Emerging Markets Finance and Trade ›
Volume 58, 2022 - Issue 3



Research Article

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

Yi Wei, Jianguo Chen & Carolyn Wirth

Pages 614-624 | Published online: 08 Sep 2020
Cite this article https://doi.org/10.1080/1540496X.2020.1816462 Check for updates



## 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, ne resolve tunnelin nd shame' of tunne d that tunnelin the anno d sample, fraudule bnormal returns f lso find that informal g tunneling. Overall, our results suggest the means by which Chinese regulatory mechanisms have

been effective in protecting minority shareholders from expropriation by controlling shareholders.

KEYWORDS: Tunneling fraudulent financial statements Chinese listed firms

JEL: G30 G32 G38 K22

## Acknowledgments

We would like to thank Paresh Kumar Narayan (the editor) and two anonymous reviewers for their helpful comments and suggestions.

## Supplemental Material

Supplemental data for this article can be accessed on the publisher's website.

# Notes

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 o ... ), using the nationwi ... n 2000 to estimate ... dquartered.

4. U ... ms and matchin ...

5. The V ... not a problem.

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).

---