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Managerial ability, political connections, and fraudulent financial reporting in China ☆

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ABSTRACT

The primary objective of this paper is to examine the associations among managerial ability, political connections and enforcement actions for financial reporting misrepresentation (hereafter financial reporting fraud) in China. Using a sample of listed firms in China during 2007–2012, we first find that increased managerial ability leads to less financial reporting fraud. Second, political connections of firms can weaken or limit the effect of managerial ability on the likelihood of financial statement fraud. Further analyses indicate that the results are primarily driven by non-state-owned firms, rather than state-owned firms. Finally, we further find that firms with capable managers face less severe penalties by the regulatory agencies relative to those without capable managers.

1. Introduction

China is the largest transitional economy, and plays an increasingly critical role in the global economy.[1] However, because of high-level political corruption and lax legal enforcement in China (Allen et al., 2005; La Porta et al., 2008), the incidence of financial and accounting scandals has increased dramatically over the past two decades. The resulting decline in investor confidence in the capital market and firm financial reporting has received increasing attention from academics, practitioners and regulators. In this paper, we explore two potentially crucial determinants of financial statement fraud in China: managerial ability and political connections. More specifically, we first examine the relation between managerial ability and the likelihood of fraudulent financial reporting. Next, because political connections play a major role in business activities in China, we further examine whether the association between managerial ability and fraud probability varies systematically across the degree of managerial political ties.

The first question to be addressed is whether managerial ability is associated with the likelihood that listed firms will face enforcement actions by the regulatory agencies (China Securities Regulatory Commission, hereafter CSRC, and stock exchanges). Whereas most archival work on financial scandals or financial reporting quality focuses mainly on firm-specific characteristics (e.g., Klein, 2002; Dechow et al., 2010), several recent papers in the accounting literature show that

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[1] If current trends continue, China will overtake the U.S. to become the largest economy in the world by 2025 (Allen et al., 2005).

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managers' individual preferences have an effect on firms' voluntary disclosure and financial reporting outcomes (Bamber et al., 2010; DeJong and Ling, 2013; Dyreng et al., 2010; Ge et al., 2011; Yang, 2012; Demerjian et al., 2013). In this paper, we focus on a major manager-specific feature or "style", managerial ability. Because more capable managers are knowledgeable about their business and can therefore make effective judgments and estimates, they can better transform firm resources and thus achieve better business performance. In addition, the decreased risk of business failure due to better managerial ability will further mitigate the going concern risk and audit risk (Krishnan and Wang, 2015). Based on the "Fraud triangle" (Cressey, 1950; Szwajkowski, 1985; Weygandt et al., 2015),[2] the incentive for firms or managers to commit fraud is stronger when firms face larger financial pressure and needs. We predict that managerial ability would thus reduce firms' financial pressure and, in turn, the likelihood of committing fraud in general and financial reporting fraud in particular.

Next, the quality of a firm's management can have a certifying effect on firm value (Chemmanur and Paeglis, 2005). In this case, the staff of regulatory agencies, faced with time and resources constraints, will more likely be attracted to firms without able managers. Therefore, we predict that managerial ability will be expected to decrease the likelihood of being scrutinized and sanctioned by regulatory agencies (CSRC and stock exchanges).

Extant studies often use SEC enforcement actions or AAERs as a proxy for financial reporting fraud (Files, 2012). The main reason for this is that enforcement action has the advantage over other proxies based on financial statement information (e.g., earnings management) in that it provides a direct measure of financial reporting quality. Therefore, this measure is more objective and not subject to measurement error. Next, although high accruals may signal the poor quality of financial reporting, these accruals may not arise from a violation of GAAP. In contrast, enforcement actions by the regulatory agencies arise from the violation of GAAP, which arguably imposes greater costs on companies and managers (Chen et al., 2005). Following and extending prior studies, this paper focuses the analyses primarily on enforcement actions related to financial reporting (hereafter financial reporting fraud).

The second question to be addressed is whether the presence of political connections will weaken the effectiveness of managerial ability regarding the likelihood of reducing financial reporting fraud. In the Chinese setting, which is characterized by a relationship-based economy (Chan et al., 2012; Du et al., 2015), listed companies tend to resolve information asymmetry through connections, and thus have lower-quality financial reporting (Ball and Shivakumar, 2005) in the sense that financial reporting quality decreases with the level of political connections; therefore the likelihood of financial reporting fraud increases with the level of connections. In this case, political connections will weaken the ability of, and incentive for, a firm's manager to provide high-quality financial reporting. It follows that *ceteris paribus* the effectiveness of managerial ability in reducing fraud will decrease with the extent of political connections.

Next, connected firms typically derive gains from their connections over and above the payments they make.[3] In an attempt to mislead investors so that insiders are able to make gains at the expense of investors, connected firms tend to remain more opaque and thus more likely commit financial reporting fraud than non-connected firms (e.g., Chaney et al., 2011; Fan et al., 2007; Gross et al., 2016; Hellman et al., 2003). Third, political rent-seeking is prevalent and highly lucrative in China. To reduce competitive rent-seeking from rivals and/or to avoid social sanctions, connected firms that extract substantial political benefits tend to deliberately remain less transparent by providing low quality accounting information. In particular, legal enforcement in China is weak and the penalties imposed for financial statement fraud tend to be too low to enhance the incentive for insiders to provide high quality financial reporting. Therefore, connected firms are more likely to be involved in financial reporting fraud.

According to the above arguments, political connections weaken or limit the effectiveness of managerial ability in reducing the likelihood of fraudulent financial reporting. Consequently, we hypothesize that the effectiveness of managerial ability in reducing the fraudulent financial reporting likelihood is weaker for firms with political connections than for firms lacking such connections.

We focus our analyses on China for the following reasons. First, unlike western countries where business is characterized by rules-based governance, the Chinese cultural context is widely recognized to be more relationship-based than rules-based (Sue-Chan and Dasborough, 2006; Chan et al., 2012; Du et al., 2015; Piotroski et al., 2015). Relationships play a critical and pervasive role in shaping and influencing the management of Chinese business. In contrast, western countries' relationships play a more surface-level impersonal role in shaping the operation of business. As such, in China, as relationships have a dominant effect on business operation, it is unclear whether the extant findings on the effect of managerial ability on business can be generalized to Chinese listed firms, in particular in the setting of fraud. For example, Ball and Shivakumar (2005) argue that unlike publicly listed firms in the U.K., Chinese listed firms tend to resolve information asymmetry via connections networks, and thus have lower demand for high quality financial reporting. Second, in the context of the "relations" culture in China, we can further examine whether the effect of managerial ability on fraud, *if any*, systematically varies with political connections, a very common type of connection in China. China provides us with a setting to test our predictions.

[2] According to fraud triangle theory, three elements contribute to fraudulent activities: financial pressure, opportunity and rationalization. In our setting, we focus on the first element: financial pressure. Specifically, we argue that because firms with capable managers outperform those without capable managers, they face less financial pressure; this in turn leads to the lower likelihood of committing fraud.

[3] Regarding the benefits from political connections, see Khwaja and Mian (2005) for a discussion of preferential access to credit; Dinc (2005) for preferential treatment by government-owned banks; Agrawal and Knoeber (2001) for preferential treatment in the awarding of government contracts; and Faccio et al. (2006) for bailouts. With respect to the costs of political connections, Fan et al. (2007) discuss vote-buying behavior; Hellman et al. (2003) discuss bribe behavior.

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