The determinants of financial fraud in Chinese firms: Does corporate governance as an institutional innovation matter?

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**ABSTRACT**

China has adopted a gradual and experimental approach to the political and economic reform process since the late 1970s. The reforms continue to this day and have produced a unique corporate governance structure in China which can be viewed as an institutional innovation. This study deals with social changes and institutional innovations in China. We provide direct evidence on the association of corporate governance and financial fraud using a sample of Chinese listed firms, differing from previous studies that focused on western firms. We find that ownership structure, dual CEO/chairman of the directorate status, external auditors and regulators' requirements contribute to the likelihood of financial fraud. Specifically, when firms have less concentrated ownership, dual CEO/chairman of the directorate status and shorter audit service tenures, as well as when they experience greater regulation pressure, they tend to engage in financial fraud. However, we do not find evidence that the percentage of independent directors in the directorate, the presence of an audit committee or the proportion of shares owned by the supervisory board members play a role in deterring financial fraud. The evidence in this study offers insights into whether corporate governance is effective in the control of financial fraud in China.

1. Introduction

Reports of high profile financial frauds have made corporate financial statements unreliable and eroded investors’ confidence. For example, in the US, loss of market capitalization resulting from fraudulent practices committed by Enron, WorldCom, Tyco, Global Crossing and Qwest has been estimated at about US$ 460 billion (Cotton, 2002); and in Europe, Parmalat, previously a major corporate success story, was forced into administration because of financial fraud, leaving shareholders, who once owned a company valued at EUR 1.8 billion, with nothing (Coron, 2004). In addition to developed economies, emerging markets have also suffered from financial frauds. It has been widely acknowledged that China, the largest emerging market in the world, has high levels of corporate frauds (Li and Wu, 2007). A series of fraudulent financial reports produced by so-called blue chip companies, such as Yin Guangxia, Lan Tian, and Ke Long, resulted in an unprecedented crisis of investors’ confidence. Fraud at Yin Guangxia, which has been seen as “China’s Enron”, led to devastating losses as high as CNY 0.77 billion to its shareholders and significant numbers of investors and creditors (Chinese Finance and Economics, 2001). The former Chinese Premier Zhu Rongji even used “No Fictitious Records” as the motto of the newly established Shanghai National Accounting Institute (Firth et al., 2005), suggesting that financial fraud among Chinese firms was too serious to be ignored (Jia et al., 2009).

The existence of financial fraud has raised substantial concerns regarding the effectiveness of corporate governance in China. A commonly held view is that corporate governance ensures the accountability of certain individuals in the firm through mechanisms intended to lessen or eliminate fraudulent behaviours. The underlying notion is that corporate governance acts as institutional constraints at the firm level (Coriat and Weinstein, 2002). It lies in “social technology” (proposed by Nelson and Sampat, 2001) area, and in an institutional sense it can be viewed as “the rules of the game” (North, 1990) and mechanisms constraining and shaping behaviours (Nelson, 2008; Nelson and Nelson, 2002; Williamson, 1985). Previous studies based upon western firms (e.g., Loebbecke et al., 1989; Dechow et al., 1996; Beasley, 1996; Beasley et al., 2000; Farber, 2005; the Committee of Sponsoring Organizations of the Treadway Commission report 1999, 2010; Rezaee and Kedia, 2012) have empirically documented a positive association between poor corporate governance and financial fraud, through examining specific corporate governance components.

However, the above evidence cannot be generalized to cover Chinese firms because China has a unique corporate governance structure that is distinct from that in western countries. China has
adopted a gradual and experimental approach to the political and economic reform process since the late 1970s, rather than the “Big Bang” approach used in other transition economies (Xiao et al., 2004). The reforms continue to this day, which differentiates China from developed economies and other transition economies. The reforms have produced a unique corporate governance structure in China by importing concepts and practices from western countries. For example, the primary aspects of Anglo-American and European Continental corporate governance structures, such as the American independent directors system and the German supervisory board system, are both required in Chinese firms. Due to this institutional innovation, gatekeepers are not believed to work in the same manner in preventing financial frauds as those in other countries do (Filatotchev et al., 2013; Tian and Lau, 2001).

The point noted above raises an important research question: does Chinese corporate governance, as an institutional innovation, play a role in the control of financial fraud in firms? This paper aims to answer this question through empirically investigating Chinese firms with financial fraud and corporate governance structure of the concerned firms. We follow the Committee of Sponsoring Organizations of the Treadway Commission (COSO) reports (1999, 2010) and define financial fraud as the intentional material misstatement of financial statements or the perpetration of an illegal act that has a material direct effect on financial statements. We follow Organisation for Economic Co-Operation and Development (OECD) (2004) and define corporate governance as the rules and practices that govern the relationship between the managers and shareholders of corporations, as well as stakeholders, such as employees and creditors.

### 1.2. Corporate governance in Chinese firms

Transition economics provide significant capacity for corporate fraud (Baucus and Near, 1991). Table 1 indicates financial frauds occurred in China across time and industries, based on the enforcement actions carried out by the China Securities Regulatory Commission (CSRC) between 2002 and 2009. We find pervasive and persistent fraudulent financial reporting in China since 1996 and occurrences of fraud appear to be increasing. As observed in Table 1, from 1996 to 2004, 87 cases of financial fraud by listed firms were detected and reported. It seems that after 2004, the number of fraud cases decreased. The most likely reason is that a time delay exists between the investigation of financial fraud and the disclosure of enforcement actions by the CSRC. The CSRC is most inclined to pursue formal investigations for which there is strong evidence and a high probability of enforcement actions usually do not represent the fraud population as those in other countries do (Filatotchev et al., 2013; Tian and Lau, 2001).

The innovative corporate governance structure in Chinese firms results from the unique political and economic reforms in China. China has transformed from a traditionally planned economy to a socialist market economy during the past two decades. In this time, China has privatized many state-owned enterprises, formed joint stock companies, developed stock markets, and moved toward a free-enterprise system (Cao et al., 1999; Chen et al., 2006; Gao, 1996; Groves et al., 1994). The enterprise reform involved several steps. In 1990 and 1991, the Shanghai Stock Exchange and the Shenzhen Stock Exchange were developed. A large number of Chinese state-owned enterprises have been restructured into joint stock companies and have begun to raise capital by implementing initial public offerings. Many other state-owned enterprises offered a portion of their operations separately in a listed entity but retained the largest controlling stakes in the entity (Brandt and Rawski, 2008). This process allows state-owned enterprises to achieve the economic objective of earning profits that extends beyond their original social and political objectives (Bai et al., 2000). A major characteristic of Chinese listed firms is the state’s retention of a controlling stake in the firms (Globerman et al., 2011; Sun et al., 2011). On average, during the late 1990s, approximately 60% of shares were ultimately owned by the State, either directly owned by central and local governments and their associated ministries or indirectly owned by state-owned enterprises (Chen et al., 2006). These shares are not publicly traded on the stock exchanges. The other 40% of listed firms’ shares owned by private institutions and individuals are tradable on the exchanges, including A-shares issued to domestic investors, B-shares issued to foreign investors, H-shares listed on the Hong Kong exchange and N-shares listed on the New York exchange (Chen et al., 2006). Between 2001 and 2004, almost half of Chinese firms were state-owned enterprises (Brandt and Rawski, 2008). The State’s retention of a controlling stake in Chinese listed firms that cannot be publicly traded introduces new agency problems. The principal problems that have emerged are the manipulation of share prices and the expropriation of minority shareholders. In 2005, China implemented the share-trading reform that gradually rendered non-tradable shares tradable on the exchanges. The share-trading reform aims to lessen the cost difference between holding tradable shares and non-tradable shares and to minimize large shareholders’ motives to manipulate share prices (Zheng et al., 2007). The reform also leads to a decreasing proportion of state-owned shares in Chinese listed firms (a decrease to < 30%, on average, after 2006, based on our observations). Table 2 summarizes the Chinese contextual background and its differences and commonalities compared with other countries.

During the reforms, China imported concepts and practices from western countries to produce a unique “China-style” corporate governance structure. This structure can be considered as an institutional innovation which differentiates China from other countries. According to the Chinese Company Law stipulated in, 1993, three internal governance organs are in place: the shareholder meeting, board of directors and supervisory board. The shareholder meeting acts as the authority in charge and allows for the appointment of board of directors and supervisory board (Chinese Company Law Article 100). The board of directors is defined as a decision-making body and is responsible for appointing top management, determining internal management systems, calling shareholder meetings and undertaking certain decisions (Chinese Company Law Article 109). The supervisory board works as a monitoring body, and the responsibilities prescribed by the 1993 Company Law include financial review, overseeing directors and managers, proposing temporary shareholder meetings when necessary and reporting annually to the shareholders’ meeting (Chinese Company Law Article 119, 120). Since 2002, the CSRC has required Chinese listed firms to appoint independent directors and establish audit committees under the board of directors. Current Chinese corporate governance involves not only the supervisory board but also independent directors.
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