Available online at www.sciencedirect.com
SCIENCE DIRECT®
ELSEVIER
Journal of Corporate Finance 12 (2006) 424–448
Journal of CORPORATE FINANCE
www.elsevier.com/locate/jcorpfin

Ownership structure, corporate governance, and fraud: Evidence from China

Gongmeng Chen [a], Michael Firth [b,*], Daniel N. Gao [a,c], Oliver M. Rui [d]

[a] Antai School of Management, Shanghai Jiaotong University, China
[b] School of Accounting and Finance, The Hong Kong Polytechnic University, Kowloon, Hong Kong, China
[c] Jinhe Centre for Economic Research, Xi'an Jiaotong University, China
[d] Chinese University of Hong Kong, Hong Kong, China

Received 26 February 2005; received in revised form 7 September 2005; accepted 8 September 2005
Available online 2 November 2005

Abstract

Our study examines whether ownership structure and boardroom characteristics have an effect on corporate financial fraud in China. The data come from the enforcement actions of the Chinese Securities Regulatory Commission (CSRC). The results from univariate analyses, where we compare fraud and no-fraud firms, show that ownership and board characteristics are important in explaining fraud. However, using a bivariate probit model with partial observability we demonstrate that boardroom characteristics are important, while the type of owner is less relevant. In particular, the proportion of outside directors, the number of board meetings, and the tenure of the chairman are associated with the incidence of fraud. Our findings have implications for the design of appropriate corporate governance systems for listed firms. Moreover, our results provide information that can inform policy debates within the CSRC.

JEL classification: G34
Keywords: Ownership; Corporate governance; Fraud; China's enforcement actions

1. Introduction

China began a process of economic restructuring in the late 1970s and these reforms continue to this day. Principal aims of the reforms include the modernization of industry, stimulation of

* Corresponding author. Tel.: +852 2766 7062; fax: +852 2330 9845.
E-mail address: afmaf@inet.polyu.edu.hk (M. Firth).

0929-1199/$ - see front matter
doi:10.1016/j.jcorpfin.2005.09.002

growth, reduction of poverty, and improvements in economic efficiency. To implement these reforms, China has moved towards a free-enterprise system that has included, among other things, the privatization of many state owned enterprises (SOEs), the formation of joint stock companies, and the development of stock markets. The trials and tribulations of the reform process have been well documented (Cao et al., 1999; Gao, 1996; Groves et al., 1994; Lin and Zhu, 2001) and analyses of the effectiveness of these reforms have begun to appear in the literature (Allen et al., 2005; Chen et al., 1998, in press-a). In a detailed analysis of national economic statistics, Allen et al. (2005) conclude that it is the private non-listed sector of the economy that has driven China's economic growth. They argue that poor governance has constrained the performance of listed firms. Chen et al. (1998, in press-a) concur with the arguments of Allen et al. and they further demonstrate that the performance of partially privatized SOEs deteriorates in the years after the IPO.

China's reform process has been gradual and contrasts with the wholesale and 'overnight' reforms undertaken in many ex-Soviet-bloc countries. The reforms have borrowed concepts and "best practices" from the U.S. and other capitalist nations. For example, the governance of listed firms follows, in many respects, practices from the U.K. and the U.S. Firms have boards of directors who are charged with running the organization and the chairman of the board is the main power and takes on an executive role. Boards are required to have outside directors although, only recently, have they been required to be independent.[1] Appointment committees, compensation committees, and other committees are now becoming common in Chinese listed firms. Although there is widespread adoption of western[2] corporate governance practices, the effectiveness of them has yet to be fully evaluated. The particular issue we examine in this study is whether the style and form of corporate governance has an effect in deterring financial fraud. Our research follows the line of enquiry of Beasley (1996) but does so in a major transition economy, namely China.

The China Securities Regulatory Commission (CSRC) is charged with enforcing all aspects of the securities laws in China and its powers and operations are not dissimilar to those of the SEC in the U.S. The CSRC investigates allegations of corporate and securities fraud and makes enforcement actions in cases where fraud and malpractices are proved. We examine these enforcement actions and develop a model to explain why some firms succumb to financial fraud while others do not. In particular, we examine whether the ownership and governance structures of firms have an impact on the propensity to commit fraud.

Our study contributes to the literature in the following ways. First, China has a relatively underdeveloped legal environment when compared to the U.S. and so the role and impact of regulation and corporate governance differs across the two countries (we compare China to the U.S. because most prior research has used data from American enforcement actions). La Porta et al. (1998, 2002) and Roe (2002) show that the legal environment of a country has a significant impact on firm performance and corporate governance.[3] In China, civil litigation is very rare and thus the regulator, in this case the CSRC, is the prime discipliner of firms and their

[1] The China Securities Regulatory Commission (CSRC) issued Statement 102 'Guidelines for Establishing an Independent Directors System for Listed Companies' in August 2001 and it stipulated that by June 2003, one-third of the directors should be independent and non-executive.

[2] By "western" we mean developed or capitalist countries such as Australia, the U.K., and the U.S.

[3] Supporting evidence comes from an international study by Haw et al. (2004) who find that well developed legal and extra-legal institutions (such as the tax authorities) help reduce earnings management. Note, however, that they did not include China in their sample countries.