by setting regulations. Before 2001 the firm was required to have the return on equity to be larger than 10% in each year of the past three years to be qualified for a rights issue. This requirement was relaxed to 6% after 2001. Since 2006, there has been no requirement on returns on equity for issuing firms. However, the CSRC maintains the restrictions on the scale of rights issues. The number of rights issues should be less than 30% of the total outstanding shares of the firm. The additional new rule for rights issues that took effect in May 2006 concerns that if the subscription rate of new shares is less than 70%, the issue fails and the issuer should payback the capital with interest to the investors. Figure 3 provides a summary of the most important changes in regulations over the past ten years concerning rights issues in China.

(Insert Figure 3 about here)

Given the early stage of the development of Chinese capital markets, institutional investors play an insignificant role in providing capital to the firms. Only from 2004 onwards, do rights issues in China have to be underwritten by a "Sponsor", whose functions are similar to an investment bank in western countries. In many cases, especially for the state-controlled listed firms, it is the state (as the largest shareholder) and individual outsider investors who are providing capital to the firm. Even worse, because the state shares are not tradable, the largest shareholder (the state) is often not able to participate in purchasing new equity via rights issues due to the lack of liquidity. Therefore outside individual investors have been the main capital providers when rights

issues are concerned. Under weak outsider minority investors' protection in China, there are a lot of loopholes that provide insiders with chances in exploiting outsider individual investors.

In China, it has been a common corporate practice that the use of proceeds from rights issues has been deviated from its original plan. The destinations of the use of proceeds from rights issues are: (a) investment in un-related fixed investment projects. (b) a supplement to working capital; (c) idle capital; (d) purchasing other companies' assets; and (e) financial investment, e.g. investment in stocks and bonds through financial agencies. All of these changes in the use of the raised capital are particularly beneficial for the managers. The managers can switch the raised capital to the investment projects from which they may induce more private benefits of control. They can also officially use them as part of perquisites/perks if the raised capital is used as a supplement to working capital. In addition, the managers can always gain private benefits of control through handling the transactions concerning (d) and (e). The literature on tunneling of Chinese listed firms (e.g Lee, 2006) provides indirect evidence that the Chinese managers are benefiting from the changes in the use of the raised capital through related-transactions.

Empirical Analyses

Definition of the Change in the Use of Proceeds from Rights Issues.

In this paper we define the change in the use of proceeds from rights issues as any one or more activities from the following list that the firm is involved: (a) the raised capital is invested in proposed projects but in the way that was not described in the rights issues proposal; (b) the raised capital is invested in fixed assets that is different from the

investment project designed in the rights issues proposal; (c) the raised capital is used as a supplement to working capital; (d) the raised capital is idle for over three years; (e) the raised capital is used to purchase other companies' assets; and (f) the raised capital is invested in stocks and bonds through financial agencies. Some firms prove the changes in the use of the raised capital at formal shareholders' meetings, which are called legal changes. But other firms changed the use of the raised capital without the proof of the shareholders' meeting, which is called an illegal change. In the empirical analyses, we use the legal change in the use of proceeds from rights issues.

The Data.

The data are taken from *Shanghai* and *ShenZhen* Stock Exchanges. We manually collected and compiled the published information for the firms who had issued rights in the years 1998, 1999, 2000, and 2001. Notice that a typical firm does not have rights issues every year. Once the firm issues rights we have to follow the firm for the next three years in order to be able to identify whether the firm has changed the use of the raised capital. For example, if firm X issues rights in the year 1998, we have to follow this firm for the years 1999, 2000, and 2001 to be able to identify whether this firm has changed the use of the raised capital. This means that in our sample years, it is unlikely that a firm has more than one rights issues and that we can only conduct cross-section analyses.

In 1998, we have 154 sample firms that issued rights, 116 sample firms in 1999, 160 in 2000, and 120 in the year 2001. In total we have 550 firms that experienced rights issues during the whole sample period. The proportion of the firms that changed the use

of proceeds from rights issues to the total sample firms is 50%, 53%, 66%, and 69% respectively for the years 1998, 1999, 2000, and 2001. The average proportion of the firms that have changed the use of the raised capital over the whole sample period is 60%. Based on the published statistics from both *Shanghai* and *ShenZhen* Stock Exchanges, we derived the following variables for the sample firms:

(1) the identity of the firm, including the firm's code, name, the location, and the industry in which the firm's main business belongs to.

(2) total assets (TA)

(3) total amount of proceeds from rights issues ($\Pr oceeds$)

(4) the amount of proceeds that were actually changed in use ($Havechanged$)

(5) the amount of proceeds that has been idle for over three years ($Unused$)

(6) the amount of proceeds that has not been used as promised in the rights issue proposal ($Change = Havechanged + Unused$)

(7) one-year, two-year, and three-year ahead operating income ($\Pr ofit_{t+1}, \Pr ofit_{t+2}, \Pr ofit_{t+3}$)

(8) one-year, two-year, and three-year ahead net returns on assets ($ROA_{t+1}, ROA_{t+2}, ROA_{t+3}$)

(10) the ownership ratio of the largest shareholder ($Lshare$)

(11) the ownership ratio of the state ($Sshare$)

(12) the ownership ratio of top managers ($Mshare$)

(12) the ownership ratio of insiders, where insiders include top managers, members of the board of directors, and members of the supervisory board ($Ishare$)

Table 1 summarizes descriptive statistics for the variables used in the empirical analyses. Based on the whole sample statistics we observe that on average the sample firm changed the use of 24.37% of total proceeds by deviating from its original plan. The

largest shareholder holds on average 43.92% of the firm's assets for an average sample firm. The mean of the state share is 33.34% for an average sample firm. The mean of insider share is 0.17%. It is striking to observe that the managerial ownership is extremely low for the sample firms. The mean (median) of managerial ownership for an average sample firm is only 0.09% (0.03%).

(Insert Table 1 about here)

Comparing non-state-controlled firms (the state is not the controlling shareholder) with the state-controlled firms (the controlling shareholder is the state), we observe some differences in the changes in the use of the proceeds from rights issues. Both the mean and the median for the changes in the use of proceeds from rights issues ($Change/\Pr oceeds$) are larger in the state-controlled firms than that in non-state-controlled firms. Therefore, there appears to be a consistent pattern that as compared to the non-state-controlled firms the state-controlled listed firms are more likely to change the use of the proceeds from rights issues deviating from what they promised for the outsider shareholders. We also notice that the non-state-controlled firms have larger managerial and insider ownerships. The mean of the managerial (insider) ownership for non-state-controlled firms is 0.08% (0.15%), whereas the mean of the managerial (insider) ownership for the state-controlled firms is 0.03% (0.06%).

The Empirical Equation.

In the empirical analyses we are in particular interested in whether the ownership structure accounts for the changes in the use of the raised capital. The benchmark empirical equation is:

$$\frac{Change}{\Pr oceeds} = \beta_0 + \beta_1 year + \beta_2 Industry + \beta_3 Size + \beta_4 ROA_{t+1} + \beta_5 ROA_{t+2} + \beta_6 ROA_{t+3} + \beta_7 Share + \varepsilon \tag{1}$$

Where $Change$ is the amount of proceeds that has not been used as promised in the rights issue proposal. $\Pr oceeds$ is the total amount of proceeds from rights issues. $Industry$ is the industry dummy to be controlled in the estimations. $Size$ refers to the size of the firm. β_0 is the constant, and other β's are the parameters to be estimated. In the empirical analyses, we use the natural logarithm of total assets of the firm to proxy for firm size. We use net returns on assets years ahead (ROA_{t+i}) to proxy for future ($t+i$ year ahead) profitability of the firm, where net returns on assets is the ratio of net profits to total assets of the firm. $Share$ stands for the ownership ratio of the respective shareholder. We also add a year dummy to control for the year effect since our sample firms are taken from four different years. We believe that controlling for the year effect, the firm's industry, the firm's size and the future profitability of the firm takes account of the impact of the changing environment on the changes in the use of the raised capital. After controlling for these effects, we are interested in seeing whether the left variance in the changes in the use of the raised capital can be explained by the ownership ratios. We use the ownership ratio of the largest shareholder ($Lshare$) to proxy for the agency conflicts between the controlling shareholder and outside individual shareholders on the one hand and on the other the conflicts between the controlling shareholder and the manager, hence we can also use the ownership ratio of the largest shareholder to proxy for the monitoring on managers from the controlling shareholder. The state ownership ($Sshare$) is used as a proxy for the lack of effective monitoring on the managers. The ownership ratio of the top management ($Mshare$) is used as a proxy for the bargaining power of top managers.

The ownership ratio of insiders (*Ishare*) is used to proxy for the agency conflicts between insiders and outsiders, including the controlling shareholder.

Estimation Results.

Table 2 reports the Ordinary Least Squares (OLS) estimation results for the whole sample. The dependent variable is the amount of proceeds that has not been used as promised in the rights issue proposal (*Change*) scaled by total proceeds from rights issues. Table 2 presents a clear-cut pattern that the estimated coefficients for the insider ownership *Ishare* is significant and positive in all the estimated equations, suggesting that there is a larger amount of proceeds from rights issues that have been changed in use in the firms in which the insider ownership is higher, where the insiders include top managers, members of the board of directors, and members of the supervisory board. The positive association between the changes in the use of the raised capital and the insider ownership *Ishare* suggests that in Chinese listed firms both the board of directors and the supervisory board are not able to effectively monitor managers on behalf of shareholders. Instead members of the two boards often collude with top managers in exploiting outside minority investors.

(Insert Table 2 about here)

Table 2 also shows a positive connection between managerial ownership *Mshare* and the changes in the use of proceeds from rights issues. In a standard modern corporation, a higher managerial ownership motivates the managers to care more about the firm's value and hence it is more likely for the managers to act in the interests of ordinary shareholders. However, as mentioned above, managerial ownership is too low in China to motivate managers to take actions in the interests of ordinary shareholders. Contrary to

the standard prediction, in China a higher managerial ownership is associated with stronger motivation for the managers to deviate from the shareholders' value. Managerial ownership in China is in fact a proxy for the managerial bargaining power in making decisions. In practice, in many of the listed firms that were transformed from the former SOEs, managerial ownership was determined by the negotiation between the government and the manager and it has been hardly changed once it was decided, therefore managerial ownership can be taken as a proxy for the bargaining power of the managers. The higher the managerial ownership ratio, the stronger the bargaining power of the managers, and the more discretion the managers enjoy in making corporate decisions.

Although it is clear that the estimated coefficient for the ownership ratio of the largest shareholder $Lshare$ is negative, it is only statistically significant when the state ownership $Sshare$ is controlled in the estimation (column 5 and column 10 of Table 2). It is worth mentioning that $Lshare$ contains the possibility that the largest shareholder is the state. When both $Lshare$ and $Sshare$ are employed in the estimation, the possibility of the largest shareholder being the state is controlled for, and hence the estimated coefficient for $Lshare$ reveals the impact of the largest shareholder who is not the state. This result suggests that the controlling shareholder who is not the state has a counteracting effect on the changes in the use of proceeds from rights issues. This counteracting effect may be conducted by a tighter monitoring on the managers

Table 2 also shows a positive association between the state ownership $Sshare$ and the changes in the use of the proceeds from rights issues (column 5 and column 10 of Table 2). There may be two possible explanations for this result. On the one hand, if $Sshare$ can be used as a proxy for the lack of monitoring on the managers. The higher the

state ownership, the weaker the monitoring on the managers, and hence the managers are more likely to manipulate the use of the raised capital. On the other hand, because the state shares are not tradable, the state is often not able to participate in purchasing new equity via rights issues due to the lack of liquidity. Therefore, outside individual investors have been the main capital providers when rights issues are concerned. Due to the illiquidity feature of the state shares, the state does not benefit from any increase in the firm's market value, the state as the largest shareholder therefore also has strong motivation to deviate from the interests of outside individual investors by changing the use of the raised capital.

To summarize, the whole sample estimations reveal that (1) the largest shareholder who is not the state has prevented the changes in the use of the raised capital. (2) both the managerial ownership and the inside ownership are positively associated with the changes in the use of the raised capital. (3) the state ownership is also positively related to the changes in the use of the raised capital.

We acknowledge that the whole sample estimation can only reveal the relationship between the changes in the use of the proceeds from rights issues and the ownership structure for an average firm in the sample. Managers may behave differently depending on the nature of monitoring from both the controlling shareholder and the two boards. We argue in this paper that the Chinese managers and other insiders in the state-controlled listed firms are more likely to exploit outside investors by changing the use of the proceeds from rights issues due to the lack of effective monitoring over managers from both the controlling shareholder and the two boards. To support this argument we need further evidence.

We split the whole sample into the state-controlled and non-state-controlled firms. Through the subsample empirical analyses (a) we seek evidence whether the managers behave differently between the state-controlled and non-state-controlled firms giving that the monitoring from both the controlling shareholder and the two boards on the managers differ between the two types of the firms. (b) we want to identify the possible mechanism through which the state ownership may induce the changes in the use of the raised capital. More specifically, we want to examine whether the state-control induces the changes in the use of the raised capital due to the lack of monitoring on the managers.

We define the state-controlled firms as the firms in which the state is the ultimate controlling shareholder, otherwise it is a non-state-controlled firm. As we clarified in the introduction the state in this paper refers to either the central government, or local governments, or the former SOEs of the listed firms. There are 374 firms in the sample in which the ultimate controlling shareholder is the state, the other 176 firms in which the state is not the ultimate controlling shareholder. We repeat the estimations for these two subgroups. The OLS estimation results are shown in Table 3 for the state-controlled firms. And that for non-state-controlled firms are reported in Table 4.

(Insert Table 3 about here)

Table 3 shows that the estimated coefficient for the ownership ratio of the largest shareholder *Lshare* is not significant, suggesting that in the state-controlled firms the largest shareholder, i.e. the state, is not able to prevent the changes in the use of the raised capital. This result indicates that the state-controlled listed firms suffer from higher agency costs. Indeed the agency conflicts between managers and shareholders are very high in the state-controlled listed firms. Table 3 shows that the estimated coefficient for

the managerial ownership *Mshare* is highly significant with a positive sign. This result supports our former conjecture that the managers in the state-controlled firm enjoy too much discretion in allocating the firm's resources. They have strong motivation to change the use of the raised capital by deviating from shareholders' value. Moreover, the insider ownership *Ishare* is also highly significant with a positive sign, indicating that members of the board of directors and members of the supervisory board have no effective monitoring on the managers, to the contrary they collude with top managers when the decision on the changes in the used of rights issue capital is concerned. It is also worth mentioning that even when the state is the largest shareholder, the state does not directly benefit from the changes in the use of the raised capital. The estimated coefficient for the state-ownership *Sshare* is not significant in Table 3. This result is important for the purpose of the paper because it helps distinguish between the two possible mechanisms through which the state control may induce the changes in the use of the raised capital. The positive association between the state ownership and the changes in the use of the capital we obtained in the whole sample estimations in Table 2 can only be explained by the notion that in the state-controlled firms the monitoring on the managers by the controlling shareholder, i.e. the state, is very weak so that the managers can manipulate the use of the raised capital towards their own private interests.

(Insert Table 4 about here)

Table 4 presents a different picture from Table 3. When the controlling shareholder is not the state, the estimated coefficient for *Lshare* is always significant with a negative sign, confirming the previous result in Table 2 that the largest shareholder who is not the state has in fact prevented the changes in the use of proceeds from rights issues. In addition, in

a contrast to the results in Table 3, Table 4 shows that both $Mshare$ and $Ishare$ are negatively associated with the changes in the use of proceeds from rights issues. The estimated coefficient for the state share is in many cases not significant in Table 4.

In addition to the results concerning the ownership structure, we also observe that the firm's future profitability does not explain the changes in the use of the raised capital. Tables 2, 3, and 4 show no positive association at all between firm's future profitability (measured by future net returns on assets) and the changes in the use of proceeds from rights issues. To the contrary in many estimations the estimated coefficient for future returns on assets is negatively significant. This result suggests that the Chinese managers change the use of the raised capital on the ground of other factors rather than the shareholders' value. If the changes in the use of the proceeds from rights issue capital does not bring about future profitability, then it is highly likely that Chinese managers and other insiders in state-controlled listed firms exploit shareholders by manipulating the use of proceeds from rights issues towards their own private benefits of control.

We conducted several robustness checks. Firstly, we use the changes in the use of the proceeds from rights issues scaled by total assets of the firm ($Change/TA$) as an alternative dependent variable. Secondly, we deducted the idle proceeds ($Unused$) from the amount of proceeds that have not been used as it is promised in original plans ($Change$) to construct an alternative variable ($NetChanged$) and use ($NetChanged$) scaled by either total proceeds or total assets as an alternative dependent variable in the estimations. Thirdly, we replaced one-year, two-year, and three-year ahead net returns on assets ($ROA_{t+1}, ROA_{t+2}, ROA_{t+3}$) by one-year, two-year, and three-year ahead operating profit ($\Pr ofit_{t+1}, \Pr ofit_{t+2}, \Pr ofit_{t+3}$) as the control variables for future performance of the firm. All

of these robustness tests confirm the qualitative conclusions we draw based on the results reported in Tables 2, 3, and 4.

In sum, the results suggest that the controlling shareholder who is not the state has prevented the use of the raised capital from deviating from the original plan. In the firms in which the state is the controlling shareholder, the state despite being the controlling shareholder is not able to prevent the changes in the use of the raised capital. The state itself does not directly benefit from the changes in the use of the raised capital either. However, both the managerial ownership and the insider ownership (insiders include top managers, members of the board of directors, and members of the supervisory board) are positively related to the changes in the use of the raised capital. The results for the state-controlled firms suggest that (a) the agency conflicts between the largest shareholder i.e. the state, and managers is high due to the lack of monitoring on managers from the controlling shareholder. (b) members of the board of directors and members of the supervisory board collude with top managers when making the decision concerning the changes in the use of the raised capital. (c) the managers and members of the two boards in the state-controlled listed firms exploit not only outside minority shareholders but also the controlling shareholder, i.e. the state. The state despite being the controlling shareholder does not directly benefit from the changes in the use of the rights issue capital.

Conclusions

The controlling shareholder being the state in the state-controlled Chinese listed firms is not able to effectively monitor the managers. The problem brought about by the

controlling shareholder being the state is the ambiguity of the property right of a large proportion of firms' assets. The identity of the largest principal is not well-defined. Due to the lack of specific information about firm's operation, this type of controlling shareholder can only rely on managers in making corporate decisions. The standard principal-agency theory predicts that the agency conflicts between managers and shareholders will be very high under this circumstance simply because of the lack of effective monitoring on the managers from the controlling shareholder. Our paper provides some evidence that the agency conflicts between managers and the controlling shareholder and the conflicts between insiders and outside shareholders are indeed very high in the state-controlled Chinese listed firms.

Evidence shows that if the controlling shareholder is not the state, then the controlling shareholder has prevented the changes in the use of the raised capital from deviating from the interests of outside shareholders. However, in the state-controlled listed firms, the state as the controlling shareholder is not able to prevent the change in the use of the capital; neither does the state directly benefit from the changes in the use of the raised capital. The state being the controlling shareholder exacerbates the agency costs between managers and shareholders due to ineffective monitoring on the managers. Even worse, probably due to the politically connected personnel control over top managers and the board members in the state-controlled Chinese listed firms, members of the two boards collude with top managers when making the decision concerning the change in the use of rights issue capital. Evidence suggests that managers and other insiders in the state-controlled firms exploit not only outside minority shareholders but

also the controlling shareholder (the state) by manipulating the use of the raise capital towards their own private benefits of control

Our study adds value to the standard corporate governance theories by providing evidence on the rights issues behaviour of the controlling shareholder, managers and other insiders in the state-controlled listed firms in China, which are in contrast to firms in mature market economies. Out results are consistent with one unique feature of Chinese corporate governance, i.e. the monitoring on the managers from both inside and outside the firm is very weak, in particularly, in the state-controlled listed firms. Policy implications can be drawn regarding the necessity of further privatizing and liquidating the state- and the state-related shares in Chinese listed firms.

Due to the data restriction, in this paper we are not able to directly test how the managers and other insiders benefit from the changes in the use of proceeds from right issues and what kind of private benefits of managers and other insiders have reaped from the changes in the use of the proceeds from rights issues. Future research should link the changes in the use of the right issue capital with the indicators of private benefits of managers and other insiders in the state-controlled listed firms in order to obtain direct evidence on the exploitation of outside shareholders by managers and other insiders.

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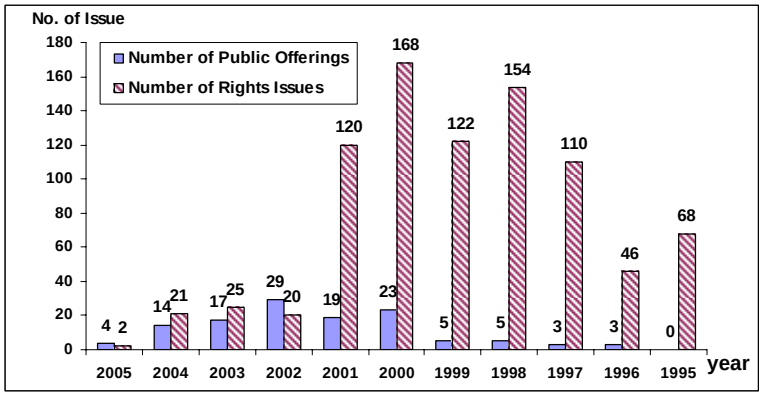

Figure 1: The number of Public Offerings and Rights Issues from 1995 to 2005

Source: Own calculations based on the statistics published on the official website of the CSRC

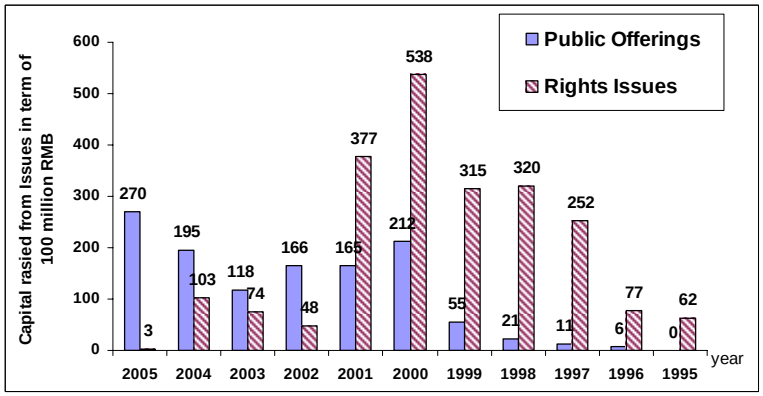

Figure 2: The capital raised by Public Offerings and Rights Issues in terms of 100 million RMB from 1995 to 2005

Source: Own calculations based on the statistics published on the official website of the CSRC

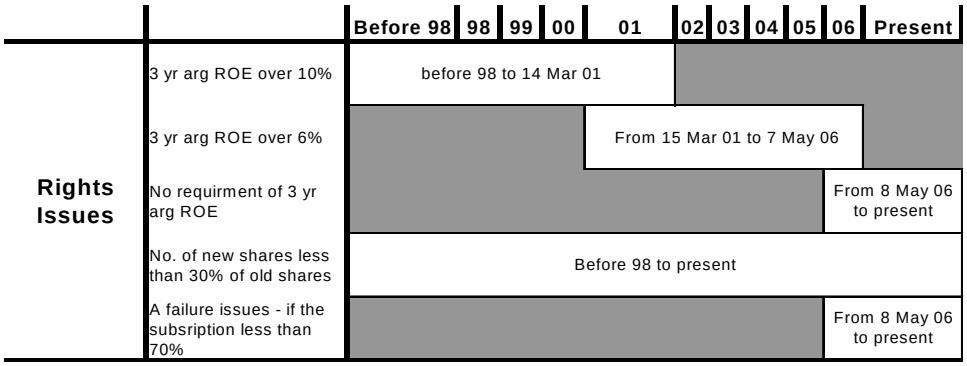

Figure 3 Changes in the regulations concerning rights issues in China

Source: Own summary based on the publications of the CSRC

Table 1 Summary Statistics

	Whole sample			The state is the controlling shareholder			The state is not the controlling shareholder		
	Mean	Median	Std.Dev.	Mean	Median	Std.Dev.	Mean	Median	Std.Dev.
$Change/Proceeds$	0.2437	0.1031	0.3019	0.2559	0.1443	0.3059	0.2177	0.0596	0.2924
$\ln TA$	20.9785	20.9275	0.7520	21.0387	20.9688	0.7422	20.8505	20.8303	0.7588
ROA_{t+1}	0.0550	0.0766	0.1541	0.0627	0.0761	0.1199	0.0386	0.0797	0.2084
ROA_{t+2}	0.0266	0.0646	0.1869	0.0257	0.0641	0.176	0.0286	0.0648	0.2088
ROA_{t+3}	0.0074	0.0475	0.3862	0.0208	0.0504	0.3828	-0.0211	0.0404	0.3928
Lshare	0.4392	0.4329	0.1680	0.4621	0.4637	0.1636	0.3903	0.3684	0.1672
Sshare	0.3334	0.3657	0.2521	0.4772	0.4884	0.1628	0.0278	0.0000	0.0701
Mshare	0.0009	0.0003	0.0055	0.0009	0.0003	0.0066	0.0008	0.0004	0.0015
Ishare	0.0017	0.0006	21.7524	0.0018	0.0006	0.0133	0.0015	0.0007	0.0030
Observation	550	550	550	374	374	374	176	176	176

Notes:

(1) Data source: *Shanghai* and *ShenZhen* Stock Exchanges

(2) Explanation of variables:

$Change/Proceeds$: the amount of proceeds that has not been used as promised in the rights issue proposal divided by total proceeds from rights issues.

$\ln TA$: natural logarithm of total assets

ROA_{t+i} : i-year ahead net returns on assets

Lshare : the ownership ratio of the largest shareholder

Sshare : the ownership ratio of the state

Mshare : the ownership ratio of top managers

Ishare : the ownership ratio of insiders, where insiders are members of either the board of directors or the supervisory board.

Table 2 Whole sample

Dependent variable: $Change/Proceeds$

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$Constant$	-86.1844 (-3.8025)	-85.5599 (-3.8237)	-89.7899 (-3.9844)	-89.8413 (-3.9866)	-80.1145 (-3.5721)	-88.2827 (-3.8845)	-88.3347 (-3.8868)	-87.6235 (-3.9088)	-87.6738 (-3.9110)	-82.2590 (-3.6584)
Year	0.0435 (2.8229)	0.0432 (3.8469)	0.0453 (4.0053)	0.0454 (4.0076)	0.0405 (3.5961)	0.0446 (3.9045)	0.0446 (3.9069)	0.0443 (3.9316)	0.0443 (3.9339)	0.0416 (3.6820)
Industry	0.0011 (0.2997)	0.0035 (0.9198)	0.0018 (0.5006)	0.0018 (0.5000)	0.0021 (0.5635)	0.0009 (0.2475)	0.0009 (0.2467)	0.0032 (0.8475)	0.0032 (0.8463)	0.0019 (0.5097)
$\ln TA$	-0.0302 (-1.3631)	-0.0356 (-1.5840)	-0.0328 (-1.4940)	-0.0328 (-1.4946)	-0.0327 (-1.4654)	-0.0307 (-1.3773)	-0.0307 (-1.3779)	-0.0360 (-1.5935)	-0.0360 (-1.5938)	-0.0332 (-1.4781)
ROA_{t+1}	-0.0974 (-0.8987)	-0.1093 (-1.0048)	-0.1050 (-0.9702)	-0.1049 (-0.9694)	-0.0983 (-0.8971)	-0.0991 (-0.9126)	-0.0990 (-0.9118)	-0.1106 (-1.0155)	-0.1105 (-1.0145)	-0.0999 (-0.9097)
ROA_{t+2}	-0.2357 (-3.3132)	-0.2351 (-3.1418)	-0.2357 (-3.1923)	-0.2356 (-3.1921)	-0.2393 (-3.4499)	-0.2370 (-3.3182)	-0.2369 (-3.3180)	-0.2366 (-3.1592)	-0.2365 (-3.1589)	-0.2405 (-3.4535)
ROA_{t+3}	-0.0279 (-0.8429)	-0.0321 (-0.9950)	-0.0295 (-0.9059)	-0.0295 (-0.9054)	-0.0297 (-0.9114)	-0.0279 (-0.8425)	-0.0279 (-0.8420)	-0.0320 (-0.9905)	-0.0320 (-0.9899)	-0.0297 (-0.9096)
Lshare	-0.0705 (-0.8083)				**-0.1693** **(-1.7896)**	-0.0651 (-0.7423)	-0.0651 (-0.7427)			**-0.1631** **(-1.7182)**
Sshare		0.0712 (1.3667)			**0.1280** **(2.3168)**			0.0723 (1.3853)	0.0722 (1.3825)	**0.1269** **(2.2925)**
Mshare			**2.7822** **(2.6525)**			**2.6743** **(2.4316)**		**2.8378** **(2.8838)**		
Ishare				**1.4156** **(2.8124)**			**1.3627** **(2.5827)**		**1.4391** **(3.0328)**	**1.3244** **(2.6310)**
R-squared	0.0651	0.0669	0.0663	0.0664	0.0727	0.0675	0.0676	0.0696	0.0697	0.0750
F-statistics	5.3928	5.5541	5.5034	5.5112	5.3039	4.8961	4.9030	5.0620	5.0677	4.8703
Prob(F-statistics)	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000	0.0000

Notes: The estimated coefficients are produced by Ordinary Least Square (OLS) estimation with total observation 550.
The White Heteroskedasticity-consistent t-statistics are reported in brackets.

Table 3 The State-Controlled Firms

Dependent variable: $Change/Proceeds$

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$Constant$	-99.3793 (-3.5494)	-98.9993 (-3.5580)	-102.8518 (-3.7083)	-102.8555 (-3.7082)	-99.1259 (-3.5337)	-103.6614 (-3.6967)	-103.6575 (-3.6966)	-103.1875 (-3.7037)	-103.1865 (-3.7035)	-103.3179 (-3.6782)
Year	0.0501 (3.5594)	0.0499 (3.5690)	0.0518 (3.7190)	0.0518 (3.7189)	0.0500 (3.5434)	0.0522 (3.7056)	0.0522 (3.7055)	0.0520 (3.7136)	0.0520 (3.7135)	0.0521 (3.6868)
Industry	0.0032 (0.6189)	0.0033 (0.6245)	0.0021 (0.4093)	0.0021 (0.4119)	0.0033 (0.6239)	0.0028 (0.5353)	0.0028 (0.5371)	0.0028 (0.5420)	0.0028 (0.5438)	0.0028 (0.5438)
$\ln TA$	-0.0313 (-1.0599)	-0.0310 (-1.0655)	-0.0296 (-1.0579)	-0.0296 (-1.0589)	-0.0312 (-1.0525)	-0.0315 (-1.0596)	-0.0315 (-1.0602)	-0.0311 (-1.0629)	-0.0311 (-1.0636)	-0.0313 (-1.0507)
ROA_{t+1}	0.1154 (0.9592)	0.1152 (0.9594)	0.1140 (0.9517)	0.1140 (0.9519)	0.1152 (0.9578)	0.1134 (0.9386)	0.1135 (0.9390)	0.1131 (0.9387)	0.1132 (0.9390)	0.1133 (0.9375)
ROA_{t+2}	-0.3237 (-3.2437)	-0.3235 (-3.2554)	-0.3218 (-3.3015)	-0.3217 (-3.3017)	-0.3237 (-3.2461)	-0.3263 (-3.2450)	-0.3262 (-3.2454)	-0.3260 (-3.2593)	-0.3259 (-3.2596)	-0.3261 (-3.2501)
ROA_{t+3}	-0.0361 (-1.1001)	-0.0363 (-1.1023)	-0.0348 (-1.0597)	-0.0348 (-1.0600)	-0.0363 (-1.1019)	-0.0361 (-1.0900)	-0.0361 (-1.0900)	-0.0364 (-1.0939)	-0.0364 (-1.0938)	-0.0363 (-1.0934)
Lshare	0.0368 (0.3378)				0.0116 (0.0531)	0.0471 (0.4308)	0.0468 (0.4281)			0.0120 (0.0554)
Sshare		0.0379 (0.3519)			0.0272 (0.1263)			0.0490 (0.4532)	0.0487 (0.4505)	0.0376 (0.1756)
Mshare			**3.5741** **(7.6545)**			**3.6459** **(7.4637)**		**3.6548** **(7.4137)**		
Ishare				**1.7885** **(7.7373)**			**1.8232** **(7.5343)**		**1.8275** **(7.4853)**	**1.8275** **(7.4733)**
R-squared	0.0659	0.0659	0.0716	0.0716	0.0659	0.0721	0.0721	0.0722	0.0722	0.0722
F-statistics	3.6928	3.6942	4.0328	4.0333	3.2239	3.5487	3.5487	3.5513	3.5513	3.1483
Prob(F-statistics)	0.0007	0.0007	0.0002	0.0002	0.0014	0.0005	0.0005	0.0005	0.0005	0.0011

Notes: The estimated coefficients are produced by Ordinary Least Square (OLS) estimation with total observation 374.
The White Heteroskedasticity-consistent t-statistics are reported in brackets.

Table 4 Non-State-Controlled Firms

Dependent variable: $Change/Proceeds$

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
$Constant$	-33.6710 (-0.8778)	-44.7638 (-1.1350)	-48.4988 (-1.2366)	-47.8047 (-1.2181)	-29.1277 (-0.7652)	-33.8652 (-0.8921)	-33.0108 (-0.8693)	-44.9962 (-1.1539)	-44.2730 (-1.1343)	-27.7052 (-0.7369)
Year	0.0174 (0.9041)	0.0229 (1.1562)	0.0246 (1.2517)	0.0243 (1.2333)	0.0151 (0.7933)	0.0174 (0.9131)	0.0169 (0.8904)	0.0229 (1.1699)	0.0225 (1.1504)	0.0143 (0.7597)
Industry	0.0002 (0.0450)	0.0044 (0.8062)	0.0057 (1.0395)	0.0058 (1.0548)	0.0001 (0.0231)	0.0015 (0.2663)	0.0016 (0.2832)	0.0059 (1.0703)	0.0060 (1.0865)	0.0015 (0.2744)
$\ln TA$	-0.0389 (-1.1452)	-0.0415 (-1.2050)	-0.0301 (-0.8651)	-0.0304 (-0.8726)	-0.0399 (-1.1783)	-0.0277 (-0.8120)	-0.0278 (-0.8154)	-0.0305 (-0.8803)	-0.0308 (-0.8879)	-0.0282 (-0.8309)
ROA_{t+1}	-0.2361 (-1.6082)	-0.3043 (-2.0849)	-0.2571 (-1.8170)	-0.2590 (-1.8297)	-0.2744 (-1.8474)	-0.2191 (-1.4963)	-0.2206 (-1.5065)	-0.2943 (-2.0355)	-0.2961 (-2.0469)	-0.2638 (-0.8309)
ROA_{t+2}	-0.1995 (-2.4155)	-0.1319 (-1.5915)	-0.1420 (-1.7833)	-0.1426 (-1.7912)	-0.1862 (-2.1800)	-0.1984 (-2.4411)	-0.1994 (-2.4577)	-0.1264 (-1.5388)	-0.1270 (-1.5475)	-0.1840 (-2.1866)
ROA_{t+3}	-0.0327 (-0.4417)	-0.0415 (-0.5637)	-0.0345 (-0.4747)	-0.0350 (-0.4805)	-0.0311 (-0.4221)	-0.0240 (-0.3302)	-0.0244 (-0.3340)	-0.0331 (-0.4571)	-0.0336 (-0.4632)	-0.0219 (-0.3026)
Lshare	**-0.3431** **(-2.2785)**				**-0.3623** **(-2.4032)**	**-0.3566** **(-2.3906)**	**-0.3595** **(-2.4121)**			**-0.3828** **(-2.5753)**
Sshare		-0.3486 (-1.3052)			-0.4323 (-1.6234)			-0.4079 (-1.4885)	-0.4064 (-1.4852)	**-0.5002** **(-1.8283)**
Mshare			**-27.7224** **(-2.8924)**			**-29.4552** **(-2.7699)**		**-29.3931** **(-2.9142)**		
Ishare				**-13.9482** **(-2.7744)**			**-15.0408** **(-2.6507)**		**-14.7988** **(-2.7910)**	**-16.1584** **(-2.6727)**
R-squared	0.1285	0.1023	0.1159	0.1151	0.1383	0.1500	0.1508	0.1247	0.1238	0.1639
F-statistics	3.5400	2.7355	3.1480	3.1232	3.3521	3.7178	3.7096	2.9744	2.9507	3.6160
Prob(F-statistics)	0.0014	0.0102	0.0037	0.0039	0.0013	0.0005	0.0005	0.0038	0.0041	0.0003

Notes: The estimated coefficients are produced by Ordinary Least Square (OLS) estimation with total observation 176.
The White Heteroskedasticity-consistent t-statistics are reported in brackets.