

Divestiture, Managerial Ability and Corporate Financial Flexibility

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Abstract: Divestment is an effective way to allocate resources in the capital market. In recent years, the frequency and scale of divestment of listed companies in China continue to increase. Based on A sample of A-share listed companies in Shanghai and Shenzhen from 2011 to 2020, this paper examines the relationship between divestment and corporate financial flexibility from the perspective of corporate governance, and examines the moderating effect of managerial ability on the relationship. The results show that divestment is significantly positively correlated with corporate financial flexibility, and the management ability can promote its positive effect. Further research finds that financial constraints play a significant intermediary role in the impact of divestment on financial flexibility, that is, divestment can promote the improvement of financial flexibility by alleviating financial constraints.

Keywords: Divestment, Financial constraints, Financial flexibility, Managerial ability.

1. Introduction

Divestment is an effective way for enterprises to adjust industrial structure and optimize asset quality. It is also an important way for enterprises to operate contractionary capital. At present, China is faced with the dual dilemmas caused by the new round of scientific and technological revolution and industrial transformation, such as the interruption of industrial chain, the interruption of supply of key products, the lack of core technology of domestic enterprises, and the serious competition of industrial chain homogeneity. It is an issue that the Chinese government and enterprises must consider together to build a more risk-resistant supply chain. According to CSMAR database, from 2011 to 2020, the frequency of divestment of Chinese A-share listed companies soared from 1607 to 6219, and the annual transaction amount rose from 128.57 billion yuan to 1020.61 billion yuan. In addition, the meaning of divestment itself has also changed. Previously, only enterprises with poor performance would use divestment to improve their performance; Tang and Li (2016) [1] found that now divestment has become a new starting point for the transformation and upgrading of Chinese enterprises.

Most of the existing studies on divestment take enterprises in Europe and the United States as research samples; The research content mainly focuses on the motivation and economic consequences of divestment. Guo et al. (2020) [2] generally believe that divestment is not only a strategic adjustment based on long-term development. Yan and Li (2014)[3] believe that divestment is also a short-term behavior of real earnings management. Although the divestment scale of Chinese enterprises is expanding rapidly, the research on Chinese enterprises' divestment is not very abundant. The research in China mainly focuses on the impact of divestment on corporate financial performance, and there are also a few studies on the perspective of earnings management around divestment, such as Xu (2012) [4], and Xue et al. (2022) [5] regarded the divestment as a corporate strategy. In fact, China is a very good scene to study divestment and corporate strategic decision making. Therefore, it is important to explore the strategic motivations

of divestment and broaden the research perspective of its economic consequences in the Chinese context.

Xue et al. (2021) [6] pointed that although Chinese enterprises have been actively participating in restructuring, divestment is still a relatively little-studied field. Enterprises in developed countries have widely used divestment in asset restructuring, and have a relatively complete theoretical system and framework. However, the economic theories of western developed countries on divestment motivation and positive value effect may not be equally applicable to emerging economies. The possible contributions of this paper are as follows: first, from the perspective of corporate governance, this paper deeply analyzes the impact of divestment on financial flexibility, and deepen the research on the economic consequences of divestment. Second, we incorporate managerial ability and corporate financing constraints into the study of divestment, and examine their moderating and mediating effects respectively, which expands the research scope of micro firm behavior and provides theoretical support for improving corporate financial flexibility.

2. Theoretical Analysis and Research Hypotheses

2.1. Divestment and Corporate Financial Flexibility

Enterprise financing theory refers to the financial activities of raising and concentrating capital economically and effectively through certain channels and financial markets and using certain methods to meet the needs of production and operation, foreign investment and capital structure adjustment. Divestiture of assets can solve the financial crisis of enterprises by revitalizing idle assets and taking cash. For those companies with excessive financial leverage or poor operating performance, asset sales are a relatively cheap source of financing if debt and equity financing is expensive. Zhang and Wang (2013) [7] found that for companies in financial distress, divestment is an effective way to avoid bankruptcy. In order to avoid underinvestment caused by debt overhang, companies can sell assets to reduce leverage ratio,

and the cash obtained from asset divestment can effectively ease the financing constraints of enterprises. Zhang and Chen (2022) [8] found that When the cost of external financing is high, divestment can help enterprises recover funds and optimize the allocation of resources. Therefore, Li et al. (2019) [9] support the idea that divestment is an important source of enterprise R&D investment.

Guo and Guo (2020) [10] pointed that both the enterprises with poor performance base and the enterprises with good performance are usually inclined to partially divest their assets to maintain the stable and sustainable operation of the enterprises. Enterprises can often take the initiative to use their resources and technological advantages to systematically and accurately evaluate the operating situation, and choose to divest businesses and resources that are no longer suitable for the overall development plan of the enterprise and are not profitable. In addition, companies with a good performance foundation, even if they have the motivation to achieve organizational change through divestitures, are likely to implement low to medium risk divestitures to avoid possible damage to the business. As a result, well-performing companies often use divestitures as a means of fine-tuning their management and financial resources, while avoiding full divestitures. In addition, enterprises with poor performance face the urgent need to raise funds, and financing constraints prevent them from raising funds in the capital market. Therefore, it is of little significance to divest some businesses with small scale and limited financial returns, which does not meet the current urgent needs, but needs to divest important assets and even core assets on a large scale. Thus access to a large amount of financial resources to avoid the risk of bankruptcy. But at the same time, there is also a high risk of major disruption and significant changes in corporate boundaries due to large-scale divestments of important assets. In addition, such divestments carry significant opportunity costs and risk the elimination of valuable resources that may provide value in the future, either to meet current use or as part of an ongoing restructuring.

Based on the above analysis, this paper puts forward hypothesis 1:

H1: Divestment is positively correlated with corporate financial flexibility.

2.2. Divestment, Managerial Ability and Corporate Financial Flexibility

According to the transaction cost theory, the marginal benefits of enterprise diversification tend to decrease as enterprises move away from the core business, but some enterprises will still diversify due to some reasons, such as managers' pursuit of their own interests, market fluctuations, and environmental changes such as the loss of information and control. Therefore, if over-diversified companies return to their main business, performance will improve.

Agency theory holds that divestiture is a remedy for the problems caused by inadequate corporate governance. Proxy conflicts between a company's management and shareholders may cause management to be reluctant to divest certain assets, thereby locking up significant shareholder value within the company and creating a discrepancy between the actual and potential value of the company's stock. Companies that do divestitures generally have fewer agency problems and are seen as correcting ineffective internal and external control mechanisms. The occurrence of divestitures is conducive to improving corporate governance, and companies with agency

problems will release value for shareholders when reversing these harmful behaviors. According to the principal-agent theory, the contractual relationship will be formed after the shareholders give the decision-making right to the managers. The managers will always consider the operating cost when they divest the company's assets, because reducing the operating cost is an important means to improve the financial flexibility of the enterprise. The loss assets will be stripped in exchange for profits, so that the enterprise is updated internally, and the bad assets of the enterprise will be stripped to "slim down" for the enterprise, so that the immediate effect gives the enterprise a rebirth opportunity, to seize the opportunity to boost the confidence of the enterprise development in the short term, which will inevitably increase the planning of long-term performance, and will inevitably improve its financial flexibility.

Based on the above analysis, this paper puts forward hypothesis 2:

H2: When other conditions are given, managerial ability will promote the relationship between divestment and financial flexibility.

3. Research Design

3.1. Sample Selection and Data Sources

This paper takes A-share listed companies in Shenzhen and Shanghai from 2011 to 2020 as the research sample, and the original data are from CSMAR database. Based on previous studies, samples are further screened according to the following criteria: (1) ST, ST*, financial and insurance listed companies are excluded; (2) only the listed companies whose trading status is the seller are examined; (3) excluding the samples of related party transactions, unsuccessful transactions and major asset reorganization; (4) Excluding the data with missing divestment data and divestment amount less than RMB 5 million; (5) The total amount of multiple divestments in the current year shall be the total amount of divestments in the current year; (6) Reduce the interference of outliers, winsorized all variables by 1% and 99%, and finally obtained 3087 data.

3.2. Variable Measurement

3.2.1. Explained Variable: Financial Flexibility (FF)

Enterprises mainly obtain financial flexibility through three ways, namely, holding cash, maintaining debt financing ability and equity financing ability, so corporate financial flexibility can be generally divided into three types: cash flexibility, debt financing flexibility and equity financing flexibility. Combined with China's institutional background, this paper draws on Zeng et al. (2013) [11] to measure financial flexibility as follows: financial flexibility = cash flexibility + debt financing flexibility, where cash flexibility = corporate cash ratio - industry cash ratio, debt financing flexibility = Max (0, industry average debt ratio - corporate debt ratio). The reason why this paper does not consider the flexibility of equity financing is that under the institutional background of China, the qualification, time and quantity of equity refinancing of listed companies are strictly controlled by China Securities Regulatory Commission, and few companies have the right to decide when and how much equity securities to issue, so few companies have the flexibility of equity financing.

3.2.2. Explanatory variable: Divestment of Assets (Div)

Referring to the method of Guo and Wang (2022) [12], this

paper measures the divestment scale by dividing the amount of divestment transactions in each year by the total assets at the end of the period.

3.2.3. Control Variables

Referring to previous studies, this paper controls common factors such as enterprise size, financial leverage, cash flow, board size, listing age and ownership concentration. In addition, year and industry fixed effects are also controlled.

3.2.4. Mediating Variable: Financing Constraints (FC)

The construction process of FC index model is as follows: (1) The three variables of company size, company age and cash dividend payout rate are standardized by year. (2) According to the mean value of standardized variables, the listed companies are ranked (ascending order), and the upper and lower tertiles are used as the cut-off points of financial constraints to determine the dummy variable of financial constraints (QUFC). Among them, the listed companies with more than 66.7% quantile are defined as low financial constraints group, QUFC=0; the listed companies with less than 33.3% quantile are defined as high financial constraints group, QUFC=1. (3) logit regression is carried out according to Formula (1), and the fitting value is the FC index of financial constraints.

$$P(QUFC = 1|ZFC_{i,t}) = \frac{e^{ZFC_{i,t}}}{1 + e^{ZFC_{i,t}}} \quad (1)$$

$$ZFC_{i,t} = \beta_0 + \beta_1 Size_{i,t} + \beta_2 Lev_{i,t} + \beta_3 \left(\frac{CashDiv}{TA}\right)_{i,t} + \beta_4 MB_{i,t} + \beta_5 \left(\frac{NWC}{TA}\right)_{i,t} + \beta_6 \left(\frac{EBIT}{TA}\right)_{i,t} \quad (2)$$

Where, Size is the size of the enterprise; Lev is the debt ratio; CashDiv is the cash dividend paid by the enterprise in the current year; MB is the price-to-book ratio of the enterprise; NWC is net working capital; EBIT is earnings before interest and taxes; TA is total assets.

3.2.5. Moderating Variable: Manager Ability (Firm Efficiency)

This paper will use data envelopment analysis (DEA) to measure the managerial ability of Chinese listed companies, that is, using DEA to calculate the managerial ability by separating the influence of managers on corporate efficiency from the total efficiency of enterprises. On the basis of avoiding missing samples, this method can simply and intuitively calculate the operating efficiency of large sample companies, which has been supported by a large amount of literature in the field of financial accounting. It can be divided into two steps: first, calculate the total efficiency of companies by industry; Secondly, the contribution value of managers is separated.

$$\text{Max Firm Efficiency} = \frac{Mbi}{\varphi_1 Mbc + \varphi_2 Smc + \varphi_3 Fa + \varphi_4 Nol + \varphi_5 Nrd + \varphi_6 Cfs + \varphi_7 lag} \quad (3)$$

Table 1. Definition of Variables

Variable name	Variable symbol	Variable explanation
Financial flexibility	FF	Cash flexible + debt flexible
Divestiture	Div	Divestiture transaction amount/total assets at the end of each year
Financing constraints	FC	FC Index
Managerial ability	Firm Efficiency	Refer to Dermerjia et al. (2012)
Size of enterprise	Size	Natural logarithm of a firm's total assets at the end of the year
Firm age	Age	(Year of the year - year of listing +1) Take the natural logarithm
Net profit margin on total assets	Roa	Net profit/total assets at year-end
Asset-liability ratio	Lev	Total year-end liabilities/total year-end assets
Cash flow ratio	CF	Operating cash flow/total assets
Number of directors	Board	Natural logarithm of the number of board members
Proportion of independent directors	Indep	Independent directors divided by the number of directors
Shareholding ratio of the largest shareholder	Top1	Number of shares held by the largest shareholder/total number of shares
Year	Year	
Industry	Ind	SEC 2012 Industry Classification

3.3. Model Design

This paper constructs the following model to test the relationship between divestment and corporate financial flexibility:

$$FF = \alpha_0 + \alpha_1 Div_{i,t} + \sum Controls + \sum Ind + \sum Year + \varepsilon_{i,t} \quad (4)$$

Where, FF represents financial flexibility, Div represents divestment, Controls represents control variable, and ε is random disturbance term.

4. Empirical Results and Analysis

4.1. Descriptive Statistics

Table 2 shows the results of descriptive statistics. Among them, the mean value of FF is -0.032, the standard deviation is 0.113, the minimum value and the maximum value are -0.045 and 0.331 respectively, indicating that there are significant differences in the financial flexibility of enterprises. The mean value of Div is 0.040, the standard deviation is 0.061, the minimum value is 0.001, and the maximum value is 0.355, indicating that there is a significant gap in the degree of divestment of enterprises.

Table 2. Descriptive Statistical Results of Divestment Enterprises

Variable	N	Mean	SD
FF	3087	0.032	0.113
Div	3087	0.042	0.061
Lev	3087	0.475	0.203
ROA	3087	0.025	0.070
CF	3087	0.035	0.068
Board	3087	2.126	0.206
Indep	3087	0.377	0.054
Top1	3087	0.314	0.141
Age	3087	2.410	0.675
Variable	Min	p50	Max
FF	0.267	0.045	0.331
Div	0.001	0.019	0.355
Lev	0.066	0.475	0.929
ROA	0.301	0.026	0.205
CF	0.179	0.035	0.248
Board	1.609	2.197	2.708
Indep	0.333	0.364	0.571
Top1	0.075	0.293	0.708
Age	0.000	2.565	3.296

4.2. Correlation Analysis

The results of correlation coefficient are shown in Table 4. Asset divestiture is positively correlated with the financial flexibility of enterprises ($r=0.079, p<0.01$), which lays a good foundation for the next hypothesis test.

The VIF test of the main variables was conducted in this paper. The VIF value of each variable was less than 10, the maximum value was 1.42, the minimum value was 1.03, and the mean value was 1.20, indicating that the results were less affected by multicollinearity.

Table 3. Correlation Analysis Results of Divestitured Enterprises

	FF	Div	Lev	ROA	
FF	1				
Div	0.079 ***	1			
Lev	0.193 ***	0.096 ***	1		
ROA	0.211 ***	0.026	0.335 ***	1	
CF	0.134 ***	0.072 ***	0.160 ***	0.294 ***	
Board	0.043 **	0.086 ***	0.136 ***	0.047 ***	
Indep	0.005	0.035 **	0.007	0.045 **	
Top1	0.124 ***	0.018	0.066 ***	0.140 ***	
Age	0.043 **	0.038 **	0.277 ***	0.109 ***	
	CF	Board	Indep	Top1	Age
CF	1				
Board	0.058 ***	1			
Indep	0.019	0.510 ***	1		
Top1	0.060 ***	0.002	0.038 **	1	
Age	0.063 ***	0.094 ***	0.013	0.088 ***	1

Note: *, ** and *** indicate significance at the level of 10%, 5% and 1%, respectively; T-values of robust standard errors are in parentheses. Same below.

4.3. Regression Analysis

This paper uses dual fixed effects of year and industry for regression. The FF coefficient of column (1) in Table 3 is 0.210, significant at the level of 1%, indicating that there is a positive correlation between divestment and corporate financial flexibility. The regression results of Column (2)

show that the coefficient between Div and FF is 0.141, which is significant at the level of 1%, and the coefficient of the interaction term between Div and Firm_Efficiency is 0.263, which is significant at the level of 10%, indicating that the managerial ability positively regulates the relationship between them. To sum up, the above hypotheses are all valid.

Table 4. Main Regression Results of Divestment and Financial Flexibility

VARIABLES	(1) FF	(2) FF
Div	0.210 *** (6.09)	0.141 *** (4.570)
Firm_Efficiency		0.076 *** (6.113)
Div×Firm_Efficiency		0.263 * (1.728)
Lev	0.545 *** (43.09)	0.141 *** (12.60)
ROA	0.002 (0.04)	0.114 *** (3.640)
CF	0.102 *** (2.95)	0.157 *** (5.202)
Board	0.029 ** (2.34)	0.042 *** (3.845)
Indep	0.079 * (1.70)	0.129 *** (3.222)
Top1	0.053 *** (3.33)	0.042 *** (2.999)
Age	0.001 (0.27)	0.010 *** (3.059)
Constant	0.174 *** (4.47)	0.152 *** (4.493)
Observations	3133	2976
R-squared	0.460	0.239
Ajusted R2		0.223
F test		0

t-statistics in parentheses *** p<0.01, ** p<0.05, * p<0.1

4.4. Robustness Test

4.4.1. Surrogate Variables

Considering the robustness of the conclusion, the explained

variable FF is measured by the equal-weighted average market value of financial flexibility, which is replaced by the weighted total market value of financial flexibility. It can be seen that the regression results are still robust.

Table 5. The Regression Results of Distinguishing Property Rights

VARIABLES	(1) FF
Div	0.190 *** (4.879)
Firm_Efficiency	0.0680 *** (4.329)
Div×Firm_Efficiency	0.254 (1.322)
Lev	0.610 *** (43.24)
ROA	0.00376 (0.0953)
CF	0.110 *** (2.888)
Board	0.0378 *** (2.759)
Indep	0.125 ** (2.475)
Top1	0.0468 *** (2.672)
Age	0.00657 * (1.698)
Constant	0.148 *** (3.461)
Observations	2976
R-squared	0.515
Ajusted R2	0.505
F test	0

t-statistics in parentheses *** p<0.01, ** p<0.05, * p<0.1

4.4.2. Reduce the Sample Size

The novel coronavirus pandemic has brought unprecedented external environmental risks to enterprise

operations. In order to eliminate this impact, 371 samples in 2020 were removed from this paper for re-regression. Table 6 shows that the regression results are basically consistent with the above.

Table 6. Main Regression Results of Divestment and Financial Flexibility

VARIABLES	(1) FF
Div	0.139*** (4.246)
Firm_Efficiency	0.0752*** (5.810)
interact	0.305* (1.922)
Lev	-0.136*** (-11.66)
ROA	0.0773** (2.296)
CF	0.163*** (5.143)
Board	0.0401*** (3.537)
Indep	0.117*** (2.752)
Top1	0.0337** (2.319)
Age	-0.00864*** (-2.672)
Constant	-0.141*** (-3.958)
Observations	2,611
R-squared	0.220
Ajusted R2	0.202
F test	0

t-statistics in parentheses *** p<0.01, ** p<0.05, * p<0.1

Table 7. Main Regression Results of Divestment and Financial Flexibility

VARIABLES	(1) State-owned enterprises	(2) Non-state-owned enterprises
Div	0.0774 (1.436)	0.189 * * * (4.966)
Firm_Efficiency	0.0754 * * * (3.918)	0.0777 * * * (4.736)
Div×Firm_Efficiency	0.182 (0.741)	0.368 * (1.897)
Lev	0.0884 * * * (4.943)	0.172 * * * (11.82)
ROA	0.184 * * * (2.730)	0.0728 * * (2.001)
CF	0.119 * * (2.507)	0.199 * * * (5.119)
Board	0.00245 (0.153)	0.0635 * * * (4.166)
Indep	0.0209 (0.360)	0.244 * * * (4.330)
Top1	0.00378 (0.168)	0.0417 * * (2.191)
Age	0.0243 * * * (3.643)	0.0110 * * * (2.777)
Constant	0.0346 (0.657)	0.236 * * * (4.847)
Observations	1073	1901
R-squared	0.251	0.273
Ajusted R2	0.249	0.249
F test	0	0

t-statistics in parentheses *** p<0.01, ** p<0.05, * p<0.1

4.5. Further tests

4.5.1. Heterogeneity test

Xu and Wu (2021) [13] and Zhang et al. (2019) [14] found that corporate characteristics are important factors that affect the economic consequences of divestment. It can be seen that divestment by state-owned enterprises cannot effectively improve the financial flexibility, while divestment by non-state-owned enterprises can effectively improve the financial flexibility of enterprises.

4.5.2. Mechanism Checking

According to the previous analysis, the alleviation of

financing constraints plays an important role in the process of divestment. Therefore, this paper takes corporate financing constraints (FC) as an intermediary variable to test the mechanism. It can be seen from Column (2) of Table 7 that divestment Div is negatively correlated with financial constraints FC, and the correlation coefficient is -0.053 , which is significant at the level of 5%. Column (3) shows that divestment Div is positively correlated with financial flexibility FF after controlling financial constraints FC, and the coefficient is 0.085 , which is significant at the level of 10%. It shows that asset stripping can effectively improve the financial flexibility of enterprises by alleviating financial constraints.

Table 8. Main Regression Results of Divestment and Financial Flexibility

VARIABLES	(1) FF	(2) FC	(3) FF
FC			0.085 ** (2.28)
Div	0.126 ** (2.42)	0.053 ** (3.16)	0.130 ** (2.54)
Size	0.120 (1.74)	0.223 *** (4.04)	0.101 (1.52)
Lev	0.118 *** (7.46)	0.001 (0.14)	0.118 *** (7.50)
ROA	0.177 *** (4.32)	0.076 *** (4.51)	0.171 *** (4.20)
Cashflow	0.167 *** (4.54)	0.002 (0.12)	0.167 *** (4.65)
Board	0.045 *** (3.70)	0.002 (0.18)	0.045 *** (3.69)
Indep	0.125 * (2.23)	0.056 ** (2.29)	0.129 ** (2.32)
Top1	0.052 ** (2.42)	0.023 (1.64)	0.054 ** (2.55)
ListAge	0.006 (0.81)	0.038 *** (14.67)	0.009 (1.11)
Constant	0.237 (1.19)	1.987 *** (11.35)	0.068 (0.35)
Observations	3084	3084	3084
R-squared	0.228	0.330	0.230

t-statistics in parentheses *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

5. Conclusions and Policy Recommendations

Based on the data of listed companies from 2011 to 2020, this paper studies the impact of divestment on corporate financial flexibility and its mechanism. The results show that divestment can promote the improvement of corporate financial flexibility, and the managerial ability can significantly regulate the relationship between divestment and financial flexibility, and higher managerial ability will promote the positive relationship. Further analysis shows that financial constraints and cash holdings are the important influencing mechanisms of divestment on corporate financial flexibility. The positive effect and moderating effect of divestment on financial flexibility are more significant in non-state-owned enterprises.

Based on the conclusions, the following suggestions are put forward:

(1) As an effective means of optimizing resource allocation, divestment plays an important role in enterprise innovation and development as well as industrial transformation and

upgrading. The divestment of Chinese enterprises is becoming more and more frequent. It should be recognized that the value effect of divestment is closely related to the financial flexibility of enterprises, which can improve the efficiency of resource allocation, improve the competitiveness and market value of enterprises, thus conducive to the continuous development of enterprises' R&D and innovation activities, and achieve good development of enterprises.

(2) Enterprises employ high-ability managers to manage their enterprises. If the enterprise managers have rich experience in divestment, they can more skillfully alleviate the financial situation of the enterprise and improve the financial flexibility of the enterprise, so as to enhance the risk-bearing ability of the enterprise.

(3) The financial market system should be improved to make full use of its functions of reducing financing costs and improving resource allocation efficiency, so as to make the divestment assets fairly priced in the market, guide the capital flow to the most likely successful investment direction, and accelerate the innovation of enterprises, so that the enterprises

with good performance and good management can benefit from the specialization and efficiency brought by asset divestment.

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