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An Empirical Study on the Relationship between Entrepreneur's Reputation and Financing Constraints

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Abstract: Information asymmetry is an important reason that causes external financing constraints. Because reputation has the function of signal transmission, a better reputation of an entrepreneur can reduce the degree of the firm information asymmetry and alleviate financing constraints of the firm. Based on the grouped sample of 94 listed companies of China from 2007 to 2009, this paper did empirical study on the relationship between entrepreneur's reputation and financing constraints. The results show that entrepreneur's reputation has a significant effect on firm financing activity. In other words, higher entrepreneur's reputation leads to lower financing constraints. This study has a significant impact in helping managers and investors realize the importance of signaling effect of a good reputation in capital market. Meanwhile, it helps motivate entrepreneurs to establish good reputation, increasing the efficiency of capital market.

Keywords: entrepreneur; reputation; financing constraints; debt financing capability

1. INTRODUCTION

MM theory believes that in perfect capital markets, the external and internal capital can completely replace each other. Due to the existence of information asymmetry, agency problem and transaction cost, perfect capital market doesn't exist in real world. Myers and Majluf (1984) bring the information asymmetry problem into the research of capital markets and suggest the pecking order theory of capital structure in imperfect capital market^[1]. They held the opinion that the internal and external financing costs are quite different; the degree of financing constraints has a positive correlation with the degree of information asymmetry. The improvement of information asymmetry may enhance the external financing capability of the firm.

Building a good corporate or entrepreneur's reputation is one of the most efficient solutions to mitigate the information asymmetry problem. Based on signal theory, accountants' researches show that reputation has the functionality of signal transmission which can reduce the degree of information asymmetry for both sides of the transaction^[2-4]. Good corporate reputation may send positive signal to the publicity which can make corporate be trusted by stakeholders, attracting more customers, excellent employees and investors, raising the stock price and financing capabilities, thus making more excess earnings.

Entrepreneur refers to the CEO, manager or entrepreneur of a firm. Except the own identity of being "economic man" and "social man", entrepreneur also has the identity of "enterprise man", which means entrepreneur is very important to the existence and development of a firm.

Based on the reputation effects model in interior handlers market, scholars find that reputation can motivate managers to work harder^[5]. Meanwhile, the pursuance of a good entrepreneur's reputation not only can increase the bargaining capability of the entrepreneur in the market and also can convey good signal to the public. The CEO of Vanke group in China conquered seven peaks on the earth including Mount Everest which greatly enhanced the reputation and raised the visibility of his company. It is clear that the identity of "enterprise man" determines when entrepreneurs build their own reputation it also help corporate to develop at the same time. In

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China, what's the relationship between entrepreneur's reputation and the financing constrains of a firm? Can good entrepreneur's reputation improve the debt financing capability?

To find the answers of the above questions, this paper did empirical research on the relationship between entrepreneur's reputation and financing constraints based on the grouped sample of 94 listed companies of China from 2007 to 2009. We find that entrepreneur's reputation has a positive significant effect on a company's financing activity. If entrepreneur's reputation is higher, financing constraints will be lower. The result approves that reputation has significant signal transmission functionality in the capital market

Section II is about literature review. Section III discusses the research design. Section IV presents empirical research and results and section V concludes.

2. LITERATURE REVIEW

Information asymmetry causes external financing constraints to companies. One effective way to resolve this issue is to build a good entrepreneur reputation. Reputation is the remarks of somebody or something made by public; it's a signal to reflect the quality of the subject. The signal spread in public with the reputation mechanism and will directly affect the social image of reputation subject^[6,7]. Macaulay (1963) thinks reputation information can replace formal contract and public legal system, reducing the opportunism tendency and the possibility of adverse selection^[8]. Kennes and Schiff (2003) find that reputation collects and reflects the past transaction information, so it is an important signal identify and search mechanism^[9].

Entrepreneur's reputation is a treasure which can provide customer valuable information about products and services and bring excess earnings to companies^[10, 11]. Good entrepreneur's reputation can attract external investors and improve the information transparence. It can improve the companies' external financing environment. Gaines-Ross (2002) find firms may acquire more investment through entrepreneur's reputation^[12]. Gomes (2000) suggests that in IPO companies, as an implicit covenant, reputation is an important alternate mechanism for corporate governance which can facilitate financing^[13]. Aoki (2001) also points out that entrepreneur's information that are hard to qualified are usually used as affiliations in business decisions, like ability, personality and skills, etc^[14]. This phenomenon is particularly common is developing countries and transition economies.

Researches based on relationship lending show that soft information will appear in the long-term cooperation between banks and companies. That information can replace financial statements in some way. It can also reduce the degree of information asymmetry between the two parties, improve companies' financing environment and lift the efficiency of financing activities especially when judicial system cannot ensure the executions of debt covenant, the debtor's reputation will have significant impact to the debt covenant^[15]. Political relationship is regarded as an important reputation mechanism. The public believes entrepreneurs with political status have higher reputation. Good entrepreneurs' reputation sends signal outside, thus give more development opportunities to companies, facing lower financing constraints^[16-18]. Egli, Ongena and Smith (2006) find that relationship financing can help entrepreneurs build good reputations and the build of reputation mechanism will help companies to reduce financing cost^[19]. Diamond (1991) also points out that Entrepreneur's Reputation make positive contribution^[20] to finance market and Banking Supervision^[20].

Information asymmetry exists in the capital market. The financing companies have more financing information, but the investors could not identify the repayment capacity of financing companies. Investors can only get the future's profit promise from financing companies which affect the investors' confidence. But entrepreneur's reputation plays an important role in strengthening the promise. Good entrepreneur's reputation usually means better management capability and personality; it's an important intangible asset for companies. Investors believe entrepreneurs with good reputation have more experience in corporate management and the

selection of investment projects thus can be more trusted. On the other hand, in order to keep a good reputation impression to investors, entrepreneurs will usually make the promise of not misusing the funds. The higher entrepreneur's reputation is, the more effect it will take in the corporate financing which means better investment environment and more financing opportunities.

In China, debt financing is one of the most important approaches of corporate financing. The effect of entrepreneur's reputation to corporate financing will be reflected in the capability of corporate financing. Under the condition of legal system and corporate governance imperfect, information asymmetry problem is very serious in China which caused strict monitoring and controlling from banks or additional restrictive covenant to corporate debts in order to reduce the high risks deriving from information asymmetry. Entrepreneur's reputation has the functionality of signal transmission which can reduce the degree of information asymmetry in capital market, avoiding the adverse selection before debt financing and ethical risk after debt financing. Also, a company that has a good entrepreneur's reputation can attract more investors more easily and get trust and support from shareholders. In order to keep good reputation for companies and themselves, entrepreneurs will keep improving their management capability. Entrepreneur with a positive reputation can reduce the transaction cost and risk which been caused by information asymmetry and bring more financing opportunities for the firms. It is also a good guarantee for banks to reduce bad debt thus companies can get more debt from banks.

Based on this, two hypothesis of this paper are proposed,

Hypothesis 1: Entrepreneur's reputation has a significant impact to corporate financing. The higher entrepreneur's reputation is, the lower financing constraints will be.

Hypothesis 2: Entrepreneur's reputation has a great influence on corporate financing capability. The higher entrepreneur's reputation is, the stronger financing capability will be.

3. WHAT IS A SYSTEMS APPROACH?

3.1 Observation Sample selection

Current research on measurement of entrepreneur's reputation is focused on the CEO and manager's reputation. Magazine of "Financial World" (1975) evaluated CEO's reputation from financial performance, external environment and CEO's community responsibility and ethic. Milbourn (2003) measures CEO's reputation using the proxy variable of serving years, serving ways and publicized times on the magazines of their industries^[21]. Kaplan and Ravenscroft (2004) select entrepreneurs' ethic evaluation, capability and working opportunity as the proxy variables to measure entrepreneur's reputation^[22]. Johnson, Young and Welker (1993) measures CEO's reputation from both of the internal and external reputation^[23]. Sun, Zhao and Zhu (2006) measures CEO's reputation of state-owned enterprises in China through companies' performance and CEO's capabilities^[24]. Francis et al. (2008) uses the publicized times to media as the proxy variable to measure CEO's reputation^[25]. Malmendier and Tate (2009) use the honor given by publication and organizations to measures CEO's reputation^[26].

Refer to the method used by Malmendier and Tate (2009)^[26], this paper selects 'figure of Chinese economy year' from 2000 to 2009, 'Thirty years of China's reform and opening up economic 100 list' that was selected by multiple authoritative medias of China and 'Best entrepreneurs of China' from 2006 to 2009 provided by the magazine of "Manager" to measure the CEO's reputation in China. Those three results cover entrepreneurs in Chinese Mainland, Hongkong and Taiwan. And 57 of them work in listed company in stock markets of Shanghai and Shenzhen of China. The sample of this paper is based on companies that those 57 entrepreneurs in, and does following filter according to the research purpose: (1) filter out 5 finance and insurance listed companies; (2) filter out 2 listed companies that listing time less than one year; (3) filter out 3 listed companies that missing data in database. So finally there are 47 listed companies left. This paper will regard those 47

companies that have high entrepreneur's reputation as the observation sample, including 16 Shenzhen stock market listed companies and 31 Shanghai stock market listed companies.

3.2 Control sample selection

The control sample is selected following the below principles: (1) Does not get any awards motioned above in observation period; (2) In the same industry, and the first two digit industry code is the same as observation sample for the manufacturing industry companies; (3) scale is almost the same.

This paper finally selects 47 observation samples and 47 control samples, totally 94 samples. To avoid the impact of new accounting standards that implemented from Jan 1, 2007 in China, this paper select samples' data from 2007 to 2009.

3.3 Data source

Samples' raw data are from the databases of CSMAR and RESSET. Through calculating get all financial data needed, and the statistic test of this paper is done using EVIEWS 5.0.

3.4 Variables defined

Financing constraints, due to the special feature of investment, using the investment — cash flow sensitivity which is suggested by FHP in 1988 as the proxy variable of financing constraints has big flaw^[27]. Almeida, Campello and Weisbach (2004) create new financing constraints model based on previous studies^[28]. Their research shows that company that facing financing constraints would like to draw cash from cash flow to increase cash holding and company liquidity. The bigger financing constraints are the more sensitive degree between cash and cash flow will be. Thus, according to the method used by Almeida, Campello and Weisbach (2004), this paper takes cash — cash flow sensitivity as the proxy variable of financing constraints(CH).

Debt financing capability, debt financing include direct financing through company bonds and indirect financing through debt from bank and other companies. This paper uses the sum of companies' short-term loan, long-term loan and bonds payable current year divided by total assets at the end of year as the debt financing ratio (DFR) to evaluate company's debt financing capability.

Entrepreneur's reputation, this paper focuses on the importance that entrepreneur's reputation plays in corporate financing. Here, set the entrepreneur's reputation (reputation) as the dummy variable, if entrepreneurs get awards listed in this paper, we will regard those entrepreneurs have higher reputation, the variable will be set to 1; otherwise it's 0.

Control variables, relevant research results show that the selection of auditing firm (audit) has an important impact on companies' financing capabilities^[29]. State-owned enterprises have lower financing constraints than private enterprises^[30, 31]. Thus final controller type (D) is controlled in this paper. And this paper selects company profitability (profit) and company size (Size) as the control variables referring to the research of^[32, 33]. CF represents cash constraints, FA means asset structure, Tobin's_Q is the potential investment opportunities,

STD is the current liabilities held by the company, NWC represents the non-cash working capital, INV is the capital expenditures, growth means the growth rate of total profits, ind_dummy is the dummy variables of industry. When designing the empirical models, this paper selects different control variables based on different research hypothesis.

3.5 Model design

In order to find the impact of entrepreneur's reputation on corporate financing constraints, this paper builds regression model based on the extended financing constraints model raised by Almeida, Campello and Weisbach (2004) and the adjusted model suggested by Khurana, Martin and Pereria (2006) ^[34]. We estimate model (1) below using ordinary least-squares.

$$CH_{it}/A_{it-1} = a_0 + a_1 CF_{it}/A_{it-1} + a_2 size_{it} + a_3 Tobin's_Q_{it} + a_4 STD_{it}/A_{it-1} + a_5 NWC_{it}/A_{it-1} + a_6 INV_{it}/A_{it-1} + a_7 D_{it} + ind_dummy + \varepsilon \quad (1)$$

In regression model (1), the coefficient (a1) of CFit represents cash — cash flow sensitivity degree. It is used to evaluate the degree of financing constraints.

In order to find the impact of entrepreneur's reputation on corporate debt financing capability, this paper builds regression model referring to the debt financing model raised by Barclay and Smith (1995); Guedes and Opler (1996) [35,36]. We estimate model (2) as follows using ordinary least-squares.

$$DFR_{it} = b_0 + b_1 reputation_{it} + b_2 audit_{it} + b_3 FA_{it} + b_4 profit_{it} + b_5 size_{it} + b_6 growth_{it} + ind_dummy + \varepsilon \quad (2)$$

In regression model (2), the coefficient (b1) of reputation_{it} means the sensitivity of entrepreneur's reputation to corporate debt financing capability.

4. EMPIRICAL RESEARCH

4.1 Empirical test and analysis of the impact of entrepreneur's reputation to corporate financing constraints

Table1 reports the results of OLS estimation of model (1). We can find out that the coefficient of CFit/Ait-1(a1) in both observation group and control group are positive and significant at $p < 0.001$, which means entrepreneur reputation in both group are affected by financing constraints. But by comparing, we can find out that the regression coefficient of CFit/Ait-1 (0.265) in observation group is lower than that in control group (0.321). This means that the cash — cash flow sensitivity in low reputation companies is bigger than that in high reputation companies. Thus comparing to low reputation companies, high reputation companies will face less financing constraints. Thus, hypothesis 1 is approved.

Table 1. Regression results of using model (1)

Variables	Observation Sample	Control sample	Variables	Observation Sample	Control sample
constant	0.187 (0.879)	-0.148 (-0.626)	STDit/Ait-1	0.399*** (6.723)	0.242*** (4.372)
CFit/Ait-1	0.265*** (2.154)	0.321*** (3.175)	NWCit/Ait-1	0.239*** (5.925)	0.167*** (3.537)
sizeit	-0.006 (-0.690)	0.006 (0.616)	INVit/Ait-1	-0.322* (-1.297)	-0.218* (-1.934)
Tobin's_Qit	-0.002 (-0.462)	0.011*** (2.069)	Dit	-0.040* (-1.521)	-0.004 (-0.133)
ind_dummy	controlled	controlled	ind_dummy	controlled	controlled
R-squared	0.595	0.420	Adjusted R-squared	0.503	0.288
F-statistic	6.452***	3.184***	Durbin-Watson	2.192	2.310

a. ***, ** and * indicate the coefficient estimate differs from zero at $p < 0.01$, 0.05, and 0.10 level, respectively, . t-Statistic value of each parameter is shown in brackets.

4.2 Empirical test and analysis of the impact of entrepreneur's reputation to corporate debt financing capability

Table2 reports results from estimating equation (2) , which test the impact of entrepreneur's reputation to firm debt financing capability. Reputation has the functionality of signal transmission which mitigation the information asymmetry in capital market, avoiding the adverse selection and moral hazard, hence, increasing

firm debt financing capability. As can be seen from the regression results of model (2), the coefficient on reputationit (entrepreneur's reputation) is positive and significant at $P < 0.10$. In sum, we find the evidence that entrepreneur's reputation can mitigate information asymmetry, hence, increasing firms debt financing capability, results confirm the hypothesis 2.

Table 2. Regression results of using model (2)

Variables	Model (2)	Variables	Model (2)
constant	0.378*** (2.589)	profitit	-0.821*** (-7.113)
reputationit	0.019* (1.373)	sizeit	-0.005 (-0.893)
auditit	-0.002*** (-2.138)	growthit	0.001 (1.060)
FAit	0.131*** (2.233)	ind_dummy	controlled
R-squared	0.442	Adjusted R-squared	0.388
F-statistic	8.138***	Durbin-Watson	0.449

a. *** , ** and * indicate the coefficient estimate differs from zero at $p < 0.01$, 0.05, and 0.10 level, respectively,. t-Statistic value of each parameter is shown in brackets.

5. CONCLUSION

Based on the grouped samples of 94 listed companies of China from 2007 to 2009, this paper did empirical research on the relationship between entrepreneur's reputation and financing constraints. We find that entrepreneur's reputation can reduce the degree of information asymmetry and alleviate corporate financing constraints. If entrepreneur's reputation is higher, financing constraints will be lower. Besides, entrepreneur's reputation has a significant impact on debt financing activities. If entrepreneur's reputation is higher, company will get the trust of financial institutions more easily, debt financing capability will be stronger.

The research results above indicate that the difference of entrepreneur's reputation will leads to different corporate financing environments. This paper covers the shortage of current research on the impact of entrepreneur's reputation to corporate financing activity and further approves the reputation has a significant signal transmission functionality in capital market.

In the real world, the financing activities between enterprises and financial institutions belongs to repeated games, which makes financing enterprises have strong motivation to focus on their long-term interests. Good entrepreneur's reputation can improve the information asymmetry state in capital market and bring enterprises more excess earnings. But for now, the efficiency of reputation system is low in China. Listed companies do not pay enough attention to entrepreneur's reputation which severely impacted the operational efficiency of capital market. So in order to increase the efficiency of capital market, listed companies of China not only need to design incentive and constraint mechanism for entrepreneurs, let entrepreneurs pay more attention to reputation management, but also need to enhance transparency of capital market information, enhance information communication mechanism and insure the efficiency of reputation system.

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