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Delisting pressure, executive compensation, and corporate fraud: Evidence from China

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ABSTRACT

This paper studies the relationship between executive compensation and the incidence of corporate fraud in Chinese listed companies from the perspective of delisting pressure. We find that delisting pressure directly contributes to the incidence of fraud, especially the incidence of information disclosure violations, given the unique listing and delisting systems in the Chinese stock market. We also find that CEOs and CFOs with relatively low pay are more likely to commit fraud, regardless of whether or not delisting pressure is present. However, delisting pressure weakens the negative relationship between executive pay and the likelihood of corporate fraud. Finally, when equity incentives are also considered, the effect of CEOs' total compensation on fraud is contingent on delisting pressure. High CEOs' total compensation has a deterring effect on fraud for firms with no delisting pressure, while this effect disappears for firms with delisting pressure.

1. Introduction

In China, corporate fraud has been prevalent since the country's stock market was established in 1990. According to Zhang (2007), financial fraud is detected in one out of six Chinese publicly traded firms during the period from 1993 to 2004. Ding et al. (2010) find that corporate fraud is severe in China because of the relative infancy of Chinese capital markets and the difficulties in implementing laws and regulations. In mature capital markets in developed countries, fraud also occurs frequently in public companies, leading to huge welfare losses (Yu, 2013). In the literature a substantial amount of research is devoted to the issue of corporate financial fraud with a primary focus on the effects of executive (especially CEO) compensation and corporate governance structure on the incidence of fraud. However, most previous studies investigate developed markets, and provide conflicting evidence on the relationship between executive compensation and corporate fraud (Bhattacharya and Marshall, 2012). There is a lack of empirical evidence on this issue for emerging markets. Research on this subject in emerging market countries is particularly interesting, and may have distinct findings due to these immature security and capital markets, weak legal protection of investors, different listing and delisting systems, and a relative lack of incentive compensation for executives (such as executive stock options).

In this paper, we investigate the impact of executive compensation on the incidence of corporate fraud under delisting pressure in the context of the unique Chinese stock market delisting system. More specifically, we are interested in examining the way in which delisting pressure shapes the association between executive compensation and corporate fraud. The research question is threefold.

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First, is the incidence of corporate fraud related to delisting risk? Second, how does executive compensation affect the inclination of executives to commit fraud? Third, what is the mediating effect of delisting pressure? In other words, is the effect of executive compensation on fraud contingent on delisting pressure? Conceptually, we examine these issues within the framework of Becker (1968) to see whether corporate fraud in China can be explained by economic rationality. Our findings may have direct policy implications, given the fact that during corporate governance and ownership reforms in recent years, executive compensation in Chinese listed companies has increased significantly.

A pivotal concept for understanding the listing and delisting systems in the Chinese stock market is the so-called shell resource, which refers to the transferable listing qualification of listed companies. Listed companies in China have significant advantages over unlisted ones, such as easy access to capital market and support from the government. The transferable listing qualification, or shell resource, is very scarce and thus is a highly valuable resource. Due to the lengthy and restrictive approval process of listing, initial public offering (IPO) is beyond the reach of most unlisted companies. Thus, acquiring the shell of a listed company becomes a more practical avenue to gain access to the equity market and other benefits (Cai and Chen, 2004; Kam et al., 2008). When financial performance is the most important (or even the sole) criterion for delisting from the stock market, committing fraud to save the shell resource may be a rational decision for corporate executives even if the potential punishment is taken into account. This unique institutional context provides us with an interesting case study to better understand causes of fraud in Chinese listed firms.

Given the unique delisting system in China, we conjecture that under delisting pressure, executives have robust incentives to commit fraud in order to maintain the shell resource. However, the value of such shell resources for corporate executives varies with the level of executive compensation, including the fixed pay and shareholding by executives. Thus, it is important to take delisting pressure into consideration when exploring the relationship between executive compensation and the likelihood of fraud. Some prior research investigates the cause of Chinese corporate fraud from the perspectives of board composition, ownership structure, or efficiency of law enforcement actions (Chen et al., 2005, 2006; Chen et al., 2011a, 2011b; Firth et al., 2011). Following the literature, we also explore the mediating effects of ownership structure, board oversight, external audit, and CEO power in our empirical analysis.

Despite frequent media coverage and numerous academic studies in China, as is noted in the work of Li and Cheng (2006), Li and Zhou (2007), Sun and Luo (2011) and Xie et al. (2013) regarding the shell resource of listed companies, it is not well known or recognized in developed countries' academic literature. Many studies on corporate fraud in Chinese companies follow research designs in similar studies in developed markets, and therefore do not incorporate unique features such as China's distinct delisting system. For corporate executives, CEOs in particular, in developed countries the most common reason for committing fraud is their equity incentives (shareholdings and stock options). In financially struggling companies, executives may commit fraud to save their career by "saving" the company. In China, in addition to these factors, the distinct delisting system is the 'Sword of Damocles' over the head of corporate executives because the statuses (financing opportunities, government protection and support, etc.) of listed and non-listed companies are poles apart. In a comparative study of the delisting systems in China and U.S., Zhou (2017) notes that the reason for the poor implementation effect of the delisting system in China lies in the uniqueness of the shell resource. We believe that the unique angle of delisting pressure (due to the shell resource) can provide new insight into the relationship between executive compensation and corporate fraud in China.

To examine our research issues, we focus on a sample of listed companies in the Shanghai and Shenzhen stock exchanges' A-share markets between 2007 and 2014. A multivariate Probit regression model is employed. Additionally, propensity score matching (PSM) paired samples are created and examined to address the endogeneity concern in the results. We find that in the Chinese stock market the higher the delisting pressure, the greater the propensity for a company to commit fraud. Executive monetary pay (fixed salary and cash bonus) is negatively related to the likelihood of corporate fraud, regardless of whether or not firms face delisting pressure. However, this negative association is less pronounced for firms under delisting pressure. We argue that these results are consistent with economic rationality in a cost–benefit framework (Becker, 1968). In general, executives with relatively low monetary pay are more likely to be involved in fraud since the benefit outweighs the cost. Executive pay represents both the direct cost of committing fraud and the direct benefit of maintaining the shell resource for executives personally. Moreover, cost and benefit are broader since they also include intangible factors such as professional reputation and career prospects. Under delisting pressure, there are two factors that weaken the negative relationship between executive pay and fraud. One factor is that delisting pressure enhances the incentives to commit fraud for executives with high pay to a relatively larger extent than it does for executives with low pay. The other factor is that companies with imminent delisting risk tend to attract closer scrutiny from regulators, and thus executives' chances of being caught for fraud are higher. Thus, compared with their better paid colleagues, executives with low pay tend to take a more cautious approach toward fraud because the benefit of maintaining the shell value is relatively smaller for them. Together these two factors make the negative relationship between executive pay and fraud less conspicuous under delisting pressure.

Another type of corporate executive compensation is equity-based incentives. While the equity-based incentive is relatively new in China, it is of interest to explore the impact of executive total compensation, including both monetary pay and equity incentives, on corporate fraud. Many studies on companies in developed countries find that equity incentives (stock options and shareholdings) for management can fuel corporate fraud (Bergstresser and Philippon, 2006; Denis et al., 2006; Harris and Bromiley, 2007; Armstrong et al., 2013; Hass et al., 2016). In China stock options are uncommon in executive compensation, and for companies in which stock options are awarded, the detailed information is usually undisclosed. Thus, we measure the total compensation for CEOs and CFOs as the sum of monetary pay and the value of shareholdings. Consistent with the findings when only monetary pay is considered, we find that CEOs' total compensation can also reduce the likelihood of corporate fraud for firms under no delisting pressure. However, this deterring effect does not prevail in companies under delisting pressure.

The remainder of the paper is organized as follows. Section 2 introduces listing requirements, monitoring, and delisting measures