Journal of Corporate Finance 52 (2018) 53–72

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

The effects of a comply-or-explain dividend regulation in China[☆]

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ARTICLE INFO

JEL classification:
G11

Keywords:
Dividends
Dividend regulations
Corporate finance
China
Emerging markets

ABSTRACT

We examine the effects of the world's first comply-or-explain dividend regulation in China's Shanghai Stock Exchange, which requires firms to either pay at least 30% of profits as dividends or explain the use of funds. We find that many firms increased their payout ratio to comply, by increasing dividends or decreasing earnings. Firms with high profitability, state ownership, and fewer agency conflicts were more likely to comply. However, complying firms subsequently issued more debt and had a decline in accounting performance and firm valuation. The evidence suggests that the comply-or-explain regulation increased firms' dividends at substantial costs.

1. Introduction

We examine the effects of the world's first comply-or-explain dividend regulation in China's stock market. On 7 January 2013, the Shanghai Stock Exchange, one of the two stock exchanges in China, issued a new set of guidelines on the distribution of cash dividends in order to boost the cash dividends available to minority investors. The 2013 guidelines recommended, but did not mandate, a minimum 30% dividend payout ratio for firms with positive earnings. Profitable firms that fail to meet the 30% payout ratio are required to explain in detail how they are going to use the profits and funds in future years. The regulation took effect immediately and affected firms' dividend payouts for fiscal year 2012 and beyond.[1] This comply-or-explain regulation presents an important and interesting alternative to mandatory dividend regulations that force profitable firms to pay dividends. Our study investigates three research questions: Does the regulation achieve its objective of increasing dividends? What motivates firms to comply with the regulation? And are there any unintended consequences of the regulation?

It has been widely documented that agency conflicts between corporate insiders and outside investors result in low dividends available to minority shareholders (La Porta et al., 2000; Faccio et al., 2001; Bartram et al., 2012; Glendening et al., 2016). Particularly in emerging markets where investor protection is generally weak, outside investors are subject to insiders' expropriation and do not receive many dividends (La Porta et al., 2000; Allen et al., 2005). To protect the interests of minority shareholders, some emerging markets including Brazil, Chile, Colombia, Greece and Venezuela make it mandatory for profitable firms to pay dividends (Martins and Novaes, 2012). One concern about mandatory dividend rules is that the compulsory dividend payments could leave firms with insufficient funds to support their operations and growth opportunities. Consequently, firms might be forced to raise external financing at a high cost (Farre-Mensa et al., 2018).

☆ For helpful comments, we thank an anonymous referee, Jeffry Netter (the editor), Joyce Yu, Qingbo Yuan and participants in seminars at the University of Melbourne.

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[1] Chinese firms' fiscal year ends on 31 December. The regulation was announced and took effect on 7 January 2013, before firms disclosed their 2012 annual reports and declared their 2012 dividends, so the regulation immediately applied to dividend payouts in fiscal year 2012 and beyond.

https://doi.org/10.1016/j.jcorpfin.2018.07.002
Received 29 October 2017; Received in revised form 16 June 2018; Accepted 12 July 2018
Available online 17 July 2018
0929-1199/

An alternative approach is comply-or-explain regulations that require firms either to pay a minimum percentage of profits as dividends or to explain why they cannot comply. The comply-or-explain regulations, which have been widely used in setting corporate governance codes around the world,[2] recognize that firms are diverse and complying with a mandatory one-size-fits-all regulation may not be optimal or value increasing for every firm. Therefore, firms with sufficient cash flows can choose to comply with the regulation and pay required dividends, while firms with financial constraints or growth opportunities can choose to 'explain' instead of paying dividends. Non-complying firms are required to publicly disclose information that allows investors and regulators to judge whether firms' non-compliance is justified. By not forcing firms to pay dividends regardless of their growth opportunities or financial constraints, comply-or-explain regulations could potentially minimize the downside of mandatory one-size-fits-all dividend rules.

However, it is also likely that firms may take advantage of the flexibility of comply-or-explain regulations and opportunistically choose not to comply, rendering the regulation completely ineffective.[3] This concern is particularly relevant in emerging markets where controlling shareholders do not have strong incentives to pay dividends and the cost of 'explain' could be negligible, as financial disclosure is often opaque and there is little litigation risk for accounting disclosure.

In this study, we first investigate whether a comply-or-explain dividend regulation can effectively increase dividends in China, a representative emerging market with weak investor protection and low dividend payouts (Allen et al., 2005). The regulation only applies to firms listed in Shanghai Stock Exchange, and firms listed in Shenzhen Stock Exchange are not subject to the regulation. This allows us to adopt a difference-in-difference research design and use firms listed in Shenzhen Stock Exchange as a benchmark to control for market-wide changes in institutional factors. The data reveal a sharp increase in the number and the percentage of firms in Shanghai Stock Exchange that have a dividend payout ratio over 30% since the enactment of the regulation. Specifically, the percentage of firms in Shanghai Stock Exchange with payout ratios equal to or above 30% increased from 25.2% in 2011 to 54.6% in 2012. In stark contrast, such an increase is completely absent in firms listed in Shenzhen Stock Exchange. The increase in payout ratios in Shanghai firms remains robust in multivariate regressions where we control for a number of firm characteristics including size, profitability and growth opportunities. Further analysis finds that Shanghai firms meet the target payout ratio mainly by increasing their cash dividends, though decreasing reported profits also seems to play a role. The evidence suggests that the comply-or-explain regulation did achieve the purpose of increasing dividends to outside investors.

Second, to understand these firms' motivations to comply with the regulation, we conduct cross-sectional analyses and examine the effect of firm characteristics on the decision to change dividend policies. We find that firms with high profitability are more likely to increase their payout ratios, suggesting the ability to pay dividends is a key determinant. State-owned firms are also more likely to comply, consistent with the idea that political pressure may motivate firms to comply with the regulation. We also find that firms with a higher level of management ownership or mutual fund ownership are more likely to comply, implying that high agency costs could prevent firms paying dividends.

Finally, we examine the consequences of increasing dividends on firms' financing decisions and future performance. On one hand, the non-compulsory nature of the comply-or-explain regulation implies there should no negative consequences since firms have the option to choose the optimal action. On the other hand, firms may have to comply, despite the option to explain, because of political pressure given that China is still a command-and-control economy and governments and regulators have significant impacts on firm operations and performance (Li et al., 2008; Wu et al., 2012). If this is the case, the dividend regulation can affect external financing and firms' performance for two reasons. First, firms need capital for operations and investments in growth opportunities.[4] But increasing dividends to meet the regulatory guidance may be a burden to firms and force firms to forego growth opportunities or increase external financing (Farre-Mensa et al., 2018). Second, the regulation is intended to encourage firms to distribute excessive cash to outside investors, cash that might otherwise be expropriated by insiders through tunnelling, over-investments or related party transactions. However, insiders can choose to keep their consumption of private control benefits but increase the dividends by raising external funds and sacrificing investments and future profitability.

We find that complying firms that increased their payout ratios to meet the regulation are more likely to raise debt in the following year, consistent with the findings in Farre-Mensa et al. (2018) that firms prefer to finance their payouts with debt. Furthermore, we find some evidence that complying firms have weaker future accounting performance, implying paying out dividends reduces funds available for investment in growth opportunities and negatively affects future operating performance.

We also investigate whether there is any change in the valuation of firms after complying with the regulation. On one hand, firm valuation could increase as the increase in dividends should be valued more highly because cash dividends are not subject to insiders' expropriation, particularly in countries like China where investor protection is weak (Pinkowitz et al., 2006). On the other hand, more debt financing and the weaker operating performance may lead to a lower valuation of the firm because of a higher bankruptcy risk and lower future cash flows. Using Tobin's Q to measure firm valuation, we find that complying firms had a decline in valuation, suggesting that investors perceive the costs of increasing dividends as outweighing the benefits.

Our study contributes to the literature in two ways. First, it provides the first piece of evidence on the effectiveness of the world's

[2] See, for example, Aguilera and Cuervo-Cazurra (2004, 2009), Haxhi and van Ees (2010), and Luo and Salterio (2014). Zadkovich (2007) provides a detailed discussion on the advantages and disadvantages of comply-or-explain governance regimes relative to mandatory governance regimes.

[3] For example, in contrast to many European countries that adopt comply-or-explain governance regimes, the US still follows compulsory governance rules such as Sarbanes and Oxley Act, due to concerns of governance failures when firms lack incentives to comply (Romano, 2005).

[4] DeAngelo et al. (2010) find that the majority of US firms issuing new equity could run out of cash if they did not raise external capital.