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Impact of Punitive Supervision on Corporate Financial Performance

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Abstract: Financial performance is an indicator to measure the strength of a company's business operation capability, which is of great concern to enterprise managers, external investors, and government regulators. Based on the data of Chinese listed companies from 2012 to 2016, this paper included government administrative penalties regulation into the study of factors influencing corporate financial performance and conducted an empirical analysis. The research shows that punitive supervision has a significant negative impact on corporate financial performance; rectifying the effect on financial performance would increase the operating cost. Simultaneously, the degree of punitive supervision will also affect corporate financial performance, with the financial performance of listed companies subjected to severe punitive supervision being poorer.

Keywords: Financial performance; Punitive supervision; Administrative penalties regulation; Stakeholder theory

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1. Introduction

A company's illegal behavior affects the company's own development, erodes investors' confidence, and jeopardizes the stability of the capital market. The research on the impact of punitive supervision on corporate financial performance is conducive to the reform of capital market, especially that in China.

2. Literature review

2.1. Research on the impact of corporate violations

He Xiaogang and Deng Hao pointed out that the pressure faced by companies to compete for the first place and to maintain that position drives companies to be engaged in illegal operations [1]. The greater the pressure, the stronger the motivation to violate rules, leading to unethical behaviors. In violating the law, an enterprise usually seeks to maximize short-term interests, but in the long run, this illegal behavior will lead to a significant decrease in shareholder wealth [2]. Zhou Jun pointed out that the illegal behaviors of enterprises have a serious effect on economy and society, hindering their healthy development [3].

2.2. Impact of government supervision on corporate performance

A meta-analysis was conducted to study the correlation between corporate law-breaking and its financial performance [2]; the data showed a significant decline in corporate financial performance and shareholder wealth. It is concluded that complying with laws and regulations is necessary for companies to increase shareholder wealth. Ma Libo and Ni Huiqiang asserted that government regulation plays a major role in external supervision and has a good guiding mechanism for punishing companies that violate regulations,

thus urging enterprises to fulfill social responsibilities and operate in an ethical manner [4].

3. Theoretical analysis and research hypothesis

3.1. Impact of punitive supervision on corporate financial performance

When a listed company is publicly punished by the government for violating regulations, China Securities Regulatory Commission (CSRC) and the stock exchange will make corresponding disclosure announcements, and the listed company must also make announcements and disclose information in their annual report. On the one hand, the offending company has to pay large costs in view of lawyers' fees and legal costs, while the company's performance declines, and the cost of capital increases. On the other hand, regulators such as CSRC and China Banking Regulatory Commission (CBRC) will pay closer attention to companies that violate regulations and thus strengthen supervision. Therefore, a hypothesis is proposed.

Hypothesis H1: There is a significant negative correlation between punitive supervision and corporate financial performance; that is, punitive supervision will worsen a company's performance.

3.2. Impact of the degree of punishment on corporate performance

Bhagat and other researchers claimed that the loss of wealth depends on the type and severity of litigation [5]. As the most active element in the capital market, listed companies are bound to receive more attention and supervision. Hence, another hypothesis is proposed.

Hypothesis H2: The degree of punishment will have a negative inhibitory effect on corporate performance; the heavier the punishment, the poorer a company's performance.

4. Empirical analysis of punitive regulation on corporate financial performance

4.1. Sample selection and data source

The samples selected in this paper included the data of listed companies from CSMAR, RESSET, and WIND databases from 2012 to 2016, with 17,018 observations in total. Using SPSS 16.0, empirical regression analysis was conducted on the samples to study the impact of punitive supervision and the degree of punishment on corporate financial performance. In order to ensure the reliability of sample data and eliminate the influence of outliers on the parameter estimation results, the samples were selected as follows:

(1) continuous variables such as average return on equity (ROE), asset liability ratio (Lev), and operating income growth rate (grow) of the current year were reduced in the quantiles of 1% and 99%;
(2) ST companies and new third board companies were excluded.

4.2. Model setting and variable definition

4.2.1. Model setting

Based on the analysis method proposed by Zeidan MJ [6], Model 1 was constructed to verify Hypothesis H1, while Model 2 was constructed to verify Hypothesis H2.

$$\text{Model 1: AvgROE} = \beta\ 0 + \beta\ 1\text{AP} + \beta\ 2\text{Control} + \varepsilon$$
$$\text{Model 2: AvgROE} = \beta\ 0 + \beta\ 1\text{DP} + \beta\ 2\text{Control} + \varepsilon$$

4.2.2. Variable definition

The variables are defined as shown in **Table 1**.

Table 1. Defining variables

Variable type	Variable name	Symbol	Description
Explained variable	Financial performance	AvgROE	The average ROE of the current year is used
Explanatory variable	Administrative punishment	AP	Dummy variable, 1 = punished, 0 = not punished
	Degree of punishment	DP	The judgment is based on the natural logarithm of the penalty amount actually received by the company
Control variable	Asset liability ratio	LEV	(Liabilities/total assets)*100%
	Enterprise scale	SIZE	Measured by the natural logarithm of the total assets of the enterprise at the end of the year, size = ln (total assets)
	Capital intensity	CD	Fixed assets/total number of employees
	Nature of property rights	STAT	Dummy variable, 1 = state-owned enterprise; 0 = private enterprise
	Enterprise growth	GROW	Measured by the growth rate of operating revenue (growth of operating revenue/total operating revenue of the previous year)*100%
	Shareholding ratio of senior executives	SR	The ratio of the total number of shares held by all senior executives of the company divided by the total share capital of the company
	Annual variable	YEAR	If the punishment occurred in this year, the value is 1; otherwise, it is 0
	Industry variables	INDU	If the sample company belongs to this industry, the value is 1; otherwise, it is 0

4.3. Descriptive statistics

After screening the collected data, 17,018 valid sample data were obtained. Descriptive statistical analysis was conducted on the main variables using SPSS 16.0, as shown in **Table 2**.

Table 2. Descriptive statistics

Variable	Sample size	Mean value	Median	Standard deviation	Minimum value	Maximum value
AvgROE	17018	9.592	9.632	24.642	-271.42	63.720
AP	17018	0.111	0.000	0.315	0.000	1.000
DP	17018	13.300	13.260	2.103	6.21	19.62
LEV	17018	43.657	42.692	21.381	4.910	105.370
SIZE	17018	21.875	21.698	1.578	14.94	30.81
CD	17018	14.423	14.155	2.283	5.72	23.43
STAT	17018	0.320	0	0.466	0.000	1.000
GROW	17018	11.830	9.026	37.816	-100	208.6
SR	17018	0.107	0.0001	0.181	0.000	0.82

4.4. Correlation coefficient analysis

The test results are shown in **Table 3**. AvgROE, a financial performance indicator, was found correlated with most variables and has a high level of significance. The correlation coefficients between AvgROE and independent variables AP, LEV, and STAT were negative and significant at 1% level. The correlation coefficient between AvgROE and independent variable DP was negative and significant at 10%. It has been preliminarily verified that there is a negative inhibition effect on the financial performance of listed companies subjected to supervision; in addition, the degree of punishment also has a negative impact on financial performance; that is, the performance of a company will be poorer as a result of punishment.

Table 3. Pearson correlation coefficient analysis of main variables

	AvgROE	AP	DP	AD	SIZE	CD	STAT	Grow	SR
AvgROE	1	-0.131***	-0.058*	-0.182***	0.022***	0.011	-0.155***	0.128***	0.084***
AP	-0.131***	1	0.006***	0.062***	-0.016**	-0.007	0.028***	0.013*	-0.040***
DP	-0.058*	0.001***	1	0.003	0.054**	-0.016	0.035	0.002	-0.028
LEV	-0.182***	0.062***	0.003	1	0.145***	0.028	0.290***	-0.009	-0.353***
SIZE	0.022***	-0.016**	0.054**	0.145***	1	0.007	0.061***	-0.006	-0.045***
CD	0.011	-0.007	-0.016	0.028	0.007	1	0.045*	-0.016	-0.0013
STAT	-0.155***	0.028***	0.035	0.290***	0.061***	0.045	1	-0.087***	-0.444***
GROW	0.128***	0.013*	0.002	-0.009	-0.006	-0.016	-0.087***	1	0.092***
SR	0.084***	-0.040***	-0.028	-0.353***	-0.045***	-0.013	-0.444***	0.092***	1

***p < 1%; **p < 5%; *p < 10%

4.5. Regression results

4.5.1. Impact of punitive supervision on corporate financial performance

The regression results of Model 1 are shown in **Table 4**.

Table 4. Regression results of administrative punishment (AP)

Variable	State-owned enterprise		Private enterprise		Full sample	
	Coefficient	T value	Coefficient	T value	Coefficient	T value
CONS	49.437**	2.530	25.228***	2.663	45.905**	1.782
AP	-7.758**	-2.290	-7.445**	-2.159	-15.034***	-4.004
LEV	-0.568***	-10.603	-0.297***	-4.392	-0.630***	-8.490
SIZE	0.000***	4.214	0.000	1.266	0.000***	2.795
CD	0.000	1.034	-0.000	-0.593	0.000*	1.924
STAT					0.514	0.653
GROW	0.216***	6.761	0.051*	1.848	0.114***	3.191
SR	22.633	0.434	0.052*	1.988	39.996	0.424
YEAR	control	control	control			
INDU	control	control	control			
N	5444	11574	17018			
Adj-R2	0.152	0.051	0.114			

Under the condition of all samples, AP is negatively correlated to an enterprise's financial performance, at a significant level of 1%, as proven in this paper. Hypothesis H1 suggests that the financial performance

of an enterprise will worsen when being punished upon violating regulations. This also shows that the interests of the company at the risk of offending in the pursuit of short-term gain do more harm than good. LEV has a negative relationship with financial performance and is significant at 1% level, regardless of whether all samples or state-owned and private samples are included. It can be seen that capital structure affects the value of enterprises; the higher the company's LEV, the greater the financial risk of the company. In addition, the increase in financing costs and financial expenses reduces the cash flow of operating activities of an enterprise, so the enterprise's financial performance (AvgROE) decreases. There is a significant positive correlation between enterprise scale (SIZE) and the financial performance of companies at a level of 1%, indicating that the larger the enterprise scale, the better its financial performance. There is no significant correlation between the nature of property rights (STAT) and financial performance, indicating that state-owned enterprises and private enterprises are on the same competitive platform and are not treated differently even with different natures of property rights. There is a significant positive correlation between corporate growth and financial performance, at a significance level of 1%, indicating that companies with better growth have stronger performance in market development and innovation capability. These advantages are gradually internalized into the core competitiveness of corporate performance, which has a significant positive effect on financial performance. Capital intensity (CD) is correlated with financial performance at the level of 10%. There is no obvious correlation between senior executive shareholding ratio (SR) from the empirical results.

4.5.2. Impact of the degree of punishment on corporate financial performance

The regression results of Model 2 are shown in **Table 5**.

Table 5. Regression analysis of the degree of punishment (DP)

Variable	State-owned enterprise		Private enterprise		Full sample	
	Coefficient	T value	Coefficient	T value	Coefficient	T value
CONS	21.443	0.202	20.836	0.495	-22.645	-0.193
DP	-0.000	-0.033	-13.376**	-1.996	-8.324*	-2.633
LEV	-1.265***	-5.103	-0.642***	-3.090	-1.830***	-5.781
SIZE	-0.000*	1.933	0.000	0.831	0.000**	2.282
CD	0.000	0.761	-0.000	-0.312	0.000	0.515
STAT					1.771	0.132
GROW	0.314**	2.541	0.050	0.689	0.601***	3.696
SR	377.339	0.138	92.607	0.659	124.141	0.268
YEAR	control	control	control			
INDU	control	control	control			
N	5444	11574	17018			
Adj-R2	0.139	0.326	0.233			

There is a negative correlation between the degree of punishment (DP) and financial performance in the whole sample, at a 10% level. The degree of punishment (DP) is negatively correlated with financial performance in private enterprises, at a significance level of 5%, indicating that the heavier the punishment, the inhibition effect on the company's financial performance is clearer, which is consistent with Hypothesis H2. However, this is not obvious among state-owned enterprises. It can be seen that in administrative punishment regulation, even with high or low amount, there is no significant inhibitory effect on state-owned enterprises. This may be attributable to the abundant capital of state-owned enterprises. In addition,

asset-liability ratio (LEV) and enterprise growth (GROW) are significantly correlated with corporate financial performance at 1% level, in which asset-liability ratio is negatively correlated, whereas enterprise growth is positively correlated. Enterprise scale (SIZE) is positively correlated with corporate financial performance, at a significance level of 5%. There is no significant correlation between the nature of property rights (STAT), capital intensity (CD), and executive ownership ratio (SR) with corporate performance.

5. Conclusion and suggestions

5.1. Conclusion

There is a significant negative correlation between punitive supervision and corporate financial performance. The financial performance of enterprises subjected to punitive supervision has declined significantly. This also shows that government supervision is effective in curbing violations performed by enterprises. The degree of punishment has a significant negative correlation with the financial performance of private enterprises, in which the more severe the punishment, the worse the performance of private enterprises. However, in terms of state-owned enterprises, the correlation is unapparent, which may be due to several factors, including the sufficient funds, abundant capital, and less competitive pressure among these enterprises. Due to the nature of the property rights of state-owned enterprises, the market still has high confidence in them even when they are subjected to supervision.

5.2. Suggestions

5.2.1. Improve relevant laws and regulations, and increase the cost of violation

In recent years, corporate violations have emerged one after another. The fundamental reason is that the cost of violation is smaller than its income. The supervision of listed companies requires administrative, civil, and criminal functions to perfect the supervision of the capital market.

5.2.2. Strengthen supervision, and establish an effective supervision system

It is necessary to strengthen the supervision of listed companies and securities institutions, gradually form a tripartite regulatory framework involving industry consciousness, social supervision, and government supervision, as well as build an effective regulatory system for the capital market.

5.2.3. Create and cultivate corporate culture based on integrity, and deepen its integration into enterprise governance

Listed companies should establish a corporate culture based on integrity and compliance. At the same time, the government should help enterprises establish "credit banks," so as to reduce the occurrence of violations. At the same time, the government should also set a good example for enterprises, enhance the transparency in law enforcement, and reduce the randomness in law enforcement.

Disclosure statement

The author declares no conflict of interest.

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