

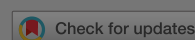
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Research Article

## Tunnelling, Fraudulent Financial Statements and Regulation Effects: Chinese Evidence

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## ABSTRACT

This study investigates the impact of regulatory intervention on tunneling through inter-corporate loans in Chinese fraudulent firms. We find fraudulent firms have significantly higher tunneling through inter-corporate loans than matching firms, and suggest that controlling shareholders are motivated to delay the recognition of the ensuing loss in the financial statements to make it more difficult for auditors to detect tunneling. In 2006, new regulations were implemented to reduce tunneling. We find that the impact of tunneling on firm performance is significantly reduced after the implementation of the regulations. Our results suggest that the means by which Chinese regulatory mechanisms have

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Q KEYWORDS: Tunneling fraudulent financial statements Chinese listed firms

Q JEL: G30 G32 G38 K22

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Supplemental data for this article can be accessed on the [publisher's website](#).

1. In 2006, the CSRC noted the pervasiveness of tunneling practices through excess borrowing by controlling shareholders, and officially labeled it “non-operational fund occupancy”.
2. The 2006 regulatory year observations are included in the analysis, but the results remain materially the same when they are excluded.
3. Due to the inherent stability of institutions, social trust can remain stable for a long period of time.
4. Using nationwide estimates from 2000 to 2010, we find that the average quarterly return on equity for firms and their subsidiaries is significantly higher than the return on equity for non-affiliated firms.
5. The VCA problem is not a

6. In our un-tabulated OLS regression results with industry and year dummies, the coefficients on FRAUD are 0.038 in the low social trust subsample and 0.080 in the high social trust subsample. Both are significant at the 1% level. The difference is also significant at the conventional level, which supports our argument that greater tunneling balances differences between fraudulent firms and matching firms occur in the high social trust provinces.

7. Similar (un-tabulated) results are also found when we industry-adjust ROA, return on equity and return on sales by subtracting the industry median to allow for potential macro-economic impacts (Tu and Yu [2014](#)).

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