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Empirical Research on Debt Restructuring Gains in China's Listed Companies

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Abstract
China's Ministry of Finance issued New Accounting Standards of debt restructurings in 2006. According to the new standards, fair value was introduced again and debt restructuring gains were recognized as non-operating income. This paper uses empirical study to discuss the correlation between debt restructuring gains and financial indicators. This paper selects 2009 A-Share listed companies on Shanghai and Shenzhen Stock Exchanges as research sample, using descriptive statistics, linear regression analysis and paired samples T test analysis to identify the influencing factors of debt restructuring gains. Based on the research conclusions, the paper proposes corresponding suggestions to improve debt restructurings standards and perfect accounting supervisory system.

Key words: Debt restructurings; Accounting standards; China's listed companies; Gains; Empirical research

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INTRODUCTION

China's Ministry of Finance issued New Accounting Standards of debt restructurings in 2006-*Accounting Standards for Enterprises No. 12: Debt Restructuring*, for the purpose of regulating the recognition and measurement of debt restructuring, and disclosing of the relevant information. This new issue will improve financial reporting and accounting standard system by creating greater consistency in the way GAAP is applied for debt restructurings.

So far, China's Accounting Standards of debt restructurings have evolved through three stages: first published in 1998, significantly revised in 2001, and reissued in 2006. Two core issues were involved in the evolvement of debt restructurings standard: the recognition of the debt restructuring gains and the choice of measurement attributes. The debt restructurings standard of 1998 first introduced the fair value, allowing the debtor to include the difference between the book value of the debt to be restructured and the fair value of the non-cash asset transferred into the current profits and losses. However, since the domestic capital market and property rights market were immature at that time, the fair value approach was difficult to be used. Debt restructurings standard had to experience vital revision only two and a half years after its first issue. The revised standard of 2001 recorded the gains on debt restructurings as capital surplus rather than as profits and losses in the current period with the fair value fading into the background.

With the increasing development of market economy and steady perfection of capital market, debt restructurings standard was amended by Ministry of Finance in 2006. In the latest standard, there were mainly two changes: Firstly, the fair value measurement was introduced again, which replaced the old criteria of the "book value"; secondly, debt restructuring gains was no longer included in capital surplus, but recognized as non-operating income.

On one hand, the new regulation creates greater consistency in the way GAAP deals with debt restructurings; on the other hand, the regulation leaves room for profit manipulation for China's listed companies. The existing domestic and foreign research is limited to theoretical analysis and prediction, which lacks empirical

study. On the basis of previous research accomplishment, this paper goes beyond the purely theoretical approach, using empirical study to discuss the correlation between debt restructuring gains and listed companies' financial indicators and to identify the major factors influencing debt restructuring gains.

1. RESEARCH DESIGN

1.1 Research Hypotheses

Hypothesis 1: ST companies tend to have stronger intention of manipulating profit by taking advantage of debt restructurings.

According to provisions of Shanghai and Shenzhen Stock Exchange, if listed company's audited net profit of two most recent fiscal years is negative, the company's stock will require special treatment.

Earnings management behavior by adjusting income in or around the year of loss is prevalent among China's listed companies with heavy losses, for the purpose of avoiding the scrutiny and penalty of the security supervisory department for the losses of three consecutive years (Lu, 1999).

Therefore, including debt restructuring gains into current profits will allow the listed company to manipulate current financial statements in order to paint a rosy picture of the company's financial condition and to meet established expectations. For this reason, this paper hypothesizes that ST companies tend to have stronger intention of manipulating profit by taking advantage of debt restructurings.

Hypothesis 2: Companies with higher debt ratio tend to have stronger intention of manipulating profit by taking advantage of debt restructurings.

Debt ratio indicates the percentage of a company's assets that are provided via debt. This measure gives an idea to the leverage of the company along with the potential financial risks the company faces in terms of its debt-load. The higher the ratio, the greater risk will be associated with the firm's operation. In addition, high debt ratio may indicate low borrowing capacity of a firm, which in turn will lower the firm's financial flexibility.

The larger portion of interest-bearing debt of a listed company, the greater financial pressure the company will have. So will the earnings management motivation (Li, *et al*, 2009). Therefore, this paper hypothesizes that companies with higher debt ratio tend to have stronger intention of manipulating profit by taking advantage of debt restructurings.

Hypothesis 3: Companies with longer years of stock listing tend to have stronger intention of manipulating profit by taking advantage of debt re structurings.

Companies' overall governance structure affects the choice of accounting policies to a considerable extent. Generally, a large majority of companies with longer years of stock listing have adopted management mechanisms of state-owned enterprises (Fan, 2010).

The IPO phenomenon in China's listed companies indicates that there is serious long-term underperformance after the IPO and the longer years of stock listing, the more unsatisfactory operating results and financial condition will be (Wang, 2000). Therefore, this paper hypothesizes that companies with longer years of stock listing tend to have stronger intention of manipulating profit by taking advantage of debt restructurings.

Hypothesis 4: Companies that were given "qualified" "disclaimer" or "adverse" audit opinion tend to have stronger intention of manipulating profit by taking advantage of debt restructurings.

The study shows that most companies experiencing debt restructurings discontinue the appointment of current Certified Public Accountants in order to avoid being given unclean audit opinion (Yan & Wang, 2003) . Therefore, this paper hypothesizes that companies that were given "qualified" "disclaimer" or "adverse" audit opinion tend to have stronger intention of manipulating profit by taking advantage of debt restructurings.

1.2 Sample Selection

This paper relies on the financial statements of 2009 A-Share listed companies on Shanghai and Shenzhen Stock Exchanges. Observations are focused on the disclosure of significant events and the report of debt restructuring gains in the notes. The sample is selected from a population of all those A-Share listed companies which meet the following set of conditions.

- First, the companies are not financial institutions dealing with securities or insurance.
- Second, the financial data of the companies is complete and readily available.
- Third, the companies obtained gains from debt restructurings activities in 2009.

The resulting research sample includes 207 listed companies. For better comparison, this paper chooses another 207 A-Share listed companies that didn't obtain gains from debt restructurings in 2009 as control sample. In order to eliminate the impact of industry, the control sample is selected according to the industry classification and total assets scale of the research sample.

The data of the research sample and the control sample is collected directly from annual reports of 2009 A-Share listed companies and RESSET database. This paper uses Excel and SPSS11.0 software package for statistical analysis.

1.3 Variable Settings

In order to discuss the correlation between debt restructuring gains and listed companies' financial indicators and to identify the major factors influencing debt restructuring gains, this paper selects six independent variables as measures of operating performance, regulatory policy, debt-paying ability and governance structure to test the above hypotheses, as shown in Table 1.

Table 1
Definition and Symbol of Independent Variables

Measure of	Definition of variables	Symbol of Variables
Operating performance indicators	Rate of Return on Common Stockholders' Equity	ROE
	Operating Cash Flow Per Share	OCF
Regulatory policy indicators	Whether the company is ST or not	ST
	Whether the company is given unclean audit opinion or not	SJ
Debt-paying ability indicators	Debt ratio	DR
Governance structure indicators	The years of stock listing	AGE

Calculations of variables:

● ROE is equal to a company's fiscal year's net income (after preferred stock dividends but before common stock dividends) divided by average shareholders' equity (excluding preferred shares), expressed as a percentage. In this paper, "average shareholders' equity" is calculated by adding the shareholders' equity at the beginning of a period to the shareholders' equity at period's end and dividing the result by two. ROE measures a firm's efficiency at generating profits from every unit of shareholders' equity.

● OCF is determined by taking the cash flow from operating activities, subtracting the preferred dividends and then dividing by the number of common shares outstanding. A company that generates higher OCF creates more value for shareholders.

● Dummy variable ST: if the company is marked as S, ST, SST, *ST, or S*ST, the variable ST takes the value of 1; otherwise, the variable takes the value of 0.

● Dummy variable SJ: if the company was given "qualified" "disclaimer" or "adverse" audit opinion in the year of 2009, the variable SJ takes the value of 1. If the company's audit opinion of 2009 was unqualified, the variable takes the value of 0.

● DR is equal to a company's total debt divided by total assets.

● AGE is determined by subtracting the year of the company's stock listing from 2009. It measures the total years of stock listing for a company.

Furthermore, this paper selects the ratio of debt restructuring gains to total profits as dependent variable Y. The ratio reflects the contribution of debt restructuring gains to total profits in the same year.

2. EMPIRICAL ANALYSIS AND RESULTS

2.1 Industy Classification of Research Sample

Table 2 shows the industry classification of the research sample. 207 listed companies that experienced debt restructurings and obtained debt restructuring gains in 2009 are classified into 12 industries. Obviously, debt restructurings involve more and more industries, among which manufacturing industry makes up the largest proportion, accounting for 67.15%. Therefore, manufacturing industry remains to be the main force of debt restructurings.

Table 2
Industry Classification of Reaerch Sample

CSRC Industry Name[a]	Number of Companies	Percentage
Mining	8	3.86
Communication and Cultural Industry	2	0.97
Utilities	7	3.38
Real estate	12	5.80
Construction	3	1.45
Transportation	4	1.93
Agriculture, forestry, livestock farming, fishery	3	1.45
Wholesale and retail trade	10	4.83
Social Services	4	1.93
IT	7	3.38
Manufacturing	139	67.15
Comprehensive	8	3.86
Total	207	100.00

a. The result is based on CSRC Industry Classification 1st Standard.

2.2 Descriptive Statistics Analysis

First, this paper compares types of audit opinion and status of listed stock between research sample and control sample. The results are as follows, 65 companies of the research sample are listed as ST or *ST, accounting for 31.40% of the total; 46 companies of the research sample were given unclean audit opinion in 2009, accounting for 22.22% of the total. In contrast, 24 companies of the control sample are listed as ST or *ST, accounting for 11.59% of the total; 11 companies of the control sample were given unclean audit opinion in 2009, accounting for 5.31% of the total.

This reflects that listed companies with debt restructuring gains in 2009 has larger proportions of ST or *ST companies and unclean audit opinion than those of listed companies without debt restructuring gains in 2009.

Second, this paper compares the descriptive statistics results of six independent variables between research sample and control sample. The results are expressed in Table 3. From this, it comes to the following analysis.

Table 3
Descriptive Statistics Results

Variables[b]	Maximum value		Minimum value	
	Research Sample	Control Sample	Research Sample	Control Sample
ROE	1.5762	0.7648	-79.8885	-1.8544
OCF	4.3044	9.4222	-3.3901	-1.7257
DR	55.4086	41.9394	0.1027	0.0360
ST	1.0000	1.0000	0.0000	0.0000
AGE	19.3111	19.3111	0.0056	0.0361
SJ	1.0000	1.0000	0.0000	0.0000

To be continued

Continued

Variables [b]	Maximum value		Minimum value	
	Research Sample	Control Sample	Research Sample	Control Sample
ROE	1.5762	0.7648	-79.8885	-1.8544
OCF	4.3044	9.4222	-3.3901	-1.7257
Variables [b]	**Mean**		**Standard Deviation**	
	Research Sample	Control Sample	Research Sample	Control Sample
ROE	-0.5007	0.0581	6.0476	0.2789
OCF	0.3017	0.7068	0.8174	1.1580
DR	1.1815	0.8309	3.9884	3.4784
ST	0.3140	0.1159	0.4652	0.3209
AGE	11.2992	9.1546	3.9921	5.1194
SJ	0.2222	0.0531	0.4167	0.2249

b. The data is collected form RESSET database.

- Rate of return on common stockholders' equity (ROE)

The research sample's ROE mean is negative and significantly lower than that of the control sample (-0.5007 VS. 0.0581). The minimum value of the research sample's ROE is also significantly lower than that of the control sample (-79.8885 VS. -1.8544). This shows that from the perspective of stockholders' equity, listed companies with debt restructuring gains in 2009 have weak abilities to generate earnings compared with listed companies without debt restructuring gains in 2009.

- Debt ratio (DR)

The mean of research sample's debt ratio is significantly higher than that of the control sample (1.1815 VS. 0.8309). The maximum value of the research sample's debt ratio is as high as 55.4086. If a company's debt ratio is higher than 100%, it means that a company's assets can not offset its debts and the company is on the verge of bankruptcy. Therefore, from the perspectives of companies' debt structures and long-term debt paying abilities, companies with debt restructuring gains in 2009 bear higher financial risks and lower long-term solvency.

- Operating cash flow per share (OCF)

The mean of research sample's OCF is significantly lower than that of the control sample (0.3017 VS. 0.7068). The maximum and the minimum of the research sample's OCF was 4.3044 and -3.3901 respectively, both lower than those of the control sample. This shows that listed companies with debt restructuring gains in 2009 have lower operating cash flow per share, which largely reflects that these companies' capacity of cash collection from operating activities is very weak and these companies' growth prospects are rather poor.

- The years of stock listing (AGE)

The mean of research sample's AGE is higher than that of the control sample (11.2992 VS. 9.1546). This reflects from the perspective of overall governance structure that companies with longer years of stock listing tend to have poorer financial condition and stronger probabilities of obtaining debt restructuring gains.

2.3 Linear Regression Analysis

In order to further analyze the correlation between the ratio of debt restructuring gains to total profits and financial indicators in the research sample, this paper uses multiple linear regression analysis on the following regression model.

$$Y=\alpha_0+\alpha_1 ROE+\alpha_2 OCF+\alpha_3 ST+\alpha_4 DR+\alpha_5 AGE+\alpha_6 SJ+\varepsilon$$

α_0 is the constant term of the regression equation. α_i is the estimated coefficient of independent variables (i=1,…,6). ε is the random item of the regression equation.

- Multicollinearity diagnosis

Multicollinearity in regression models is a result of strong correlations between independent variables. The existence of multicollinearity may result in lack of statistical significance of individual independent variables while the overall model may be strongly significant. Multicollinearity may also result in wrong signs and magnitudes of regression coefficient estimators, and consequently in incorrect conclusions about relationships between independent and dependent variables. Examining the correlation coefficients between independent variables can help detect multicollinearity.

Table 4 shows the correlation coefficients of variables in the research sample, which indicates that the correlations between most independent variables are weak. The maximum value of correlation coefficients 0.690 exists in between independent variable ST and SJ. Typically, correlation coefficient greater than or equal to 0.8 is considered as strong relationship between variables. The maximum value 0.690 is less than 0.8. Therefore, multicollinearity doesn't exist in six independent variables, which can be included in the regression model.

Table 4
Correlation Coefficients of Variables in Research Sample

	Y	ROE	OCF	ST	DR	AGE	SJ
Y	1						
ROE	0.028	1					
OCF	-0.116	0.020	1				
ST	0.267**	-0.141*	-0.168*	1			
DR	0.172*	-0.002	-0.062	0.227**	1		
AGE	0.077	-0.087	-0.008	0.247**	0.156*	1	
SJ	0.163*	-0.168*	-0.162*	0.690**	0.281**	0.208**	1

**. Significant at 1% level (two-tailed) *. Significant at 5% level(two-tailed)

- Significance test of regression model

This section first conducts the overall significant test in order to verify whether there are strong linear relationships between dependent variable and six independent variables. As illustrated in Table V, since significance F (0.002445) is less than α (0.05), the overall regression model is strongly significant. Therefore, the ratio of debt restructuring gains to total profits has significant linear relationship with six independent variables ROE, OCF, ST, DR AGE and SJ. However, this doesn't mean the

dependent variable is significantly correlated with every independent variable. To determine statistical significance of individual independent variables, T test on every individual coefficient α_i is needed.

Table 5
Output of Linear Regression Analysis

Analysis of Variance					
	df	**SS**	**MS**	**F**	**Significance F**
Regression	6	34.30739	5.717898	3.52505	0.002445
Residual	200	324.4151	1.622076		
Total	206	358.7225			
Coefficient Estimates					
	Coefficients	**Std. Error**	**t Stat**	**P-value**	**Lower 95%**	**Upper 95%**
Intercept	0.16732	0.25496	0.65627	0.512407	-0.3354	0.67007
ROE	0.01382	0.01615	0.85596	0.393043	-0.0180	0.04567
OCF	-0.11884	0.11045	-1.0759	0.283269	-0.3366	0.09897
ST	0.79876	0.26751	2.98588	0.003181	0.27125	1.32627
DR	0.04014	0.02336	1.71826	0.087297	-0.0059	0.08620
AGE	0.00246	0.02204	0.11143	0.911387	-0.041	0.04591
SJ	-0.21939	0.30122	-0.7284	0.467245	-0.8134	0.37457

Compared P values in Table V with the given significant level, independent variable ST is significant at 1% level and independent variable DR is significant at 10% level. This suggests that among the six independent variables, ST and DR are significantly correlated with the ratio of debt restructuring gains to total profits. In addition, the correlations are positive.

2.4 Paired Samples T Test

From the above linear regression analysis, it can be seen that ROE, OCF, AGE and SJ have no significant linear correlations with the dependent variable. The lack of statistical significance of individual independent variables is most probably due to the fact that these four variables don't relate to the ratio of debt restructuring gains to total profits, but rather they are pertinent to whether companies obtained debt restructuring gains in 2009 or not. Thus, taking the control sample into consideration can help eliminate the deficiency of linear regression analysis.

In order to further explore the major factors influencing debt restructuring gains, this paper uses paired samples T test for comparison of matched pairs between the research sample and the control sample. The results are shown in Table VI.

The paired samples T test compares the means of matched pairs. In this paper, matched pairs are composed of one variable from the research sample and the same variable from the control sample. It computes the difference between the matched pair for each case, and tests to see if the average difference is significantly different from zero.

This paper compares the mean of six independent variables (ROE, OCF, ST, DR, AGE, SJ) between companies with (research sample) and without (control sample) debt restructuring gains in 2009. The purpose is to identify the major influencing factors of debt restructuring gains in listed companies.

As illustrated in Table VI, there is significant difference between the research sample and the control sample in terms of OCF, ST, AGE and SJ. P values of these four independent variables are all significant at 1% level. It means that most listed companies with debt restructuring gains have lower operating cash flow per share and longer years of stock listing. These companies have greater likelihood to be marked as ST and to be given unclean audit opinion in the year of obtaining debt restructuring gains. This empirical result supports hypothesis 1, hypothesis 3 and hypothesis 4.

The means of the other two variables are not significantly different between the research sample and the control sample. P values of ROE and DR are not significant at 1% level. It indicates that existing data is not enough to prove that ROE and DR have significant influences on debt restructuring gains. Hypothesis 2 has not been fully validated.

Table 6
Paired Samples Test

Variables	**Paired Differences**			
	Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference
				Lower
ROE	-0.48624	5.60668	0.38969	-1.2545
OCF	-0.40509	1.39584	0.09702	-0.5964
ST	0.19806	0.55248	0.03840	0.1224
DR	0.35056	5.31987	0.36975	-0.3784
AGE	1.97994	5.09674	0.35425	1.2815
SJ	0.16908	0.47807	0.03323	0.1036
Variables	**T Value**	**df**	**Sig. (2-tailed)**	
ROE	-1.248	206	0.214	
OCF	-4.175	206	**0.000**	
ST	5.158	206	**0.000**	
DR	0.948	206	0.344	
AGE	5.589	206	**0.000**	
SJ	5.088	206	**0.000**	

2.5 Conlusions of Empirical Research

This paper proposes research hypotheses from four perspectives: status of listed stock, debt ratio, years of stock listing and audit opinion. It selects 207 listed companies satisfying certain conditions as research sample and chooses another 207 listed companies as control sample for comparison. Further, this paper selects

six independent variables to test the proposed hypotheses. The purpose of this paper is to analyze the correlation between debt restructuring gains and listed companies' financial indicators and to identify the influencing factors of debt restructuring gains.

The following conclusions are arrived at by using descriptive statistics analysis, linear regression analysis and paired samples T test, combined with existing theoretical study of the new debt restructurings standard.

Four variables (OCF, ST, AGE, SJ) as indicators of operating performance, regulatory policy and governance structure largely explain why certain listed companies obtain debt restructuring gains. In terms of operating performance, companies with poor operating performance usually suffer from cash flow problems and have no margin of safety in case of unanticipated expenses. These companies with negative net profits have strong probabilities of obtaining gains from debt restructurings.

In terms of regulatory policy, companies with heavy losses may face higher pressures of supervision and penalty. These penalties include being labeled as ST for two consecutive years' losses or being suspended listing or terminated listing for more serious situations. Therefore, companies are more likely to obtain gains from debt restructurings because of regulatory policy.

In terms of overall governance structure, governance structure is the intrinsic restricting mechanism of implementing accounting policies. Companies with longer years of stock listing tend to have bigger problems in governance structure, which will affect the choices of accounting policies. The IPO phenomenon indicates that the longer years of stock listing, the poorer operating performance will be. Therefore, these companies have strong incentives to make their financial statements look better than they actually are and to bolster investors' confidence.

Therefore, most listed companies with debt restructuring gains in 2009 have poorer profit performance and weaker cash collection capacity. The majority of these companies are labeled as ST for their bad earnings results. These companies have longer years of stock listing and are more likely to be given unclean audit opinion in the year of obtaining debt restructurings gains.

3. SUGGESTIONS AND LIMITATION

Based on the research conclusions, this paper proposes following suggestions in order to improve debt restructurings standards and perfect accounting supervisory system.

● To improve the acquisition mechanism of fair value. The new debt restructurings standard introduces the fair value measurement attribute. Fair value measurement provides more relevant and reliable accounting information; however, it opens the door for manipulation. For instance, managers could use deviations from market values to obtain larger gains from debt restructurings. Therefore, in the course of implementing the new standard, it is important to establish independent, authoritative, third-party appraisal agencies engaged in econometric study of fair value. This measure will help determine the fair value of assets more accurately and more scientifically.

● To strengthen the disclosure of accounting information. Fair value accounting with sufficient disclosure provides more reliable, timely and comparable information. This paper suggests including more subsidiary ledgers for disclosure and adding more details to the existing disclosing information. For instance, important financial indicators such as cash flow per share generated from debt restructuring gains can be included into disclosure. This measure can provide comprehensive and elaborate information for investors' decision making process.

● To perfect performance evaluation system for listed companies. The existing performance evaluation system over emphasizes profit indicators. Listed companies use various means of profit manipulation catering to the needs of supervision. Therefore, both profit indicators and cash flow indicators must be taken into consideration when debt restructurings standard is formulated and implemented. Cash flow indicators are of equal importance as income and profit indicators. Including cash flow indicators into performance evaluation system will help maximize the value of the company and contribute to long term development.

This paper sets out to explore correlation between debt restructuring gains and listed companies' financial indicators and to identify the major factors influencing debt restructuring gains by using empirical research method. The limitation of this paper lies in the fact that the sample size is relatively small. It has only examined data of 2009. Whether the findings will be transferable to other years remains to be analyzed.

With the continuous development and perfection of empirical research methods, future research on debt restructurings in listed companies will be carried out and debt restructurings activities will be further standardized.

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