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Three essays on corporate fraud in Chinese listed companies

A thesis presented in fulfilment of the requirements for the degree of

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Copyright is owned by the Author of this thesis. Permission is given for a copy to be downloaded by an individual for the purpose of research and private study only. This thesis may not be reproduced elsewhere without the permission of the Authors.
This thesis investigates the detection, processes and capital market impact of corporate fraud in China. Three specific issues are researched in the Chinese context through three interconnected essays: the identification of fraudulent financial statements; the measurement of illegal tunnelling of company funds by controlling shareholders; the evaluation of the stock market response to the public exposure of firm fraud violations.

First, the link between accounting balance sheet values and the exposure of fraudulent activities in Chinese firms is investigated. Other receivables, inventories, prepaid expenses, employee benefits payables and long-term payables are found to be important indicators of fraudulent Chinese financial statements. The findings from previous studies that document asset accounts that are associated with fraudulent financial statements are confirmed, but previous evidence that overstates the value of total liabilities is challenged. A new model applied to all Chinese listed firms correctly predicts the absence of fraud approximately 81% of the time. Balance sheet accounting values scaled by total assets or sales are found to provide valuable information to predict fraudulent financial statements.

Next, valuable insights are provided into the factors and processes surrounding cash tunnelling, a form of embezzlement by controlling shareholders, in firms accused of fraud. The controlling shareholder’s financial motivation for tunnelling is found to be negatively related to the percentage of shareholdings of the top owner, the profitability of the firm, and the costs of tunnelling. A new theoretical model of cash tunnelling is developed, through which the process of tunnelling in the Chinese market is revealed. The overall tunnelling loss in the sample of fraudulent firms is about 5.54 times that of net income.

Lastly, long-term market responses surrounding announcements of firm fraud are investigated. Although fraudulent firms are shown to display worse operating performance, lower dividends and higher other equity distributions than matching firms, long-term abnormal stock returns following the fraud announcements are insignificant. This is consistent with a view that stock market prices in China do not fully reflect the losses incurred by fraudulent firms and that in this regard, the stock market in China is not fully efficient.
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# TABLE OF CONTENTS

ABSTRACT ............................................................................................................................ iii

ACKNOWLEDGEMENTS ................................................................................................. iv

TABLE OF CONTENTS ................................................................................................. v

LIST OF TABLES ............................................................................................................ ix

LIST OF FIGURES .......................................................................................................... xii

CHAPTER ONE: INTRODUCTION ............................................................................. 1

1.1 Introduction ......................................................................................................................... 2

1.2 Background and motivation ............................................................................................... 3

1.3 Research aims .................................................................................................................... 6

1.4 Contributions of the research .......................................................................................... 10

1.5 Research outputs from the thesis ...................................................................................... 12

1.6 Structure of the thesis ...................................................................................................... 13

CHAPTER TWO: OVERARCHING LITERATURE REVIEW .................................. 15

2.1 Institutional background .................................................................................................. 16

2.1.1 Overview of China’s capital markets .......................................................................... 16

2.1.2 Stock markets .............................................................................................................. 17

2.1.3 Chinese accounting and financial reporting practices .................................................. 20

2.1.4 Fraudulent financial statement (FFS) and regulatory agencies .................................. 25

2.1.5 Conclusion .................................................................................................................... 30

2.2 Corporate governance .................................................................................................... 31

2.2.1 Internal governance .................................................................................................... 32

2.2.1.1 Ownership structure ............................................................................................... 32

2.2.1.1.1 Different types of ownership ............................................................................... 32

2.2.1.1.2 The 2005 split share reform ............................................................................... 34

2.2.1.1.3 Ownership concentration .................................................................................. 36

2.2.1.2 Board structure ....................................................................................................... 39

2.2.1.2.1 Board of directors ............................................................................................. 39

2.2.1.2.2 Supervisory boards ............................................................................................ 41

2.2.1.2.3 Audit committees ............................................................................................... 42

2.2.2 External governance ................................................................................................... 44
4.4.3 Identification of accounts related to tunnelling .......................................................... 138
  4.4.3.1 Soft accounts ....................................................................................................... 138
  4.4.3.2 Solid accounts .................................................................................................... 140
  4.4.3.3 Cost accounts .................................................................................................... 140
  4.4.4 Univariate tests ..................................................................................................... 142

4.5 Multivariate tests ......................................................................................................... 145
  4.5.1 Determinants of the change of other receivables (ΔOREC) ................................... 145
  4.5.2 Robustness checks when variables are deflated by sales ..................................... 152
  4.5.3 Robustness tests when earnings management is controlled ............................... 153
  4.5.4 The proxy of tunnelling in the form of impairment losses .................................. 155
  4.5.5 Comparison between fraudulent firms and matching firms .............................. 158
  4.5.6 Characteristics of tunnelling firms ........................................................................ 159

4.6 Conclusion .................................................................................................................... 166

CHAPTER FIVE: ESSAY THREE: LONG-TERM STOCK PRICE AND
ACCOUNTING PERFORMANCE OF FRAUDULENT FIRMS IN CHINA ............ 169
  5.1 Introduction ................................................................................................................. 171
  5.2 Literature review and hypotheses development ....................................................... 174
  5.3 Sample, methodology and empirical results ............................................................ 180
    5.3.1 Short-term abnormal stock returns ................................................................. 181
    5.3.2 The change in firm operating performance surrounding fraud events ............ 185
    5.3.3 Long-term accounting performance of fraudulent and matching firms around fraud events ................................................................. 186
    5.3.4 Long-term abnormal stock returns ................................................................. 188
      5.3.4.1 Consequences of fraudulent activities ....................................................... 188
      5.3.4.1.1 Buy-and-hold abnormal returns ......................................................... 190
      5.3.4.1.2 Calendar time abnormal returns approach .......................................... 195
      5.3.4.2 Consequences of fraudulent activities—robustness check .................... 198
    5.3.5 The relationship between operating performance and stock price performance .... 201
    5.3.6 Effect of enforcement actions and firm performance ....................................... 203
    5.3.7 Other potential explanations for stock performance ........................................ 206

5.4 Conclusion .................................................................................................................... 211

CHAPTER SIX: CONCLUSION .............................................................................. 213
  6.1 Review of hypotheses, major findings and implications ........................................... 214
    6.1.1 Essay One: Detecting fraud in Chinese listed companies using balance sheet
          accounting values .................................................................................................... 215
6.1.2 Essay Two: Cash tunnelling in Chinese firms .............................................................. 217
6.1.3 Essay Three: Long-term stock price and accounting performance of fraudulent firms
in China ..................................................................................................................................... 218
6.2 Limitations of the thesis and future areas of research ..................................................... 219

LIST OF TABLES: CHAPTER THREE: ESSAY ONE: DETECTING FRAUD IN
CHINESE LISTED COMPANIES USING BALANCE SHEET ACCOUNTING
VALUES ............................................................................................................................... 222

LIST OF TABLES AND FIGURES: CHAPTER FOUR: ESSAY TWO: CASH
TUNNELLING IN CHINESE FIRMS .............................................................................. 240

LIST OF TABLES AND FIGURES: CHAPTER FIVE: ESSAY THREE: LONG-
TERM STOCK PRICE AND ACCOUNTING PERFORMANCE OF
FRAUDULENT FIRMS IN CHINA .................................................................................. 286

Reference List ....................................................................................................................... 317

APPENDIX A: ESSAY ONE: DETECTING FRAUD IN CHINESE LISTED
COMPANIES USING BALANCE SHEET ACCOUNTING VALUES .............................. 331
Appendix A.1: Examples of the violation types ........................................................................ 331
Appendix A.2: Weighted probit regression results .................................................................. 334
Appendix A.3: Probit regression results of balance sheet account values (scaled by sales) on
corporate fraud indicator ..................................................................................................... 339
Appendix A.4: An example of the spurious relationship ........................................................ 340

APPENDIX B: ESSAY TWO: CASH TUNNELLING IN CHINESE FIRMS ............ 341
Appendix B.1: Torch Automobile: A typical fraudulent case .................................................. 341
Appendix B.2: enforcement action process ............................................................................ 341
Appendix B.3: From the view of event year .......................................................................... 342
  B.3.1 Soft accounts ............................................................................................................ 342
  B.3.2 Solid accounts .......................................................................................................... 345
  B.3.3 Cost accounts ........................................................................................................... 347
  B.3.4 Measuring the level of overstated amounts in identified accounts after adjustment
  based on matching firms ................................................................................................. 350
Appendix B.4: Variable definitions ........................................................................................ 354
Appendix B.5: Regulations of tunnelling ............................................................................. 354
Appendix B.6: The approximate total losses ......................................................................... 355
Appendix B.7: Robustness tests in three typical violation types .......................................... 356
Appendix B.8: Robustness tests in the determinants of other receivables ............................ 359
Appendix B.9: Robustness tests in the determinants of impairment losses .......................... 361
<table>
<thead>
<tr>
<th>Table</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1</td>
<td>Empirical studies</td>
<td>223</td>
</tr>
<tr>
<td>3.2</td>
<td>Sample description of fraud</td>
<td>225</td>
</tr>
<tr>
<td>3.3</td>
<td>Descriptive statistics and mean comparison between fraud and matching firms</td>
<td>228</td>
</tr>
<tr>
<td>3.4</td>
<td>Indicators of multicollinearity and OLS regression results</td>
<td>229</td>
</tr>
<tr>
<td>3.5</td>
<td>Probit regression results of balance sheet account values (scaled by total</td>
<td>231</td>
</tr>
<tr>
<td></td>
<td>assets) on corporate fraud indicator</td>
<td></td>
</tr>
<tr>
<td>3.6</td>
<td>Probit regression results of different types of fraud violations</td>
<td>234</td>
</tr>
<tr>
<td>3.7</td>
<td>Probit regression results of balance sheet accounts on corporate fraud</td>
<td>236</td>
</tr>
<tr>
<td></td>
<td>indicator – Robustness checks</td>
<td></td>
</tr>
<tr>
<td>3.8</td>
<td>Correct predictions of fraudulent and non-fraudulent firms</td>
<td>238</td>
</tr>
<tr>
<td>3.9</td>
<td>Probit regression results of balance sheet accounts, corporate ownership,</td>
<td>239</td>
</tr>
<tr>
<td></td>
<td>board structure, and firm specific information on corporate fraud</td>
<td></td>
</tr>
<tr>
<td>4.1</td>
<td>Descriptive statistics for regulatory enforcements</td>
<td>241</td>
</tr>
<tr>
<td>4.2</td>
<td>Comparison of fraudulent firms and matching firms</td>
<td>244</td>
</tr>
<tr>
<td>4.3</td>
<td>Correlation matrix of explanatory variables to explain the tunnelling process</td>
<td>250</td>
</tr>
<tr>
<td>4.4</td>
<td>OLS regression results of changes in other receivables on other operating</td>
<td>252</td>
</tr>
<tr>
<td></td>
<td>costs and net cash flows (total assets version)</td>
<td></td>
</tr>
<tr>
<td>4.5</td>
<td>OLS regression linking other operating costs, net cash flows, change of some</td>
<td>253</td>
</tr>
<tr>
<td></td>
<td>controlling variables to the change in other receivables (total assets version)</td>
<td></td>
</tr>
<tr>
<td>4.6</td>
<td>OLS regression results of change in other receivables on other operating</td>
<td>257</td>
</tr>
<tr>
<td></td>
<td>costs and net cash flows (sales version)</td>
<td></td>
</tr>
<tr>
<td>4.7</td>
<td>OLS regression linking other operating costs, net cash flows, change of some</td>
<td>258</td>
</tr>
<tr>
<td></td>
<td>controlling variables to the change in other receivables (sales version)</td>
<td></td>
</tr>
<tr>
<td>4.8</td>
<td>OLS regression results of change in other receivables on other operating</td>
<td>262</td>
</tr>
<tr>
<td></td>
<td>costs and net cash flows when earnings management is controlled</td>
<td></td>
</tr>
<tr>
<td>4.9</td>
<td>OLS regression linking other operating costs, net cash flows, change of some</td>
<td>263</td>
</tr>
<tr>
<td></td>
<td>controlling variables to the impairment losses (total assets version)</td>
<td></td>
</tr>
</tbody>
</table>
Table 4.10 OLS regression linking other operating costs, net cash flows, change of some controlling variables to the impairment losses (sales version) .......... 267
Table 4.11 OLS regression results of change in other receivables in both fraud and matched sample ................................................................................................................. 271
Table 4.12 OLS regression results of the determinants of other receivables (OREC). 274
Table 4.13 OLS regression results of the determinants of impairment losses (Impairment) ......................................................................................................................... 276
Table 5.1 Cumulative abnormal returns around the enforcement announcements in the short run .................................................................................................................................. 287
Table 5.2 Determinants of CARs ......................................................................................................................... 288
Table 5.3 Changes in operating performance of fraudulent firms ................................................................. 290
Table 5.4 Financial performance--before event and post event ...................................................................... 291
Table 5.5 Cumulative abnormal returns around the enforcement announcements in the long run—buy and hold abnormal returns approaches ......................................................................................... 292
Table 5.6 Cumulative abnormal returns around enforcement announcements in the long run—calendar time abnormal returns ........................................................................................................ 297
Table 5.7 Cumulative abnormal returns--Robustness test ................................................................................. 301
Table 5.8 The relationship between stock performance and other receivables ............................................. 302
Table 5.9 Cross-sectional regressions of post-event stock returns on operating performance .................................................................................................................................. 303
Table 5.10 The effects of enforcement actions from the CSRC on fraudulent firms ............................................. 304
Table 5.11 Cumulative and mean net income, dividend and grey accounts in both fraud and matched samples .......................................................................................................................... 307
Table A.2.1 Weighted probit regression results of balance sheet account values on corporate fraud indicator .................................................................................................................................. 334
Table A.2.2 Probability cutoffs that minimize the expected costs of misclassification ........................................ 336
Table A.2.3 Weighted probit regression results of balance sheet account values (scaled by sales) on corporate fraud indicator ................................................................................................. 337
Table A.3.1 Out-of-sample prediction .................................................................................................................. 339
Table B.3.4.1 Overstated balances of operating expenses and non-operating expenses in fraudulent firms .................................................................................................................................. 350
Table B.3.4.2 Overstated percentage of operating expenses and non-operating expenses in fraudulent firms .................................................................................................................................. 351
Table B.6.1 Annual loss in fraud sample .................................................................................................................. 355
Table B.6.2 Annual loss in matched sample .......................................................................................................... 355
Table B.7.1 OLS regression results of change in other receivables in three different fraudulent types.................................................................................................................................356

Table B.8.1 OLS regression results of the determinants of other receivables (OREC)359

Table B.9.1 OLS regression results of the determinants of impairment losses (Impairment).................................................................................................................................361
LIST OF FIGURES

Figure 4.1: The differences between fraudulent and matching firms in some soft balance sheet accounts ................................................................. 278
Figure 4.2: The differences between fraudulent and matching firms in some solid balance sheet accounts ................................................................. 279
Figure 4.3: The differences between fraudulent firms and matching firms in operating revenue ........................................................................................ 280
Figure 4.4: The differences between fraudulent and matching firms in some income statement accounts ........................................................................ 281
Figure 4.5: The differences between fraudulent firms and matching firms in non-operating income and non-operating expenses ............................................... 282
Figure 4.6: The relationship between TopRatio and OREC ......................................................... 283
Figure 4.7: The relationship between TopRatio and Size .......................................................... 284
Figure 4.8: The relationship between TopRatio and impairment ............................................. 285
Figure 5.1 Cumulative risk adjusted abnormal returns (CRAARs) ........................................ 308
Figure 5.2 Cumulative market adjusted abnormal returns (CMAARs) .................................. 310
Figure 5.3 Monthly cumulative abnormal returns—buy and hold abnormal returns approaches ........................................................................................................ 312
Figure 5.4 The differences between fraudulent and matching firms in selected accounts from Equation 20 .................................................................................. 316
Figure B.3.1.1 The differences between fraudulent firms and matching firms in some soft balance sheet accounts ................................................................. 344
Figure B.3.2.1 The differences between fraudulent firms and matching firms in a set of solid accounts .................................................................................. 346
Figure B.3.3.1 The differences between fraudulent firms and matching firms in operating revenue ............................................................................................ 348
Figure B.3.3.2 The differences between fraudulent firms and matching firms in other-operating costs ................................................................................................ 348
Figure B.3.4.1 The adjustment based on matching firms in a set of other-operating costs .......................................................................................................................... 352