

The political effects on corporate financial fraud: Evidence from China

by

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DEDICATION

I dedicate this dissertation to my loving wife, Xiaoyu Xu, who encouraged me to step out of my comfort zone and pursue my Ph.D. dream, and offered unwavering support during the process. Her love and encouragement made it possible for me to accomplish my academic journey. I will forever appreciate all she has done for me.

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NOMENCLATURE

CCP	Chinese Communist Party
CGO	Central Government Owned
CPI	Corruption Perception Index
CSMAR	China Stock Market and Accounting Research
CSRC	China Securities Regulatory Commission
RDA	Regionally Decentralized Authoritarianism
SEC	Securities and Exchange Commission
SOE	State-owned Enterprises
SSE	Shanghai Stock Exchange
SZSE	Shenzhen Stock Exchange

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ABSTRACT

Why does corporate financial fraud in China remain prevalent after the aggressive anti-corruption campaign that began in 2012? To explore this phenomenon, this study examines how the political factors embedded in China's Regionally Decentralized Authoritarian system affect the commission and detection of financial fraud. Synthesizing the political mechanisms behind regulators' selective enforcement behavior and managers' financial fraud activity, I demonstrate that four critical political factors--provincial officials' factional affiliation and retirement, social unrest, and an industry's national prominence--affect fraud commission and fraud detection in opposing directions. I employ a bivariate probit model to separately test the political effects on fraud commission and fraud detection. The findings show that regulators reduce enforcement while managers commit more fraud when provincial leaders have a factional affiliation with the national president. On the contrary, regulators strengthen enforcement, and managers commit less fraud when provincial leaders are close to retiring, local social unrest becomes intense, and when firms are in state-supported industries. This study contributes to understanding the political drivers of corruption by offering a framework that combines the mechanisms behind regulators' enforcement behavior and managers' misconduct. It also extends the knowledge of the government's influence on managerial behavior, facilitates the application of the bivariate probit approach in management studies, and provides practical insights for policymakers, investors, and due diligence-based equity research firms in combating financial fraud.

CHAPTER 1. INTRODUCTION

Corporate financial fraud has a deleterious effect on many aspects of society, including global businesses, much as any other type of corporate misbehavior deliberately committed by top executives to cheat investors and other stakeholders (Zahra et al., 2005). The negative impact of financial fraud is particularly salient in China. While having an increasing number of firms listed domestically and internationally, China's financial market faces severe enforcement failures (Du & Xu, 2009). Although the Chinese government launched an aggressive anti-corruption campaign in 2012 and declared a "crushing victory" in battling corruption in 2018 (Gan & Choi, 2018), corporate financial fraud¹ (hereafter referred to as financial fraud) remains inexplicably prevalent and constitutes a disconcerting trend.

From 2003 to 2018, the annual number of financial fraud cases prosecuted by the China Securities Regulatory Commission (CSRC) tripled from 91 to 286, while the proportion of detected fraudulent firms in all publicly listed firms also went up from 7.1% to 7.9% (See Figure 1). During the same period, financial-market practitioners witnessed an upward trend in the prevalence of financial fraud cases. For example, KPMG International Limited--one of the Big Four accounting firms--reported that it witnessed "a growing trend in pervasive and sophisticated financial reporting fraud...in both domestic private Chinese entities, and even in China subsidiaries of multinational companies and listed companies, historically considered to be at lower risk for such fraud" (KPMG, 2019: 1).

¹ Typical types of corporate financial fraud in China include failure to disclose information, false statements, disclosure delays, inflated profits, asset fabrication, insider trading, speculation, and embezzlement by major shareholders among others (Chen, G. M., Firth, M., Gao, D. N., & Rui, O. M., 2006).

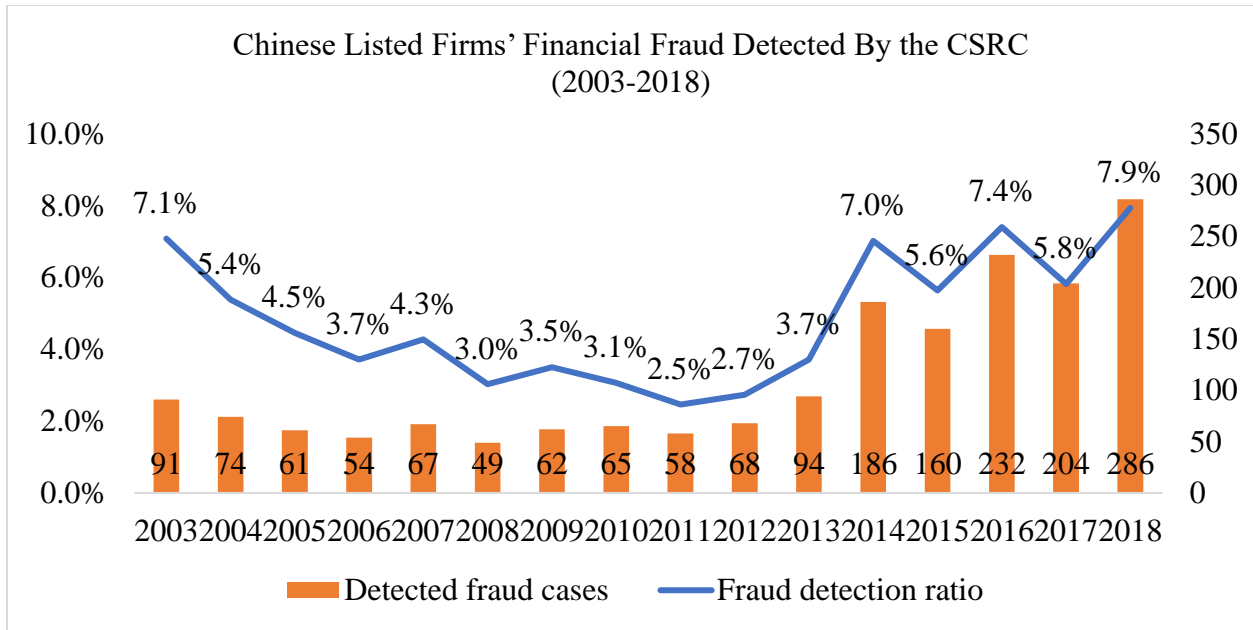


Figure 1. Financial Fraud Enforcement in China (2003-2018)

Financial fraud has become a significant threat to societies as fraudulent firms arbitrarily plunder the wealth of shareholders, disrupt economic and social order, and create social instability. Journalists report that widespread financial fraud has rendered China's stock market "full of land mines" (Shen, 2019), disrupting an array of initial public offerings and fundraising projects in China (Shen & Zhou, 2019). If the country fails to address financial fraud soon, its economy could be devastated as investors stop purchasing stock in Chinese firms (Raleigh, 2020). Now the world's second-largest economy, China's financial fraud problem has increasingly affected global investors (Alpert, 2018), raising concern among foreign stakeholders with tightly interwoven political and business relationships with China.

If we are to fully understand what propels prevalent financial fraud in China, a closer look at the two latent processes underlying financial fraud is necessary. First, a fraudulent action must be committed by managers making fraudulent decisions driven by a recognizable series of characteristics, following which it could possibly be detected by regulators whose enforcement behavior is incentivized by certain factors.

Examining the fraud detection process, while one may argue that an aggressive anti-corruption campaign might itself have contributed to the growing number of fraud cases prosecuted, reflecting regulators' intensified intentions to eradicate financial fraud, this by no means indicates that financial fraud is not rampant. On the contrary, no matter how clearly a crackdown on corruption can explain the growing number of fraud detections, the presence of a large (and increasing) scale of fraud detection per se continues to indicate pervasive and severe engagement in financial fraud across firms, possibly greater in magnitude, given the fact that not all fraudulent actions can be detected. In addition, it is more puzzling that, even if regulators' heightened vigilance driven by an aggressive anti-corruption campaign may partially explain the sharply increased number of fraud detections, this does not explain why, during the same period, both practitioners and news media have witnessed a worrying trend of more extensive fraud commission.

The classic explanation for why there is so much financial fraud in China is that illegal behavior is either condoned by or not prosecuted by the government (Jain, 2001). However, this explanation does not fit the contemporary Chinese context wherein financial fraud remains a serious problem despite the aggressive anti-corruption campaign. Hence, an understanding of financial fraud requires a familiarity with the political institutions that influence the governments' handling of illegal behavior (Rose-Ackerman, 2013) and managers' motivations to engage in fraud (Schnatterly et al., 2018).

Post-reform China is replete with sectoral and territorial economic interests (Huang, 2002), creating political institutions characterized by regulation inconsistencies and conflicts (Ring et al., 2005). Political institutions, embedded in China's Regionally Decentralized Authoritarianism (RDA) (Xu, 2011), manifest the highly-centralized political power and

personnel control exerted by the Chinese Communist Party (CCP) (subsuming the central government) and the highly-decentralized administrative implementation and resource allocations across subnational governments from provincial level down to municipal and county levels (Xu, 2015). These institutions define the political context that determines the incentives and actions of government officials, including corruption investigators lacking political independence (Yuen, 2014). Hence, law enforcement is complicated by conflicting and overlapping institutions focused on economic development rather than transparency and the rule of law (Xu, 2011, 2015, 2019). For example, political factors in this context limit the ability of the CSRC as the primary financial market regulator to make neutral and objective enforcement decisions, resulting in selective regulation enforcement (Chen et al., 2011; Xu et al., 2017).

With respect to fraud commission, research has shown that a manager's propensity to commit fraud depends on the so-called *Fraud Triangle* of *pressure*, *opportunity*, and *rationalization* that captures how much managers feel it necessary to engage in fraud, how likely they feel they are to escape detection, and how easily they can morally justify the fraud (Schnatterly et al., 2018)--all factors influenced by the behavior of government officials and regulators driven by conflicting and overlapping political institutions.

Integrating external political mechanisms underlying regulators' enforcement behavior and the internal managerial *Fraud Triangle* is particularly informative in understanding the link between political context and financial fraud. First, political factors affect managers' pressure, opportunity, and rationalization to commit fraud due to ubiquitous government intervention driven by political leaders' incentives (Wang & Luo, 2018). Second, political factors shape regulators' enforcement behavior because political dynamics constrain their incentives within the bureaucratic regime (Xu, 2019). Third, because of Chinese firms' pervasive political

embeddedness that promotes extensive interactions between managers and officials (Haveman et al., 2017), managers may be able to anticipate political effects on fraud detection and subsequently alter their decisions with respect to fraud commission (Wang et al., 2010).

This study, therefore, aims to address the research question: How does political context affect the commission and detection of financial fraud? Prior research has shown that in China's regionally decentralized authoritarian system, the political context in which Chinese firms operate can be understood as consisting of three aspects: (1) provincial leaders' incentives (Wang & Luo, 2018); (2) local province politics (Xu, 2011; Zhang & Gao, 2008), and (3) an industry's national prominence (Chen et al., 2017; Li & Lu, 2019). This suggests an explicit focus on four political influences that affect both fraud commission and fraud detection: (1) provincial officials' *factional affiliation*, (2) provincial officials' *retirement* (both factional affiliation and retirement address provincial leader's incentives), (3) *social unrest* (addresses local province politics), and (4) *national industry support* (addresses an industry's national prominence). I propose and demonstrate that when provincial leaders possess factional ties to the current national president, regulators tend to reduce enforcement and managers are more inclined to commit fraud. Conversely, when provincial leaders are about to retire, social unrest is intense, and a firms' industry receives national support, regulators tend to strengthen enforcement and managers are less likely to commit fraud. These findings also demonstrate that while political influences directly shape managers' fraudulent behavior, managers can also anticipate the political effects on regulators' selective enforcement patterns, and this too influences their decisions to commit fraud.

In short, despite China's aggressive anti-corruption campaign, so long as the pitfalls of the fundamental institutions remain, there are inevitable conflicts between the incentives of

government actors, and since the centralized regulatory system tends to lack political independence, it cannot effectively address fraud commission. Instead, when biased regulators are driven by political incentives, their enforcement behavior tends to be limited by local governmental capability and motivation to protect fraudulent firms. As Xu (2019) explicitly points out, China's most significant law-enforcement difficulties result from a lack of independent enforcement rather than incompleteness of the law. Moreover, by virtue of Chinese firms' pervasive political embeddedness, regulators' selective enforcement patterns can be anticipated by managers, potentially resulting in additional fraudulent behavior when managers believe that influential local governments may be willing and able to protect their fraudulent behavior. Expressed differently, while fraud is reduced in areas where enforcement is intense, fraud escalation appears in other areas where regulators are expected to turn a "blind eye." This is how political influences underlying the incentives of managers' fraud commission and regulators' fraud detection can help explain why financial fraud remains widespread under the aggressive anti-corruption campaign.

This study makes four contributions to management research. First, it offers an integral political framework to explain the political influence on the two latent processes of corporate financial fraud--fraud detection and fraud commission, thus enhancing the understanding of corruption in a broad sense and highlighting the importance of judicial independence to the rule of law in combating corrupt behavior. Second, it extends knowledge of how relationships among various government actors can affect private organizations, echoing the view that government is not monolithic--government actors' varying incentives may interact with one another and affect managerial behavior. Third, it helps us understand the partial observability issue of corporate financial fraud research and other management research with binary outcomes determined by

two latent processes. Finally, it provides practical insight for stakeholders such as policymakers, domestic and foreign investors, and due diligence-based equity research firms.

The remainder of the study proceeds as follows: Chapter 2 describes the fundamental institutions embedded in China's RDA regime (Xu, 2011)--the combination of political centralization and regional economic decentralization--and how these institutions define relationships between and behavioral patterns of political actors within various bureaucratic hierarchies and the political influences on both commission and detection of fraud. Chapter 3 hypothesizes the four political influences (i.e., provincial officials' factional affiliation and retirement, social unrest, and national industry support) on the commission and detection of financial fraud. Chapter 4 explains the bivariate probit model and uses it to test the hypotheses, followed by the main analysis results and the robustness test results illustrated and analyzed in Chapter 5. Finally, Chapter 6 (Conclusion) discusses how this study offers implications for a better understanding of corruption as well as the study's contributions, limitations, and suggestions for future research.

CHAPTER 2. THEORETICAL FOUNDATIONS

This chapter begins with an introduction to China's regionally decentralized authoritarian institutions (Xu, 2011), and describes how these institutions politically influence regulators' fraud detection behavior. The discussion continues to explain how the Fraud Triangle Model is employed to predict managers' fraud behavior and how political influence affects the fraud triangle. The chapter concludes with an explanation of why a holistic framework is needed to simultaneously examine fraud commission and fraud detection through the lens of political influence.

Political Institutions Embedded in the Chinese Economy

Institutions are “the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction” (North, 1990: 3). Generally, institutions include the formal organization of government and corporations as well as norms, incentives, and rules (Matten & Moon, 2008). The present study follows March and Olsen's definition of *political institutions*: “collections of interrelated rules and routines that define appropriate actions in terms of relations between roles and situations” (2010: 160). Political institutions shape the behavior of political actors, organizations, and their managers as players in society (North, 1994), and they create predictable interactions based on the players' relationships (Peters, 2019).

In post-reform China, *fundamental institutions* are described as those under regionally decentralized authoritarianism, referring to “basic and stable mechanisms that determine the incentives of the most important players in China's reform and development” (Xu, 2011: 1078). The authoritarian central government maintains tight control over personnel and resource allocation while authorizing subnational governments considerable autonomy in running the economy (Landry, 2008; Xu, 2011). This top-down personnel control promotes political

competition among local officials that motivates them to prioritize local economic development. The central government's power to mobilize and allocate resources reinforces its political control on subnational governments. Through empowering subnational officials with autonomous power to run local economies and promoting them in their jobs based on their economic performance, the central government successfully motivates economic competition among provincial governments that demonstrate desirable national economic growth (Zhou, 2014). Moreover, delegating the responsibility for maintaining social stability downward to subnational officials and holding them accountable for social unrest (Lee & Zhang, 2013), the central government effectively controls local governments that are expected to deliver social stability. Through such a political arrangement, the central government facilitates economic growth as well as maintains social stability: the two crucial goals of the party-state, helping the CCP maintain its centralized authority and legitimacy (Lin, 2011).

The RDA system has, however, intrinsic deficiencies such as incentive problems across bureaucratic hierarchies (Xu, 2019), and there is inherent information asymmetry in a hierarchical and bureaucratic system between the central government and subnational governments. The central government's top-down command implementation relies on provincial officials who are bound to know local information better than their superiors and often have incentives that vary from those of their superiors. Competing against political rivals in the "promotion tournament" (Zhou, 2007), subnational officials under the RDA regime are incentivized to maximize their territorial interests, which are well-defined under their jurisdiction, even at the expense of the central government's public goals (Huang, 2002). Subnational officials, for example, are motivated to fulfill the central government's "contractable" tasks (i.e., task performance is measurable by the central government) while

shirking on “non-contractable” tasks (i.e., task performance is not measurable by the central government), possibly ultimately deviating from central regulatory policies in costly ways (He et al., 2020). Consequently, subnational officials are both incentivized and able to deceive their superiors and the public when their self-interests are compromised, as illustrated in a familiar saying: “Where there are policies from above, there are counter-policies from below (*shang-you zhengce, xia-you duice* 上有政策，下有对策),” (Xu, 2019: 7).

Hence, the conflicting and overlapping goals and incentives of both the central and subnational governments focus on economic development rather than transparency and the rule of law (Xu, 2019). Exacerbated by information asymmetry between the “center” and localities, the incongruity between differing goals and incentives has led to strong regionalism and local protectionism (Bai et al., 2004), sometimes shaping subnational officials’ behavior when facing regulatory challenges that threaten their self-interests derived from the local economy. When regulating the financial market, these inherent institutional pitfalls may elicit undesirable regulation outcomes such as a weak rule of law and poor corporate governance.

China’s centralized regulatory enforcement approach makes the CSRC the primary financial market regulator investigating financial fraud and carrying out sanctions to punish its enactors (Cao et al., 2021; Xu & Zhu, 2017). CSRC officials perform single and relatively homogenous tasks such as protecting investors and maintaining a stable capital market, making their job performance and careers directly measurable and controlled by the central government. Failure to protect investors and deter financial fraud (i.e., party policy goals) may bring about political risks that lead to demotion (Huang, 2002). For example, Mr. Song Zhenming, the former Minister of the Petroleum Industry, was demoted in 1980 for the capsizing of an oil rig and the subsequent accident cover-up (Huang, 2002). Nonetheless, the CSRC’s inherent agency

problems also create consequences such as the previously mentioned selective regulation enforcement.

On the other hand, provincial officials face trade-offs between tasks assigned by the central government; sometimes, a task can only be performed well by sacrificing other tasks deemed less critical (Huang, 2002). To compete against rivals, local officials pervasively use their political and economic power to support local firms while reaping personal benefits from the success of favored firms through implicit arrangements (Bai et al., 2014), promoting corruption/collusion between local officials and managers (Li et al., 2018). More importantly, deep-seated regionalism can protect firms against the state's interventional behavior (Cull et al., 2017). Hence, provincial officials' incentive and capability to protect local firms may influence regulators' enforcement behavior under their jurisdiction. Figure 2 depicts the bureaucratic relationships between the central government, the CSRC, and provincial governments.

In summary, China's RDA system allows the central government to obtain its two critical goals--facilitating economic growth and maintaining social stability--through delegating subnational officials to govern localities autonomously. However, the RDA system's inherent pitfalls have resulted in conflicting and overlapping incentives for officials focused on economic development rather than transparency and the rule of law (Xu, 2019). Within this context, various government actors "initiate, negotiate, implement, divert, and resist reforms, policies, rules, and laws" (Xu, 2011: 1076). Incentive problems and the information asymmetry that exist between central and subnational officials result in strong regionalism and local protectionism (Bai et al., 2004), which further contribute to the pitfalls of fundamental institutions, creating political influences on the behaviors of local officials, regulators, and managers, and ultimately promoting ineffective regulatory enforcement and poor corporate governance.

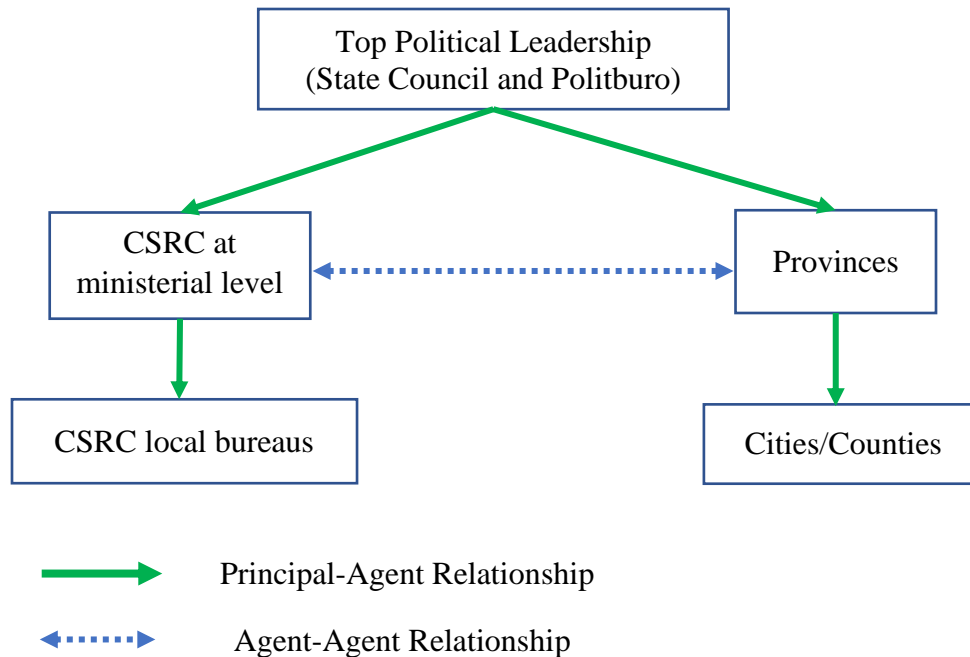


Figure 2. China's Bureaucracy Model²

Political Influence on Fraud Detection: Selective Regulation Enforcement

Political economists have acknowledged that regulatory agencies across developed and transition economies may not be neutral when proactively enforcing regulations, leading to bureaucracy, corruption, and political capture, eventually resulting in *regulatory failure* (i.e., judicial injustice and corruption brought about by biased regulators involved in proactive law enforcement) (Xu, 2019; Xu & Pistor, 2006). Regulatory failure is drastic in China because regulators face political interference from superiors and other administrative actors (Xu, 2019). The situation is not likely to be mitigated when there is only one primary regulator (i.e., the CSRC) in the financial market whose enforcement behavior is limited by upper political supervisors and constrained by other political actors.

² This model is adapted from Huang's (2002) Principal-Agent perspective which depicts the two-level (control and controlled) Chinese bureaucratic structure.

As mentioned in the previous chapter, China has a centralized regulatory approach. It is different from the multi-enforcer approach to securities fraud deterrence adopted by the United States, where the Securities and Exchange Commission (SEC), federal agencies, and state agencies such as the Department of Justice and the State Attorney's Office can independently enforce securities laws (Rose, 2009). Established in 1992 under the State Council, the CSRC's primary goal is to protect minority shareholders and improve financial-market efficiency (Qu et al., 2013). Relying on its 38 regional offices that exercise front-line supervisory actions across provinces, the Beijing-headquartered CSRC central office enforces the Securities Law in each province (Cao et al., 2021; Xu et al., 2017). The CSRC has established its credibility (Yiu et al., 2018) because its law enforcement actions and penalty can impose both severe economic and legal damage to fraudulent firms and political jeopardy to government officials (Chen et al., 2011; Chen et al., 2005).

Although the CSRC has full authority to interpret and enforce the Securities Law (Pistor & Xu, 2004, 2005), it is embedded in and controlled by the central government (Zhang, 2014; Zhou, 2015), where government officials' incentives can influence regulators' law enforcement actions for two reasons. First, prevalent bargaining between government agencies and similar bureaucratic ranks and political resources renders Chinese policymaking and regulations inefficient (Lampton, 1992; Zhang, 2014). When regulators launch fraud investigations in a province, conflicting incentives and interests trigger bargaining between regulators and local officials, possibly hamstringing fraud detection in that province. Second, law enforcement costs require regulatory agencies to execute regulations designed to optimally meet overall goals (Dai & Yang, 2006). Thus, regulators decide on when, where, and how to prioritize law enforcement actions to fit with their own interests and generate the best enforcement outcomes with minimal

political risks. These two reasons work in concert to shape regulators' selective enforcement of national laws and regulations, producing "fragmented authoritarianism" (Lieberthal & Oksenberg, 2020; Mertha, 2009) in which regulatory enforcement is constrained by other political and economic powers such as the state-ownership systems (Howson, 2013). The CSRC, for example, favorably treats state-owned enterprises (SOEs)--especially central-government-owned (CGO) firms--while imposing disproportionately harsher enforcement on non-SOEs (Xu et al., 2017). As such, political institutions limit the CSRC's ability and incentive to make neutral and objective enforcement decisions (Chen et al., 2011).

In summary, regulatory failure happens when non-neutral regulators become involved in proactive law enforcement and generate judicial injustice and corruption. Within China's political context, regulators can be biased by their relative lack of independence and thus impose selective enforcement based on their incentives and constraints. Patterns of selective enforcement are determined by both political incentives and bargaining processes operating among regulators and local officials.

Political Influence on Fraud Commission: The Fraud Triangle

Recent management research has provided insight into common antecedents of financial fraud by applying the *Fraud Triangle* from the accounting literature (e.g., Mansor & Abdullahi, 2015; Wells, 2014). The *Fraud Triangle*'s three components are *pressure*, *opportunity*, and *rationalization*. That is, managers' propensity to commit fraud depends on how much they feel necessary to engage in fraud (i.e., *pressure*), how likely they are to escape detection (i.e., *opportunity*), and how easily they can morally justify a fraud (i.e., *rationalization*) (see Greve et al., 2010; Schnatterly et al., 2018).

Within the Chinese context, deep-seated regionalism and local protectionism influence the local economy because subnational officials tend to favor local firms by providing critical

resources and favorable regulation and justice decisions (Zhou, 2010). More importantly, subnational governments “sometimes [directly] provided political protection for these firms against the predatory behavior of the state.” (Cull et al., 2017: 461). Because of Chinese firms’ pervasive political embeddedness that promotes extensive interactions between managers and local government officials (Haveman et al., 2017), political influences that define local officials’ motivation and capability to protect local firms may affect not only regulators’ selective enforcement behavior, but also managers’ perceived pressure, opportunity, and rationalization to commit fraud.

In general, managers’ pressure, opportunity, and rationalization that determine their propensity to commit fraud can be influenced by government officials’ incentives and behaviors. Hence, fraud commission can be affected by the political context in which firms operate.

Fraud Commission and Fraud Detection Combined: A Holistic Political Framework

We can only observe fraudulent acts first committed then subsequently caught, and sometimes even the same antecedent can differently affect the probability of committing fraud and the probability of its detection. For example, Khanna et al. (2015) found that personal connections between CEOs and board members increase the likelihood of fraud commission while decreasing the likelihood of fraud detection. Moreover, since managers can perceive the effects of certain ex-ante factors (For a detailed explanation of ex-ante factors, see Wang, 2013) on fraud detection and subsequently change their decision to commit fraud (Wang, Winton, and Yu, 2010), we must analyze the mechanisms of fraud detection separately from those underlying the fraud commission (Dyck et al., 2013). Accordingly, the present study aims to develop a coherent political framework that synthesizes specific political influences on regulators’ enforcement actions with managers’ propensity to commit fraud.

Prior studies have contended that the RDA political context in which Chinese firms operate can be understood as consisting of three aspects: (1) provincial leaders' incentives (Wang & Luo, 2018); (2) local province politics (Xu, 2011; Zhang & Gao, 2008); and (3) an industry's national prominence (Chen et al., 2017; Li & Lu, 2019). These three aspects are directly related to the central government's two fundamental goals: facilitating economic growth and maintaining social stability, and can significantly influence the behavior of local government officials, regulators, and managers. Therefore, I focus on four specific political influences revolving around the three aspects that affect both fraud commission and fraud detection: provincial officials' factional affiliation and retirement (both address provincial leaders' incentives), social unrest (addresses local province politics), and national industry support (addresses national prominence of an industry).

Effects on the behavior of subnational officials and regulators aside, the three political aspects generate ex-ante factors that may affect both the probability of fraud detection and the probability of committing fraud in opposing directions. As such, these ex-ante factors directly affect fraud detection, and managers' perception of these direct effects on fraud detection may subsequently influence their decisions to engage in fraud. This accounts for how the ex-ante factors indirectly influence top management fraud decisions (Wang et al., 2010). These ex-ante factors also create specific political and economic environments that directly affect managers' sense of pressure, opportunity, and their rationalization to commit fraud. Therefore, the following chapter will first explicate the specific political effects on fraud detection and then proceed to the political effects on fraud commission (See Figure 3 for the conceptual model of corporate financial fraud).

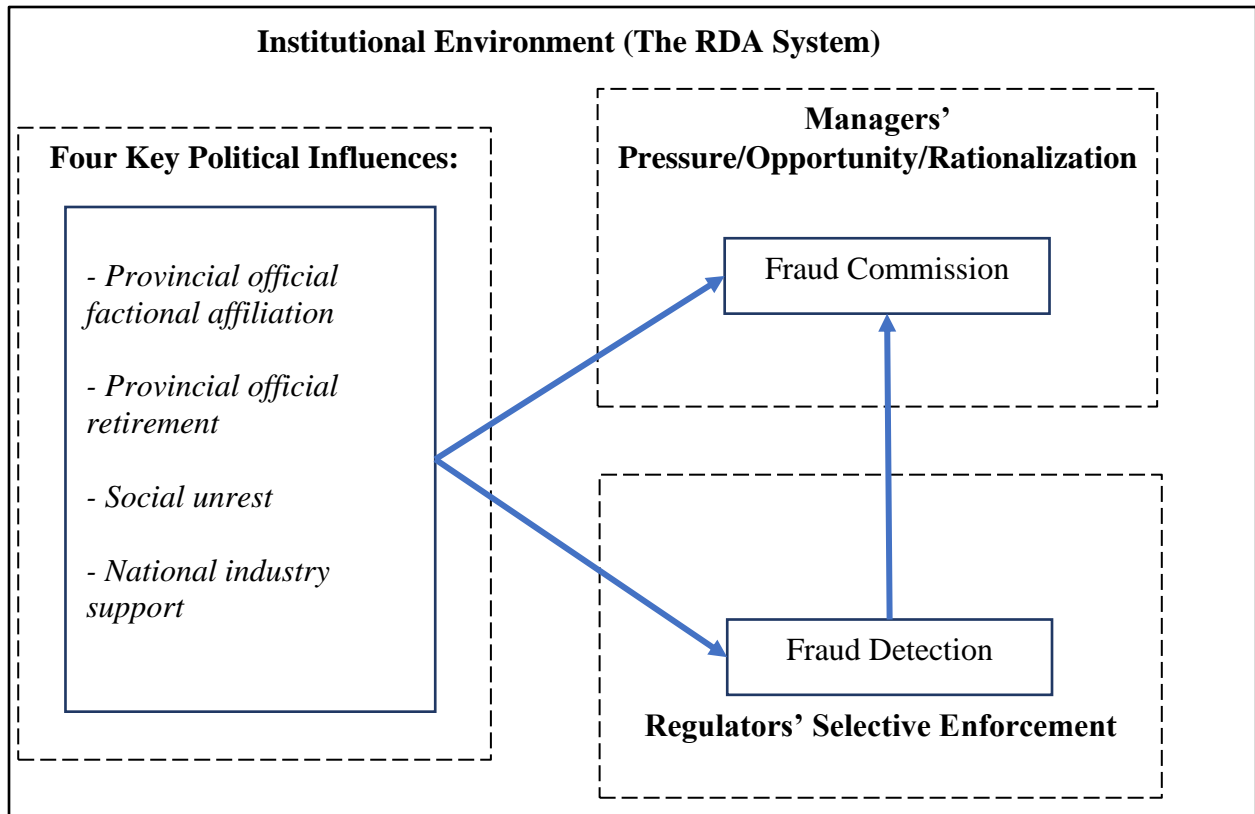


Figure 3. The Conceptual Model of Political Influence on Financial Fraud

CHAPTER 3. HYPOTHESES

Research has shown that three components of China's RDA political context--(1) provincial leaders' incentives (Wang & Luo, 2018); (2) local province politics (Xu, 2011; Zhang & Gao, 2008), and (3) an industry's national prominence (Chen et al., 2017; Li & Lu, 2019)--can influence the behavior of local government officials, regulators, and managers. To explore the political effects of financial fraud, this chapter is focused on four specific political influences to directly address the three aspects that affect both fraud commission and fraud detection: provincial officials' factional affiliation and retirement (both address provincial leaders' incentives), social unrest (addresses local province politics), and national industry support (addresses national prominence of an industry). I will first hypothesize how each political influence affects provincial officials' ability and willingness to intervene with the local economy and protect managers while motivating regulators to selectively choose when and where to enforce securities-oriented regulations, then move on to hypothesizing how each affects managers' pressure, opportunity, and rationalization--factors that determine their propensity for committing fraud.

Provincial Officials' Factional Affiliation and Financial Fraud

Provincial officials compete with rivals in the "promotion tournament" to deliver higher economic growth through regionalism and local protectionism. However, outstanding economic performance is not the only factor that determines their promotion chances. *Factional affiliation* with the top national leader also matters in provincial officials' promotions (Choi, 2012; Opper et al., 2015). Defined as a patron-client group of mutually connected elite officials (Nathan Andrew, 1973), factional affiliation consists of personal relationships with followers and powerful leaders in a hierarchical context (Pye, 1981). Factional affiliation between provincial

officials and top national leaders can be formed through a shared birthplace, overlapping educational institutions attended, or shared work units (Lieberthal & Oksenberg, 1990; Shih et al., 2012). In the post-reform era, politicians' factional affiliation remains a strong determinant of the Chinese political hierarchy (Meyer et al., 2016).

Factional affiliation in terms of a patron-client relationship between the top national leader (i.e., the patron) and local factional officials (i.e., the client) brings two advantages to the latter: political protection from both disciplinary sanctions and political attacks (Jiang, 2018; Scott, 1972), and critical resource allocations from the top leader to factional localities (Francois et al., 2016). These two advantages tend to give provincial officials with factional ties both motivation and capability to protect local firms that influence regulators' incentives and capability to detect fraud in different provinces.

Political protection from the top national leader can help officials avoid anti-corruption investigations, political attacks, and disciplinary sanctions (Jiang, 2018; Lorentzen & Lu, 2018; Scott, 1972). Moreover, studies on political selection decision-making show that the dominant strategy of risk reduction for officials is to signal loyalty to the party center in Beijing, especially during corruption crackdowns (Li & Manion, 2019). Unlike peers without factional ties, provincial officials with factional ties have less urgency to signal loyalty to the party center, and as such, they could instead capitalize on their advantageous political position for the pursuit of territorial interest within their jurisdiction.

Through negotiations and interactions between bureaucrats, regulators can perceive the political clout of provincial officials with factional ties. The dominant risk reduction strategy for officials applies to regulators because they also need to signal loyalty to the top leader. Hence, to reduce political risks, regulatory officials are incentivized to avoid violating the tight patron-

client relationship between factional provincial officials and the top leader. Even when occupying the same administrative level as peers without factional ties as well as the Chairman of the CSRC, provincial officials with factional ties--thus, protected by the current president--possess more bargaining power when facing securities regulatory enforcement under their jurisdiction. Provincial officials with factional ties, therefore, have a greater capacity to discourage regulators' enforcement actions under their jurisdiction.

Critical resource allocation--another advantage that factional officials may receive from powerful patrons (Francois et al., 2016)--grants provincial officials affiliated with the current national president an advantage in developing the regional economy through scarce resource allocation such as economic resources and office distributions (Shih, 2004; Shih, 2008; Tsai & Nathan, 1995). To compete with political rivals in the promotion tournament (Zhou, 2007), provincial and lower-level officials may use their political and economic power to support local businesses by "exercising political power to lobby the central government for the right to break the rules, to utilizing economic resources to strike special deals by providing cheap credit, improving infrastructure and offering land below market price" (Bai et al., 2014: 2). In some cases, local officials provide direct political protection for local firms against the interventional behavior of the state (Cull et al., 2017). Local officials are also motivated to maximize their territorial interest (Huang, 2002; Zhou, 2010) by supporting local firms because they can reap personal benefits from the success of favored firms through implicit arrangements such as bribes, private consumption, and equity stakes (Bai et al., 2014).

Fraud detection and subsequent penalties can impose severe political risks on local officials in the promotion tournament as well as economic damage that is detrimental to their territorial interest (Chen et al., 2011; Chen et al., 2005). The CSRC's independent fraud

detection can be thwarted by local officials motivated to conceal fraud under their jurisdiction (Chen & Kung, 2019). If, as argued, enhanced protection for local firms further encourages cronyism marked by corruption and collusion between officials and managers (Li et al., 2018), then compared to their non-factional peers, factional provincial officials will have a more significant stake in the local economy that renders them more motivated to protect local firms from a regulator's fraud detection.

To summarize, provincial officials with factional ties have the political capability to thwart fraud investigations through their political clout. They can also use such clout to protect local firms from other central government constraints. This causes factional officials and their subordinates to have a personal stake in the success or failure of local firms. Taken together, provincial officials with factional ties have both more capabilities and motivations to thwart fraud investigation under their jurisdiction than their non-factional peers due to their more powerful political standing in the bureaucratic regime and their more personal stake in the local economy. To avoid political risks that may frustrate officials with political clout, regulators will be inclined to reduce law enforcement actions in factional provinces. Therefore:

Hypothesis 1a. Provincial officials' factional affiliation with the current national president is negatively related to the probability of detecting fraudulent firms.

Given that pervasive political embeddedness in Chinese firms has created close interactions between managers and government officials (Haveman et al., 2017), if provincial leaders with factional ties to the top leader lead to a reduced likelihood of fraud investigation in their provinces, managers will be more likely to perceive that the reduced likelihood of fraud detection creates an opportunity for fraud. More specifically, the "Crony Capitalism with Chinese Characteristics" exhibits the CCP's startling tolerance of officials' exploitation of

private benefits resulting from interactions with local firms (Bai et al., 2014). Pervasive interactions between managers and local government officials may allow managers to perceive factional provincial leaders' enhanced motivation and more substantial capability to discourage regulators' enforcement actions. Managers may believe that they are shielded by factional officials willing to protect local interests and capable of doing so. Hence, managers may perceive more opportunities to commit fraud because they expect that their fraudulent actions are protected and thus avert detection (Dorminey et al., 2012).

Furthermore, by having political and economic advantages granted by the top leader, factional provincial officials may be more motivated to and capable of developing stronger regionalism and local protectionism that helps them compete with political rivals and maximize their territorial interest (Zhou, 2010), even "at the expense of the encompassing interests of the whole system" when fulfilling their multiple tasks (Huang, 2002: 67). Such an incentive may render factional provincial officials less concerned about local managers' fraudulent actions (e.g., delay in disclosure, inflated profits, or fabrication of assets) because these actions can promote local tax revenue and benefit local officials. Given the breadth and depth of a firm's political embeddedness that highlights pervasive interactions between government officials and managers in China (Haveman et al., 2017), in provinces led by factional provincial officials, managers are likely to perceive the enhanced regionalism and local protectionism in their day-to-day business and interactions (or even collusions) with local officials. A factional official's motivation to maximize a territorial interest at the expense of the whole system through enhanced regionalism and local protectionism can nurture an environmental norm in the province that promotes managers' mentality of benefitting themselves at the expense of the much broader group of stakeholders and society. The perception of enhanced regionalism and local

protectionism in that province may thus increase managers' "it is Okay" mentality in rationalizing the commission of fraud because it is easier to rationalize fraud if "everyone is doing it." (Schnatterly et al., 2018: 2418).

In brief, the motivation and capability of provincial leaders with factional ties may enhance local protectionism and influence regulators' enforcement, thus cultivating perceived opportunities and rationalization for managers to commit fraud.

Hypothesis 1b. Provincial officials' factional affiliation with the current national president is positively related to the probability of firms committing financial fraud.

Provincial Officials' Near-Retirement Status and Financial Fraud

Provincial officials' career prospects vary over time in China. Even though the law stipulates that every tenure is five years in length, research has shown that the actual tenure lengths of provincial officials range from one year to thirteen years (Cao et al., 2014). Between 1978 and 2004, the age of provincial officials ranged from 42 to 75, and their average age was 59 (Zhang & Gao, 2008). At any point in time, some provincial officials are in the early career stage while others are approaching the end of their political lives.

Outside the political labor market, other than moving up along the bureaucratic ladder, Chinese government officials have few options; thus, their perception of a future career becomes a significant behavioral incentive (Li & Zhou, 2005). Young officials have more to gain or lose in the promotion tournament, while retiring officials are usually less concerned about future promotion, so government officials' incentives may thus be dissimilar owing to their disparate career prospects. For example, compared to their retiring peers, young provincial officials who have an extensive time period to accomplish career advancement tend to focus on meeting the central government's "hard targets" such as facilitating local economic growth, to maximize

their own career outcomes (Wang & Luo, 2018), and in so doing they are more likely to interact with local firms and endorse local managers (Lin, 2011). In contrast, lacking incentives to impress the central government with economic achievements, retiring provincial officials at the end of their career stage may be less motivated to promote regionalism and local protectionism (Guo, 2009). Instead, retiring provincial officials naturally have heightened needs for signaling their compliance to the central government (Li & Manion, 2019).

Despite losing power after leaving the provincial leader position, provincial officials usually do not fully step down after retirement age because the central government typically assigns them to an honorary position such as director of the provincial People's Congress (Li & Zhou, 2005). Furthermore, provincial officials have usually gone through an intense political selection process. More importantly, their careers tend to be highly limited in a stable internal political labor market, helping them form more robust ties between officials and adhering them to one another (Rauch & Evans, 2000). Since retiring provincial officials can still expect to exploit their established political ties for personal gain after retirement, with fewer chances of being scrutinized, rather than actively competing in the promotion tournament (Zhou, 2007) and maximizing their territorial interest (Huang, 2002), provincial officials approaching the end of their career are apt to focus on a career "soft-landing" associated with the desire of "retiring in peace" (Wang & Luo, 2018). The resulting weaker motivation in enhancing regionalism and local protectionism and a stronger focus on a career "soft-landing" tend to make retiring provincial officials more willing to support regulatory enforcement under their jurisdiction, thereby increasing the likelihood of regulators enforcing securities regulation in retiring officials' provinces and enhancing their ability to detect fraud.

Moreover, retiring provincial officials' career prospects reflect their weakening political power because the principal-agent relationship between them and the central government who delegates them the power is coming to an end. Thus, even if retiring officials are less willing to cooperate with or impede regulators' enforcement, they may possess less bargaining power over regulators or influence the latter's law enforcement decision since they are of the same bureaucratic rank. Finally, compared to retiring officials, factional or young provincial officials are more likely to become national leaders in the future, overseeing the regulators and possibly retaliating against those who previously launched law enforcement under their jurisdiction. This risky scenario for regulators is not likely to happen when a provincial official is retiring, implying much less political risk to regulators.

In summary, provincial officials' closeness to retirement often signals an inclination to "retire in peace," reflecting the officials' weakened bargaining power and enhanced willingness to cooperate, as well as reduced potential political risks to regulators. Thus, since conducting fraud detection under retiring officials' jurisdiction may become a rational choice for regulators, fraud detection is more likely to occur in a province when the provincial leader is retiring.

Hypothesis 2a. Provincial officials' closeness to retirement is positively related to the probability of detecting fraudulent firms.

As previously discussed, retiring provincial officials are more likely to support regulators' enforcement under their jurisdiction. Even if retiring officials are unwilling to cooperate with or intend to impede regulators' enforcement, they possess less bargaining power over regulators. Hence, extensive interactions between managers and local government officials prompt managers to become aware of retiring provincial leaders' enhanced willingness to support regulatory enforcement and their weakened capability to discourage enforcement,

leading to retiring officials' reduced motivation and capability to protect local managers. Hence, managers' perception of more regulatory risks and less protection from local officials may reduce their perceived opportunities to commit fraud.

In order to enjoy a "soft-landing" at the end of their career, retiring provincial officials are motivated to make few political mistakes. When the need to avoid political risks becomes more salient, provincial officials are more likely to intervene in the local economy through regulating managerial behavior (Wang & Luo, 2018). Furthermore, to signal loyalty to the central government and avoid political risks (Li & Manion, 2019), retiring provincial leaders are inclined to control collusion and corruption among their subordinates and managers to eradicate potential risks that could threaten their retirement. Provincial party secretaries, for example, generally hold a Provincial Party Standing Committee Meeting twice each month. However, they also have the discretion to hold ad hoc meetings any time to carry out other tasks, such as warning local officials and managers to refrain from corrupt acts. Retiring officials' heightened risk-averse tendencies may lead to more substantial control of corruption and eventually decrease managers' opportunities to commit fraud.

Moreover, retiring provincial officials' decreased motivation to engage in the promotion tournament and maximize their territorial interest will reduce regionalism and local protectionism. In provinces led by retiring officials, since managers may perceive the reduced emphasis on regionalism and local protectionism through day-to-day interactions with local officials, reduced regionalism and local protection may nurture an environmental norm in the province that stifles a manager's "it is Okay" mentality in rationalizing the commission of fraud (Schnatterly et al., 2018).

All in all, a combination of retiring provincial officials' enhanced risk-averse tendencies to control corruption with their weakened capability to discourage regulators' enforcement may contribute to managers' perception of fewer opportunities to commit fraud. At the same time, retiring provincial officials' reduced attention to regionalism and local protectionism will decrease managers' rationalization in committing fraud. Taken together, I posit that managers will be less likely to engage in fraud when under retiring provincial officials' jurisdiction.

Hypothesis 2b. Provincial officials' closeness to retirement is negatively related to the probability of firms committing financial fraud.

Social Unrest and Financial Fraud

In contemporary China, facilitating economic growth and maintaining social stability have become two crucial goals of the party-state that help the CCP gain centralized authority and legitimacy (Lin, 2011). Contrary to the assumption that rapid economic growth would lead to greater stability (Scott, 2011), the number of "mass incidents" (e.g., public protests) in China increased from 8,700 in 1993 to a range between 180,000 and 230,000 by 2010 (Göbel & Ong, 2012). Such a fast-growing trend of social unrest has made the maintenance of social stability (*weiwèn* 维稳) a "pressing political agenda in China" (Liu, 2017: 222). Threats to social stability have since then become even more critical to local officials in the twenty-first century because the central leadership attempts to avoid social instability at all costs (Gries & Rosen, 2004). Under the RDA regime, Chinese leaders have repeatedly emphasized the critical role of social stability (Bai et al., 2006), and to secure the party-state's authority and legitimacy, the central leadership, has shifted the responsibility for maintaining social stability downward to local governments and holds local officials accountable for this daunting task (Lee & Zhang, 2013). Thus, the future career prospects of local party secretaries can be jeopardized by poor

performance evaluation related to social instability (Zang, 2004). That is, the careers of local officials can be in jeopardy if social unrest such as strikes and protests by workers occur frequently under their jurisdiction (Elfstrom & Kuruvilla, 2014).

Historically, the need for maintaining a stable capital market has been paramount to the central government (Borst & Lardy, 2015). Answering the central government, the CSRC has a motivation to maintain the stability of the financial market and society. The CSRC has reiterated on multiple occasions its mission statement of maintaining a stable capital market and has also emphasized social stability.

Financial fraud generates significant negative externalities to a society that incurs direct and indirect losses suffered by stakeholders such as employees, shareholders, suppliers, customers, and the government. For example, financial fraud can cause direct monetary loss to investors; in extreme cases, it can even incur delisting of public firms, imposing more significant losses on investors and suppliers as well as unemployment (Reurink, 2018). Moreover, regardless of whether fraud is discovered, efforts to avoid its detection can distort the business decisions of fraudulent firms and their competitors (Velikonja, 2012), thus causing further negative externalities to society. All these negative social consequences of financial fraud can induce emotional instability along with various appeals and complaints by employees, shareholders, and suppliers--thus causing collective actions that create social instability.

As Xu states: “regulatory law enforcement must do and only do the things that the court is not able to do, that is, proactive prevention, to complement the court’s reactive law enforcement.” (Xu, 2019: 10). Regulators are fully aware of the importance of proactive prevention in deterring financial fraud. For example, Mr. Jiang Yang, former Vice Chairman of the CSRC, at the 2018 Chinese People’s Political Consultative Conference, pointed out that there

are 130 million investors in China's capital market, and many families are involved. Since stabilizing society requires the capital market to be stabilized, more severe penalties are needed to deter financial fraud (CSN, 2018). Social unrest is often related to protesters' demanding to address social issues such as land encroachment, environmental pollution, and politicians' malfeasance and corruption (Wang & Luo, 2018). By resulting in more protests, these social issues may signal an environment that promotes fraudulent behavior and triggers regulators' vigilance to detect fraud proactively. Moreover, the CSRC does launch investigations based on various leads such as investor complaints, insider whistleblowing, and media reports, among other leads (Chen et al., 2005). Since intense social unrest in a province may bring up more leads, inducing regulators to launch fraud investigations, to resolve political risks that promote social instability, regulators are more likely to selectively enforce regulation in provinces at a time when social unrest becomes intense.

Failing to maintain social stability, which is institutionalized in China's cadre management system, can directly lead to the nullification of a local official's achievements, such as fulfilling economic and social welfare goals (Dickson, 2003; Edin, 2003). The ability to maintain social stability is critical to local officials because social instability can negatively influence their political careers (Fu & Distelhorst, 2018) and subsequently affect their behavior. An extreme example is that in order to repress social unrest, local officials sometimes resort to extralegal means such as intimidating persistent petitioners (Cai, 2010). By unleashing public fury and inciting collective actions, fraudulent corporate activities can cause social instability, resulting in government officials encountering imminent and salient political risk.

Recent research has shown that local governments are motivated to enforce tighter environmental regulation on pollutions when their territorial interests are immediately

encroached upon (He et al., 2020). Similarly, when collective actions such as labor strikes and protests become more intense, provincial officials will tend to prioritize the heightened need to maintain social stability over promoting regionalism and local protectionism because the need to maintain social stability now becomes the most critical political task. When facing the heightened need for maintaining social stability, both provincial officials and regulators will be more vigilant to fraudulent acts that could incur further social instability. Thereby, provincial officials and regulators may be motivated to tighten financial fraud monitoring and work more closely to deter fraud.

Hypothesis 3a. The intensity of local social unrest is positively related to the probability of detecting fraudulent firms.

In such a case, if fraud detection is more likely to happen and there are pervasive interactions between managers and government officials, then a manager's perceived opportunity for committing fraud is decreased. Research also shows that the need for maintaining social stability influences officials' governance behavior at every bureaucratic level. For example, because both central and provincial governments concern about social stability, they are not motivated to privatize SOEs because privatization of SOEs may give rise to worker layoffs and loan write-offs that could result in social instability (Bai et al., 2006). At a lower bureaucratic level, county government officials are also more responsive to citizen demands when facing collective actions (Chen et al., 2016). Notably, when the need for maintaining social stability becomes imminent, local officials are more likely to influence managers' behaviors. Wang and Luo (2018), for example, find that when local labor protests and strikes are intense, to avoid social instability, provincial officials pressure local firms to acquire bankrupt SOEs and reemploy laid-off workers. In this way, driven by the need to maintain social stability,

government officials' governance and interventional behaviors can fundamentally affect firm activities (Pearce et al., 2009).

When government officials more actively attend to a firm's fraudulence, their incentives are more likely to influence managers' behavior (Pearce et al., 2009). Intense collective actions under their jurisdiction will render both provincial officials and subordinates more vigilant and more willing to intervene in mitigating the fraudulent activities of managers. When social unrest in a province becomes intense, provincial officials, as agents required to fulfill the objectives of the central government, are incentivized to more actively seek immediate appeasement of social unrest. In such a case, provincial officials will tend to be more alert to corporate scandals and thus more incentivized to tighten control over financial fraud by warning local firms to avoid fraud and disciplining corrupt acts such as collusion between sub-provincial officials and fraudulent firms. As mentioned earlier, since failing to meet the target of maintaining social stability can lead to nullification of other achievements of local officials (Dickson, 2003; Edin, 2003), local officials facing intense social unrest will be more likely to refrain from getting involved in and impacted by fraud that could aggravate social instability. In short, local officials' incentives under the pressure of maintaining social stability and their subsequent behavior will result in fewer opportunities for managers to commit fraud.

Province-wide tightened control over fraud will create an environmental norm that discourages corrupt behavior. Managers perceiving this norm through their business operations and the interactions with local officials may thus be less able to rationalize the commission of fraud. Moreover, since collective actions such as labor strikes and protests are often related to resistance to corruption (Elfstrom & Kuruvilla, 2014), protesters often strategically position their movement as a lawful action helping the government combat corruption and local abuse of

power (Göbel & Ong, 2012). In terms of rationalization, this will further weaken managers' ability to justify their fraudulent activities. Taken together, when the number of local collective actions rises, local governments' and regulators' tightened monitoring on fraudulent activities and protesters' anti-corruption appeal jointly take effect to decrease managers' perceived opportunities and their rationalization for committing fraud. This means that when collective actions become intense in a province, managers' propensity to commit fraud will decrease due to their perception of fewer opportunities and reduced rationalization.

Hypothesis 3b. The intensity of local social unrest is negatively related to the probability of firms committing financial fraud.

National Industry Support and Financial Fraud

Under the RDA regime, China's economic model has been organized around substantial government intervention in the economy by which the central government establishes industrial policies to guide government projects and help achieve economic development. As China has grown into the world's second-largest economy over the past decades, perhaps the most long-lasting and significant influence has been China's *Five-Year Plans*. Inherited from the former Soviet Union's central planning system, China started its Five-Year Plans in 1953 and has implemented thirteen of them, pervasively and profoundly influencing the Chinese economy through government project development and helping to achieve party-state goals (Morck & Yeung, 2014).

Hence, the central government aims to fulfill China's long-term policy goals by supporting specific industries in each of the Five-Year Plans (Chen et al., 2017). For example, the Thirteenth Five-Year Plan (2016–2020) provides national support for industries such as information and communications, new energy and materials, aeronautics and astronautics, biomedicine, and smart manufacturing. These plans also stipulate favorable policies regarding

bank loans, taxes, subsidies, government approval, and other measures to encourage and support strategically important industries (Du et al., 2014; Lim et al., 2018). Local governments then implement these centrally-planned industrial policies to impact their local economy and China's financial market (Chen et al., 2017).

Prior research suggests that the proportion of firms subject to the CSRC's enforcement actions varies across industries (e.g., Chen et al., 2005). The Organization Department of the CCP ensures that cadres work in concert with party policies. Since party members and government employees comprise the cadre system, local official's and regulator's job security, their promotion prospects, and capability to advance subordinates' careers all hinge on how well they can demonstrate cooperation with party policies (Deng et al., 2015). Thus, fraudulent activities committed by firms in state-supported industries are likely to have substantial political and widely-spread societal consequences that negatively affect the performance and political career of regulators and local officials.

Moreover, such consequences could trigger further anti-corruption investigations of officials responsible for perceived dereliction of duty. In this sense, because of the prioritized responsibility to their superiors and enhanced potential risk of dereliction of duty, regulators may more vigilantly pursue fraud investigations in state-supported industries such as those stipulated in the Five-Year Plans. For the same reason, since local officials are also more likely to collaborate and cooperate with regulators' enforcement actions in state-supported industries, fraud detection in state-supported compared with non-state-supported industries is more likely to happen.

Hypothesis 4a. National industry support is positively related to the probability of detecting fraudulent firms.

If, as argued, regulators are more likely to enforce securities regulations in state-supported industries and encounter fewer obstacles, during their day-to-day business interactions with local officials, managers may perceive this law enforcement pattern and find fewer opportunities to commit fraud. Moreover, if managers in state-supported industries enjoy the benefit of being supported by the government, it is more difficult for them to morally justify fraud. Research has shown that perceived norms of fairness bind managers' intentions to maximize their personal interests. In competitive situations, managers' perceived unfair treatment can lead to negative reciprocal behaviors, while perceived fair treatment results in positive reciprocal behavior (Bosse & Phillips, 2016; Bosse et al., 2009). In state-supported industries' competitive situations, favorably treated managers are therefore even less likely to exhibit fraudulent behaviors due to their stifled rationalization of committing fraud.

A significant body of research has highlighted that industry characteristics significantly affect top managers' propensity to commit fraud (Zahra et al., 2005). "Knowing that a firm operates in a particular industry may be a good indicator in predicting the likelihood of that firm's engaging in illegal behavior" (Baucus & Near, 1991: 28). With respect to the unfavourability of a firm's primary industry's competitive conditions, environmental hostility marked by "low or declining demand, strict regulatory rules, intense competition, low profit margins, and a high rate of organizational failures" (Zahra et al., 2005: 810) will increase pressure on managers to engage in financial fraud. For example, challenging industry conditions such as competing in a declining industry or increased regulations can trigger fraud (Apostolou et al., 2001). Operating in declining industries or those with below-average performance tends to reduce a firm's slack resources and weakens its capability to cope with adversity, thus increasing the likelihood of management fraud (Hansen et al., 1996; Staw & Sz wajkowski, 1975).

Conversely, favorable industry conditions should mitigate fraud, and hostile competitive conditions are less likely to be present in state-supported industries sponsored by the Five-Year Plans. Compared to firms in non-supported industries, those in state-supported industries receiving favorable policy treatment enjoy increasing demand, less fierce competition, less strict regulations, more slack resources through critical resource allocation, and more opportunities to succeed (Chen et al., 2017). For example, firms in state-supported industries have a lower debt load (Lim et al., 2018), meaning that their managers have less need for external financing and are subject to less financial default-related stress (Johnson et al., 2009). So, managers of firms operating in state-supported industries will perceive less pressure prompting them to commit financial fraud.

In terms of financial incentives at the individual level, prior accounting research has shown that executives are motivated to avoid negative earnings surprises because their cash bonuses will probably suffer if their firms fail to meet quarterly earnings forecasts (e.g., Brown, 2001; Matsumoto, 2002; Matsunaga & Park, 2001). Since firms in state-supported industries generally enjoy higher stock market returns and higher cashflow growth (Chen et al., 2017), their executives will have less pressure to take the risk of committing fraud to inflate the stock price and receive higher compensation (Shi et al., 2016).

In summary, managers of firms in state-supported industries should be less motivated to commit financial fraud because of fewer opportunities, weakened rationalization, and reduced pressure.

Hypothesis 4b. National industry support is negatively related to the probability of firms committing financial fraud.

CHAPTER 4. METHODS

Sample

The sample consists of all the Chinese firms listed on the Shanghai Stock Exchange (SSE) and the Shenzhen Stock Exchange (SZSE) from 2003 to 2018. I began the sample period in 2003 for several reasons. China promulgated the Securities Law in December 1998, officially stipulating that the CSRC is the primary regulator of the Chinese securities market (Chen et al., 2005). The CSRC then issued the Code of Corporate Governance for Listed Companies in January 2002, setting forth the basic principles for “the means for the protection of investors’ interests and rights, the basic behavior rules and moral standards for directors, supervisors, managers and other senior management members of listed companies.” (CSRC, 2002). The collected social unrest data also began in 2003. The final sample shows that there were not many enforcement actions before 2003.

I first obtained data about corporate financial fraud enforcement actions from CSRC’s Enforcement Actions Research Database maintained by the China Stock Market and Accounting Research (CSMAR). This database contains financial fraud information of all listed companies on the SSE and the SZSE that have violated regulations since 1994, including violation information such as enforcement action year, violation year, and violation type collected from three sources: (1) corporate announcements of CSRC investigation published by listed companies, (2) reports from the news media officially designated by the CSRC, and (3) announcements issued by regulatory agencies (Shi et al., 2020). According to CSMAR, corporate announcements of CSRC investigations published by listed companies appear irregularly and inconsistently. By manually checking the dataset, I also found a high level of violation cases overlapping between the corporate announcement of CSRC investigation and the officially

announced enforcement action by regulatory agencies, so this study includes only the official financial fraud enforcement actions promulgated by the CSRC head office, its local regulatory agencies, the SSE, and the SZSE. This resulted in 1,811 observations of fraud enforcement announcements for the 16-year sample period, accounting for approximately 5.1% of the total of 35,687 observations. This means that 5.1% of the firm-year observations represent detected fraud.

Based on the collection of Chinese government officials' biographical data from the website of Chinese political figures (cpc.people.com.cn, run by the state-affiliated People's Daily), I manually coded provincial party secretaries' factional affiliation with the current President for each year. The dataset contains 114 provincial party secretaries³ from all 31 provincial administrative units through the two different administrations in power between 2003 and 2018 (i.e., President Hu Jintao: 2003-2013, President Xi Jinping: 2013-present). I then merged the provincial party secretary dataset with the following five datasets: (1) Corporate financial fraud enforcement actions promulgated by the CSRC head office and its local offices from CSMAR, (2) Financial data of Chinese listed firms from CSMAR, (3) State-supported industries identified by the Five-Year Plans from the Chinese Research Data Services Platform (CNRDS), (4) Labor strikes and protests records (2003-2012) from the website "China Strikes" combined with labor strikes and protests data (2013-2018) from the website "China Labor Bulletin." (5) Province marketization index published by the National Economic Research Institute (NERI). All these data sources have been widely used in management studies and research in finance, accounting, economics, and political science.

³ The provincial party secretary is the de facto leader of a province and at the same administrative level as the CSRC Chairman.

Measures

Dependent variable

Fraud enforcement. The CSRC engages in regular reviews and random inspections of listed firms and securities firms, and its investigations are based on information from stakeholders such as employees, investors, news press, stock exchange, and police investigations⁴ (Chen et al., 2006; Shi et al., 2020; Xu, 2018). The dependent variable of this study is *fraud enforcement*, consistent with prior fraud studies (e.g., Chen et al., 2018; Connelly et al., 2017; Harris & Bromiley, 2007; Shi et al., 2017; Yiu et al., 2018). *Fraud enforcement* is measured using a binary variable that captures the enforcement of corporate financial fraud occurrences officially announced by the CSRC head office, its local regulatory agencies, the SSE, and the SZSE. I assigned a value of 1 for each officially announced corporate financial fraud enforcement of a firm in a specific year and 0 for nonfraud observations, regardless of when and how many times the firm committed fraud.

Independent variables

Provincial official factional affiliation. Provincial party secretaries' *factional affiliation* with the current national president is a binary variable measured by the occurrence of birthplaces, educational institutions, or work units shared among provincial party secretaries and the national president (Lieberthal & Oksenberg, 1990; Meyer et al., 2016; Shih et al., 2012). If a provincial party secretary had a shared birthplace, educational institution, or work unit with the current national president in a given year, the provincial party secretary's *factional affiliation* with the current national president was coded as 1, and as 0 otherwise.

⁴ For a more detailed description of the CSRC's regulatory enforcement procedure, see Xu (2018).

Provincial official retirement. For provincial officials' proximity to retirement, I measured *provincial official retirement* for provincial party secretaries. According to Li and Zhou (2005), a typical cyclical pattern of provincial leader change is that it often occurs around the National Congress. This suggests that the number of political terms provincial party secretaries can serve depends on the number of the National Congresses of the CCP (occurrence every five years: in 2007, 2012, and 2017 during our sample period) they could attend before reaching the required retirement age of 65 (Li & Zhou, 2005). I coded *provincial official retirement* as 1 if a retiring provincial secretary served the last political term before the next congress and 0 otherwise (Wang & Luo, 2018).

Social unrest. Following Wang and Luo (2018), I measured *social unrest* as the number of labor strikes and protests in a province each year. I obtained labor strike and protest data (2003-2012) from the website "China Strikes," the most comprehensive data source covering publicly reported labor unrest (Elfstrom, 2017). However, since "China Strikes" only addresses labor strikes and protest records occurring between 2003 to 2012, I reached out to "China Strikes," and following the website founder's recommendation, I obtained additional labor strike and protest data (2013-2018) from the website "China Labor Bulletin," that also records labor strikes and protests in China and is widely used in China studies, although it started in 2011 (Elfstrom, 2019; Yang & Chen, 2019). To measure the consistency of the two sources, I compared records from January 2011 to December 2012 to determine when they had overlapping records. During these two years, "China Strikes" documented 548 cases of verified labor strikes and protests nationwide, while "China Labor Bulletin" documented 566 cases of verified labor strikes and protests nationwide, reflecting a highly consistent record.

National industry support. I measured *national industry support* by checking whether the focal firm was involved in an industry identified in the corresponding Five-Year plan (Chen et al., 2017). I collected this data from the Chinese Research Data Services Platform (CNRDS). From 2003 to 2018, *national industry support* of firms in the industries identified by the Tenth (2001–2005), Eleventh (2006–2010), Twelfth (2011–2015), and Thirteenth (2016–2020) Five-Year Plans was coded as 1, and as 0 otherwise.

Control variables

Following previous corporate financial fraud studies described in the management, finance, and accounting literature (e.g., Chen et al., 2006; Shi et al., 2017; Wang, 2013; Yiu et al., 2018), I first controlled for factors found to influence both the probability of fraud detection and the probability of fraud commission. These factors include a range of firm-level characteristics such as *firm size*, *firm age*, *firm performance*, *foreign auditor*, *state ownership*, *foreign ownership*, and *CEO central government tie*. I controlled for *firm size* by measuring the natural logarithm of the focal firm's total assets and for *firm age* by using the length of years since the firm was listed (Arthaud-Day et al., 2006; Wang, 2013). I measured *firm performance* using the return on assets (ROA) and *foreign auditor* using a binary variable indicating whether the focal firm employed a foreign auditor. Firms employing foreign auditors were coded as 1 and 0 otherwise. Chinese regulators have illustrated a tendency toward selective law enforcement by differentiating with respect to firm ownership. The CSRC has shown selective enforcement of regulation by treating SOEs favorably while imposing disproportionately harsher enforcement on non-SOEs (Chen et al., 2011). Since the Ministry of Commerce is also more stringent on foreign firms than on SOEs when enforcing the Anti-Monopoly Law on acquisitions (Zhang, 2011), I controlled for *state ownership* and *foreign ownership* using two continuous variables measured by the percentage of ownership shares held by the Chinese government and foreign shareholders,

respectively. Since a firm CEO's political connection may influence regulators' selective enforcement of regulation and firms' propensity to engage in fraud, I also controlled for the focal firm's *CEO central government tie*, using a binary variable coded as 1 if the focal firm's CEO has served as a government official in the central government and 0 otherwise. I used the CSRC's industry classification to include eighteen industry dummies, allowing control for industry effects, i.e., some industries such as the technology, service, and trade sectors may have higher fraud concentration than others (Wang, 2006). Finally, I included year dummies to control for time effects.

I then controlled for a range of variables that uniquely affect the possibility of fraud detection because these factors were found to signal potential problems of particular firms that drew regulators' vigilance and attention and were thus more likely to trigger fraud investigation (Ma & Khanna, 2016; Shi et al., 2020; Wang et al., 2010; Yiu et al., 2019). These factors included *CEO turnover*, *industry litigation*, *annual stock return*, *abnormal ROA*, and *abnormal return volatility*. *CEO turnover* was coded as 1 for CEO turnover in a given year and 0 otherwise. *Industry litigation* was measured using the natural logarithm of the annual total market values of all litigated firms in an industry. I controlled for *annual stock return* to account for potential targeting of regulators on firms with sharp stock return changes. *Abnormal return volatility* is measured by the demeaned standard deviation of monthly stock returns in a year. I also controlled for *abnormal ROA* using the residual from the regression: $ROA_{i,t} = \alpha_0 + \alpha_1 ROA_{i,t-1} + \alpha_2 ROA_{i,t-2} + \varepsilon_{i,t}$ (Shi et al., 2017; Wang, 2013).

Finally, this study controlled for a group of firm-level variables that directly influence managers' incentives to engage in fraud. These factors are *CEO duality*, *external financing need*, *independent director ratio*, *management ownership*, *sales growth*, and *firm leverage*. If a firm's

CEO also serves as the chairman of the board, this firm is more likely to engage in fraud (Kesner et al., 1986). I controlled for *CEO duality* by assigning a value of 1 to *CEO duality* if a CEO was also the board chair and 0 otherwise. Since a need for external financing represents a firm's financial pressure and is found to be positively associated with fraud commission (Teoh et al., 1998), I controlled for *external financing need* by measuring how much in excess the focal firm's asset growth rate is to the maximum internally financeable growth rate (Demirgüç-Kunt & Maksimovic, 1998; Shi et al., 2017). I similarly controlled for *firm leverage*, measured by the ratio of total short- and long-term debt to total assets. Since Beasley (1996) found that firms with lower independent director ratios and lower growth are more likely to commit fraud, I controlled for *independent director ratio* using the number of independent board members divided by the total board size and for *sales growth* by using the focal firm's annual revenue growth rate. Prior research has also found that equity-based incentives reduce managers' desire to engage in financial fraud (O'Connor Jr et al., 2006), so I controlled for *management ownership* measured by the percentage of shares held by top managers of the focal firm. I also controlled for the province-level *market development* to capture institutional environment variation at the province level. *Market development* was measured by the NERI marketization index (Fan et al., 2018).

Model Specifications--Bivariate Probit Models with Partial Observability

One challenge in fraud research is that instead of directly observing all frauds committed, we can only observe detected fraud, the product of the probability of fraud commission and the probability of fraud detection (Wang et al., 2010). Most prior corporate financial fraud research, however, does not consider this partial observability issue and instead assumes that every committed fraud is detected, an improbable condition (Yiu et al., 2018). Ignoring the partial observability problem can bias findings because a given corporate governance antecedent can have opposite effects on the probability of committing fraud and the probability of detecting

fraud (Wang, 2013). A univariate probit model cannot distinguish between a variable that increases the probability of fraud commission and one that increases the probability of fraud detection. Most importantly, if, as posited, political influences such as ex-ante factors' have opposite effects on fraud detection and fraud commission, and in conventional univariate probit models, such opposite effects may either cancel one another or one effect may overrule the other,. Hence, without differentiating between the probability of fraud detection and the probability of fraud commission, conventional univariate probit models may produce biased results and lead to incorrect inferences (Wang, 2013).

To address this partial observability issue, Poirier (1980) and Feinstein (1990) independently designed bivariate probit models that allow for solving the identification problem in corporate financial fraud research (Wang, 2013). This study, therefore, adopts such a bivariate probit approach to estimate the probability of fraud commission and the probability of fraud detection separately, allowing for testing whether (as I posit) political factors affect the probability of fraud commission and the probability of fraud detection oppositely. Specifically, following Poirier (1980) and more recent studies such as Wang (2013), Yiu et al. (2018), and Chen et al. (2018), I model fraud enforcement as a function of the joint realizations of two latent variables: the probability of fraud commission (F_i) and the probability of fraud detection (D_i):

$$F_i = x_{F,i}\beta_F + u_i,$$

$$D_i = x_{D,i}\beta_D + v_i,$$

Where F_i denotes firm i's incentive to commit fraud, and D_i denotes the firm's probability of being detected conditional on its fraud commission. What can be observed is Z_i -- the product of F_i and D_i :

$$Z_i = F_i \times D_i$$

Where $Z_i = 1$ if firm i has committed fraud and subsequently detected; $Z_i = 0$ if firm i has not committed fraud ($F_i = 0$) or has committed fraud ($F_i = 1$) but that has not been detected ($D_i = 0$). The empirical model for Z_i is:

$$P(Z = 1) = P(F_i \times D_i = 1) = P(F_i = 1, D_i = 1) = P(F_i > 0, D_i > 0) = \Phi(x_{F,i}\beta_F, x_{D,i}\beta_D, \rho),$$

$$P(Z = 0) = P(F_i \times D_i = 0) = P(F_i = 0, D_i = 0) + P(F_i = 1, D_i = 0) = 1 - \Phi(x_{F,i}\beta_F, x_{D,i}\beta_D, \rho),$$

Where Φ denotes the bivariate standard normal cumulative distribution function. Prior studies have used the maximum-likelihood method to estimate the above model. The log-likelihood function for the model is:

$$\begin{aligned} L(\beta_F, \beta_D, \rho) &= \sum_{Z_i=1} \log(P(Z_i = 1)) + \sum_{Z_i=0} \log(P(Z_i = 0)) \\ &= \sum_{i=1}^N \{z_i \log[\Phi(x_{F,i}\beta_F, x_{D,i}\beta_D, \rho)] + (1 - z_i) \log[1 - \Phi(x_{F,i}\beta_F, x_{D,i}\beta_D, \rho)]\} \end{aligned}$$

I selected two different subsets of variables for the probability of fraud detection and the probability of fraud commission (See Table 1) because we cannot obtain full identification of the bivariate probit model parameters if $x_{F,i}$ and $x_{D,i}$ contain the same variables (Poirier, 1980). Regarding fraud commission determinants, following prior studies (e.g., Chen et al., 2018; Shi et al., 2017; Wang, 2013; Yiu et al., 2018), I used variables that reflect internal governance and the external environment, such as *CEO duality, external financing need, independent director ratio, management ownership, sales growth, leverage, and provincial market development*. While these factors are likely to affect managerial incentives for the fraud, they are not directly related to whether such fraud would be detected by external regulation. In terms of fraud detection determinants, Wang (2013) categorizes fraud detection determinants into ex-ante factors and ex-post factors. Ex-ante factors' (e.g., officials' heterogeneous incentives) effects on fraud detection can be perceived by managers and thus influence their fraud decisions. The focus of this study--

provincial official factional affiliation and retirement, social unrest, and national industry support are all ex-ante factors of financial fraud. Following prior studies (e.g., Chen et al., 2018; Shi et al., 2017; Wang, 2013; Yiu et al., 2018), I also controlled for other ex-ante variables such as *firm size, firm age, firm performance, foreign auditor, state ownership, foreign ownership, and CEO central government tie*.

On the other hand, prior research has shown that some ex-post factors may affect only the likelihood of initiating a fraud investigation without influencing managers' ex-ante motivation to commit fraud (Wang, 2013). Following prior studies, I controlled for ex-post factors such as *CEO turnover, industry litigation, annual stock return, abnormal ROA, and abnormal return volatility* used in prior studies (e.g., Chen et al., 2018; Shi et al., 2017; Wang, 2013; Yiu et al., 2018). All variables are summarized in Table 1. Descriptive statistics and correlations of all variables are reported in Table 2. I also include descriptive statistics for financial fraud enforcement announcements during the 2003-2018 period by province (see Panel A) and industry (see Panel B) in Table 3.

Table 1. Model Specifications--Bivariate Probit Model with Partial Observability⁵

<i>Fraud Commission</i>	<i>Effect</i>		<i>Fraud Detection</i>	<i>Effect</i>
CEO duality	+			
External financing need	+			
Independent director ratio	-			
Management ownership	-			
Sales growth	-			
Leverage	+			
Market development	-			
<i>Feedback from Detection</i>			<i>Ex-Ante Detection</i>	
Firm size	-/+	←	Firm size	-/+
Firm age	-/+	←	Firm age	-/+
Firm performance	-	←	Firm performance	-/+
Foreign auditor	-	←	Foreign auditor	-
State ownership	-/+	←	State ownership	-/+
Foreign ownership	-/+	←	Foreign ownership	-/+
CEO central government tie	+	←	CEO central government tie	-
Provincial official factional tie	+	←	Provincial official factional tie	-
Provincial official retirement	-	←	Provincial official retirement	+
Social unrest	-	←	Social unrest	+
National industry support	-	←	National industry support	+
			<i>Ex-Post Detection</i>	
			CEO turnover	+
			Industry litigation	+
			Annual stock return	-
			Abnormal ROA	+
			Abnormal return volatility	+

⁵ This table is developed from Wang's (2013) model specification table.

Table 2. Descriptive Statistics and Correlation

Variable	Mean	S.D.	Min	Max	1	2	3	4	5	6	7	8	9	10
1 Financial fraud	0.05	0.22	0.00	1.00	1.00									
2 CEO duality	0.27	0.44	0.00	1.00	0.03	1.00								
3 External financing need	0.32	5.88	-48.88	415.60	0.00	0.00	1.00							
4 Independent director ratio	0.37	0.06	0.00	0.80	0.01	0.02	0.01	1.00						
5 Management ownership	0.08	0.16	0.00	0.89	-0.02	0.13	0.00	0.12	1.00					
6 Sales growth	0.22	0.66	-0.88	7.78	-0.01	0.01	0.25	0.01	0.03	1.00				
7 Leverage	0.49	0.27	0.03	3.89	0.08	-0.04	0.01	-0.03	-0.26	0.02	1.00			
8 Market development	7.96	1.96	-0.30	11.11	0.00	0.05	-0.01	0.07	0.23	-0.01	-0.13	1.00		
9 Firm size	22.00	1.47	10.84	30.95	-0.06	-0.15	0.03	0.07	-0.13	0.03	0.17	0.14	1.00	
10 Firm age	10.22	6.00	0.00	28.00	0.06	-0.17	0.02	0.03	-0.42	-0.02	0.19	-0.01	0.21	1.00
11 Firm performance	0.03	0.08	-0.85	0.40	-0.14	-0.05	0.01	0.00	0.10	0.17	-0.38	0.07	0.12	-0.06
12 Foreign auditor	0.04	0.21	0.00	1.00	-0.02	0.01	-0.01	0.02	-0.07	-0.01	0.08	0.06	0.30	-0.02
13 State ownership	0.11	0.20	0.00	0.97	-0.05	0.07	0.01	-0.15	-0.25	0.05	0.07	-0.21	-0.03	-0.13
14 Foreign ownership	0.01	0.05	0.00	0.89	-0.02	0.02	0.00	0.00	-0.01	0.00	-0.03	0.03	-0.02	-0.08
15 CEO central government tie	0.02	0.13	0.00	1.00	0.00	0.09	0.00	0.03	-0.01	0.00	0.01	0.00	0.10	0.00
16 Provincial official factional tie	0.32	0.47	0.00	1.00	0.00	0.05	-0.01	-0.02	0.00	0.00	0.02	0.12	-0.01	-0.08
17 Provincial official retirement	0.61	0.49	0.00	1.00	0.01	-0.07	0.00	0.05	0.04	-0.02	-0.04	0.07	0.11	0.05
18 Social unrest	57.00	82.17	0.00	417.00	0.02	-0.01	0.01	0.11	0.25	0.00	-0.13	0.38	0.12	0.04
19 National industry support	0.42	0.49	0.00	1.00	-0.01	-0.02	0.00	0.01	0.12	-0.01	-0.09	0.08	-0.05	-0.08
20 CEO turnover	0.22	0.41	0.00	1.00	0.05	-0.06	0.03	0.01	-0.06	0.05	0.07	-0.04	-0.01	0.05
21 Industry litigation	21.24	1.63	16.08	23.46	0.02	-0.14	0.00	0.17	0.26	-0.01	-0.19	0.21	0.21	0.13
22 Annual stock return	0.21	0.83	-0.88	15.21	-0.03	-0.06	0.05	-0.01	-0.02	0.11	0.03	-0.05	-0.07	-0.05
23 Abnormal ROA	0.00	0.08	-0.87	0.78	-0.09	-0.04	0.02	-0.01	0.03	0.20	-0.20	0.02	0.06	-0.02
24 Abnormal return volatility	0.13	0.10	0.01	5.94	0.03	-0.03	0.11	0.03	0.03	0.14	0.04	-0.03	-0.10	-0.01
Variable	11	12	13	14	15	16	17	18	19	20	21	22	23	24
11 Firm performance	1.00													
12 Foreign auditor	-0.01	1.00												
13 State ownership	-0.01	0.09	1.00											
14 Foreign ownership	0.04	0.01	-0.02	1.00										
15 CEO central government tie	0.03	0.03	-0.03	-0.01	1.00									
16 Provincial official factional tie	0.00	0.01	0.10	0.00	0.01	1.00								
17 Provincial official retirement	0.00	-0.03	-0.12	-0.03	0.02	-0.12	1.00							
18 Social unrest	0.04	-0.04	-0.27	-0.01	0.01	-0.08	-0.17	1.00						
19 National industry support	0.02	-0.01	-0.07	0.00	-0.01	-0.01	-0.01	0.12	1.00					
20 CEO turnover	-0.09	0.01	0.04	0.00	-0.03	-0.01	0.00	-0.03	-0.02	1.00				
21 Industry litigation	0.11	-0.08	-0.45	-0.01	0.02	-0.12	0.18	0.41	0.29	-0.05	1.00			
22 Annual stock return	0.12	-0.02	0.05	0.01	0.00	-0.02	0.00	-0.01	0.01	0.01	-0.01	1.00		
23 Abnormal ROA	0.91	0.00	0.01	0.02	0.02	0.00	-0.01	0.01	0.01	-0.04	0.06	0.15	1.00	
24 Abnormal return volatility	-0.03	-0.05	0.00	0.00	-0.01	-0.03	0.01	0.09	0.02	0.04	0.03	0.46	0.00	1.00

Table 3. Descriptive Statistics for Regulatory Enforcement (2003-2018)

Panel A: Percentage and Number of Fraud Cases by Province

Province	Percentage of fraud cases	Number of fraud cases	Province	Percentage of fraud cases	Number of fraud cases
Gansu	13.44%	52	Neimenggu	5.11%	19
Qinghai	12.57%	22	Shanghai	4.84%	147
Ningxia	11.76%	22	Fujian	4.67%	59
Guangxi	10.19%	48	Jiangxi	4.62%	23
Hainan	8.75%	35	Anhui	4.62%	51
Chongqing	7.09%	40	Guangdong	4.57%	230
Tianjin	6.64%	38	Hebei	4.53%	31
Jilin	6.60%	37	Guizhou	4.47%	14
Heilongjiang	6.56%	33	Zhejiang	4.27%	151
Shanxi	6.33%	33	Yunnan	4.16%	18
Sichuan	6.12%	79	Beijing	4.10%	125
Hubei	5.74%	71	Jiangsu	3.99%	130
Liaoning	5.71%	54	Tibet	3.64%	6
Xinjiang	5.58%	36	Henan	3.47%	31
Hunan	5.35%	54	Shaanxi	3.28%	19
Shandong	5.13%	103	Total	5.07%	1,811

Table 3 Continued

Panel B: Percentage and Number of Fraud Cases by industry

Industry	Percentage of fraud cases	Number of fraud cases	Industry	Percentage of fraud cases	Number of fraud cases
Education	15.85%	13	Scientific research/ technology service	5.50%	17
Agriculture/forestry/livestock/farming/fishery	8.56%	44	Mining	5.07%	51
Comprehensive	8.48%	29	Manufacturing	4.89%	1,008
Culture/sports and entertainment	6.26%	33	Construction	4.65%	43
Finance	6.24%	61	Water conservancy/environment/Public facilities management	3.93%	19
Leasing and commerce service	6.13%	33	Hygienism/social work	3.70%	5
Wholesale/retail	5.74%	124	Utilities	3.53%	51
Information transmission/software/information technology service	5.70%	128	Transportation	2.41%	30
Real estate	5.67%	112	Resident service/repair/other service	0.00%	0
Hotel and catering	5.52%	8	Total	5.07%	1,811

CHAPTER 5. RESULTS

Main Analysis

The probability of committing fraud and the probability of fraud detection were simultaneously estimated in a single model. In the bivariate probit model, I used robust standard error clustered at the firm level to address the potential threat of heteroscedasticity. To avoid endogeneity caused by simultaneity (i.e., reverse causality) (Hill et al., 2021) and account for the one-year median time between fraud investigation of the violation and the official enforcement announcement shown in the final sample⁶, I employed a one-year lag for the independent variables in estimating both the probability of committing fraud and the probability of detecting fraud. All continuous variables were winsorized at the 1% and 99% levels to mitigate the effect of extreme outliers. To address the potential multicollinearity issue, I calculated individual variance inflation factors (VIFs). The individual VIF ranges from 1.02 to 6.70, and the average VIF is 1.71, all below the commonly accepted VIF value of 10, thus ruling out multicollinearity concerns (Cohen et al., 2013).

Univariate analysis: Characteristics of fraud versus non-fraud firms

I used two-tailed *t*-tests to compare characteristics of fraudulent firms with those of non-fraudulent firms to determine whether there are significant differences in their sample means. Table 4 presents the comparison of characteristics of fraudulent and non-fraudulent firms. Compared to non-fraudulent peers, fraudulent firms are significantly smaller, bear more leverage, have lower sales growth, lower return on assets, and less stock return, while facing more litigation and less state ownership and foreign ownership. In addition, fraudulent firms are

⁶ The one-year median time for fraud investigation is in line with prior studies (e.g., Li et al., 2014) and reported by news media (investigation time from 6 months to 2 years, averaged at 13 months).

more likely to have powerful CEOs and higher CEO turnover while less likely to hire a foreign auditor. These results are consistent with prior studies. I found no significant differences between fraudulent and non-fraudulent firms with respect to provincial leaders' factional affiliation and closeness to retirement. However, fraudulent firms are more likely to be found in regions with a higher intensity of collective actions and less likely to appear in state-supported industries.

Bivariate probit test: The main results

Table 5 presents coefficient estimates of the bivariate probit model. $P(F)$ refers to the probability of corporate financial fraud commission, and $P(D|F)$ represents the probability of corporate financial fraud detection conditional on fraud commission. I found broad support for the hypotheses. In terms of provincial leader's characteristics, I posited in Hypotheses 1a and 1b that the provincial party secretary's factional affiliation with the current President is negatively related to the probability of the detection of fraudulent firms and that this "shielding" effect would be perceived by managers and thus enhance their propensity to commit financial fraud. The estimated coefficient of provincial party secretary's factional affiliation to fraud detection in $P(D|F)$ was negative and statistically significant ($\beta = -0.24$, $p = 0.02$). Conversely, the coefficient of provincial party secretary's factional affiliation to fraud commission in $P(F)$ was positive and statistically significant ($\beta = 0.20$, $p = 0.07$), lending support to Hypotheses 1a and 1b.

Hypotheses 2a and 2b posit that a provincial party secretary's closeness to retirement is positively related to the probability of detecting fraudulent firms and that this effect would be perceived by managers, adding to the effect that discourages managers from engaging in financial fraud. The estimated coefficient of provincial party secretary's closeness to retirement to fraud detection in $P(D|F)$ was positive and statistically significant ($\beta = 0.27$, $p = 0.00$).

Table 4. Comparison of Fraudulent and Non-Fraudulent Firms

Characteristics	Non-fraudulent firms	Fraudulent firms	Difference	<i>t</i> -statistics	<i>p</i> -value
Size	21.89	21.58	0.31	8.70	0.00
Leverage	46.50%	58.60%	-12.10%	-17.90	0.00
Sales growth	22.80%	19.40%	3.40%	2.10	0.03
ROA	3.50%	-1.60%	5.10%	26.60	0.00
Stock return	21.60%	13.70%	8.00%	3.85	0.00
Litigation	21.30	21.38	-0.08	-2.05	0.04
State ownership	11.40%	7.00%	4.40%	8.90	0.00
Foreign Ownership	1.30%	0.50%	0.70%	4.70	0.00
Management owner	10.90%	7.00%	4.00%	8.45	0.00
CEO duality	29.80%	32.70%	-2.90%	-2.60	0.01
CEO turnover	26.20%	30.40%	-4.30%	-4.00	0.00
Independent board	36.70%	37.00%	-0.30%	-2.20	0.03
Foreign Auditor	4.40%	2.80%	1.70%	3.45	0.00
Provincial official factional tie	30.90%	30.10%	0.70%	0.70	0.49
Provincial official retirement	60.20%	61.90%	-1.70%	-1.40	0.17
Social unrest	0.00	0.07	-0.07	-2.85	0.00
National industry support	43.30%	40.30%	3.00%	2.55	0.01

Table 5. Results of Bivariate Probit Regression

Dependent variable: Fraud enforcement	P(F)		P(D F)	
	Coefficient	Standard Error	Coefficient	Standard Error
<i>Fraud Commission Factors</i>				
CEO duality	0.04	(0.03)		
External financing need	0.00	(0.00)		
Independent director ratio	-0.00	(0.17)		
Management ownership	-0.11	(0.11)		
Sales growth	-0.00	(0.02)		
Leverage	0.22**	(0.09)		
Market development	-0.01	(0.02)		
<i>Ex-Ante Factors</i>				
Firm size	-0.14***	(0.03)	0.11**	(0.05)
Firm age	0.01	(0.01)	-0.01	(0.01)
Firm performance	-1.44**	(0.59)	-1.43	(1.17)
Foreign auditor	-0.30	(0.24)	0.25	(0.29)
State ownership	-0.09	(0.23)	-0.27	(0.27)
Foreign ownership	-0.91	(1.15)	0.72	(1.70)
CEO central government tie	0.01	(0.29)	0.06	(0.54)
Provincial official factional tie	0.20*	(0.11)	-0.24**	(0.11)
Provincial official retirement	-0.21**	(0.09)	0.27***	(0.10)
Social unrest	-0.15***	(0.06)	0.17**	(0.08)
National industry support	-0.19***	(0.06)	0.18*	(0.09)
<i>Ex-Post Detection Factors</i>				
CEO turnover			0.07*	(0.04)
Industry litigation			-0.07	(0.05)
Annual stock return			-0.04	(0.04)
Abnormal ROA			1.18**	(0.55)
Abnormal return volatility			0.95	(0.63)
Industry dummy variables	Included		Included	
Year dummy variables	Included		Included	
Constant	3.21***	(0.77)	-1.10	(1.27)
Observations	21,005		21,005	
Chi-squared	988.15		988.15	
Log pseudolikelihood = -4108.58				

Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1. Standard errors adjusted for 2,744 clusters in firm.

In contrast, the coefficient of a provincial party secretary's closeness to retirement to fraud commission in P(F) was negative and statistically significant ($\beta = -0.21$, $p = 0.02$). So Hypothesis 2a and Hypothesis 2b are supported.

Regarding the hypotheses related to social stability, the results show that the coefficient of provincial-level social unrest to fraud detection in P(D|F) was positive and statistically significant ($\beta = 0.17$, $p = 0.03$), while the coefficient of provincial social unrest to fraud commission in P(F) was negative and statistically significant ($\beta = -0.15$, $p = 0.01$), supporting hypothesis 3a and hypothesis 3b, suggesting that fraud detection is more likely to happen in provinces with more intense social unrest where fraud commission is discouraged. Finally, the results demonstrate that the coefficient of national industry support to fraud detection in P(D|F) was positive and statistically significant ($\beta = 0.18$, $p = 0.05$). In contrast, the coefficient of national industry support to fraud commission in P(F) was negative and statistically significant ($\beta = -0.19$, $p = 0.00$). So Hypothesis 4a and Hypothesis 4b receive support, showing that regulators are more vigilant in detecting fraud in firms receiving state support, and managers in state-supported industries can perceive this tendency and are thus more likely to stay away from engaging in fraud.

Effect size: The magnitude of political influence on financial fraud

With respect to the effect sizes, provincial officials' factional affiliation increases a firm's probability of committing fraud by 5.8% and decreases the probability of fraud detection by 3.6%, meaning that out of every 100 publicly listed firms, there will be six more firms committing fraud and four additional fraudulent firms escaping detection. Compared to the real fraud detection rate (5.1%) of all listed firms in the entire sample, this represents a 114% increase in fraud commission and a 71% decrease in fraud detection, indicating significant

impacts on both fraud commission and fraud detection. Provincial officials' retirement decreases the firm's probability of committing fraud by 6.0% and increases the probability of detection by 3.7%. Meaning that, out of every 100 publicly listed firms, there are six fewer firms committing fraud and four additional fraudulent firms getting caught. Compared to the real detection rate (5.1%), this represents a 118% decrease in fraud commission and a 73% increase in fraud detection.

Furthermore, one standard deviation increase of social unrest (i.e., 82 labor protests) in a province decreases a firm's probability of committing fraud by 4.2% and increases the probability of detection by 2.4%. Meaning that, out of every 100 publicly listed firms, there are four fewer firms committing fraud and two additional fraudulent firms getting caught. Compared to the real detection rate (5.1%), this represents an 82% decrease in fraud commission and a 47% increase in fraud detection. Finally, national industry support increases the firm's probability of committing fraud by 5.3% and increases the probability of detection by 2.3%. Meaning that, out of every 100 publicly listed firms, there are five fewer firms committing fraud and two additional fraudulent firms getting caught. Compared to the real detection rate (5.1%), this represents a 104% decrease in fraud commission and a 45% increase in fraud detection. Overall, these four political factors all have significant practical influences both on fraud commission and fraud detection.

Supplementary Analysis and Robustness Checks

Supplementary analysis: The standard univariate probit model

The bivariate probit estimation relies on the accuracy of the exclusion restrictions--the variables modeled to affect only fraud commission or fraud detection, but not both. I also ran the conventional univariate probit model that has been used in many prior fraud studies and compared results with those of the bivariate probit model. The coefficients in these models

differed, especially those of the ex-ante factors, since the opposite political effects on fraud detection and fraud commission in the bivariate probit model cancel one another out in the univariate probit model. The results from the univariate model are consistent with what Wang (2006) points out--the univariate probit model systematically underestimates the effect a variable has on the probability of fraud commission since it ignores the potential opposite effect that variable may have on fraud detection. Table 6 shows that the univariate probit model understates the estimated coefficient across the board; the provincial party secretary's factional affiliation effect became positive and nonsignificant ($\beta = 0.03$, $p = 0.42$), the provincial party secretary's closeness to retirement effect became positive ($\beta = 0.06$, $p = 0.09$), the social unrest effect became positive and nonsignificant ($\beta = 0.03$, $p = 0.11$), and the state support effect became negative and nonsignificant ($\beta = -0.05$, $p = 0.12$). The difference between the bivariate probit model results and those of the univariate probit model demonstrates that the political effects on fraud detection and fraud commission cancel one another out in the univariate probit model since the political factors affect fraud detection and fraud commission in opposite directions. It once again becomes more evident that using the conventional univariate probit model may lead to false policy and managerial implications.

Robustness check #1: Subsample in years when violation was within 1 and 2 years of detection

To further check results, I tested the theory using a subsample that only counts the violation/detection in years when a violation was within 1 and 2 years of its detection. The purpose of this analysis was to focus on the detected fraud cases within the normal range of investigation time by ruling out the cases of abnormally long investigation duration. This allows us to distinguish between political influences on regular commission and investigation of financial fraud. While, due to the limitation of the bivariate probit model, the subsample that

Table 6. Results of Univariate Probit Regression

Dependent variable: Fraud enforcement	Univariate Model	
	Coefficient	Standard Error
<i>Fraud Commission Factors</i>		
CEO duality	0.12***	(0.03)
External financing need	-0.00	(0.00)
Independent director ratio	0.02	(0.28)
Management ownership	-0.17	(0.12)
Sales growth	0.01	(0.02)
Leverage	0.02	(0.07)
Market development	0.02	(0.02)
<i>Ex-Ante Factors</i>		
Firm size	-0.07***	(0.01)
Firm age	0.01***	(0.00)
Firm performance	-5.58***	(0.48)
Foreign auditor	-0.09	(0.10)
State ownership	-0.46***	(0.10)
Foreign ownership	-0.82**	(0.41)
CEO central government tie	0.03	(0.10)
Provincial official factional tie	0.03	(0.03)
Provincial official retirement	0.06*	(0.03)
Social unrest	0.03	(0.02)
National industry support	-0.05	(0.03)
<i>Ex-Post Detection Factors</i>		
CEO turnover	0.17***	(0.03)
Industry litigation	0.03**	(0.01)
Annual stock return	-0.08***	(0.02)
Abnormal ROA	4.32***	(0.46)
Abnormal return volatility	0.53***	(0.12)
Industry dummy variables	Included	
Year dummy variables	Included	
Constant	-0.99***	(0.35)
Observations	23,911	
Chi-squared	581.69	
Log pseudolikelihood = -4862.22		

Robust standard errors in parentheses. *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. Standard errors adjusted for 3,160 clusters in firm.

contained violation/detection in years when the violation occurred within one year of detection did not converge, the subsample containing violation/detection in years when the violation occurred within two years of detection presents results largely consistent with those of the main bivariate probit model (see Table 7). The effects of provincial leader factional ties are consistent with those in the main analysis but insignificant, while the effects of the other three political factors are consistent with those found in the main analysis and remain statistically significant.

Robustness check #2: Univariate analysis of fraud detection duration time

In a subsample where fraud commission had happened and was later detected, I focused on analyzing the differential fraud detection time regulators took while under different political influences. I use two-tailed *t*-tests to compare fraud detection time (i.e., how many years the regulator takes to detect fraud) across the four focal political influences to see whether there are significant differences in their sample means. Table 8 shows a comparison of the fraud detection duration time across the four political influences. While I found no significant difference in the average fraud detection duration between factional and non-factional provinces, the average fraud detection duration time is significantly shorter in provinces with retiring leaders than those with non-retiring province leaders. More specifically, it takes about a 16% shorter time for regulators to investigate and announce fraud in provinces with retiring leaders. In addition, the average fraud detection duration time is significantly shorter in provinces with high social-unrest intensity than those with low social-unrest intensity. It takes about a 31% shorter time for regulators to investigate and announce fraud in provinces with high social unrest intensity. Finally, the average fraud detection duration time is significantly shorter in state-supported industries than in those without state support; it takes about a 9% shorter time for regulators to investigate and announce fraud in industries with state support. These findings are broadly consistent with the arguments for fraud detection.

Table 7. Results of Bivariate Probit Regression (Violation Within 2 Years of Detection)

Dependent variable: Fraud enforcement	P(F)		P(D F)	
	Coefficient	Standard Error	Coefficient	Standard Error
<i>Fraud Commission Factors</i>				
CEO duality	0.04**	(0.02)		
External financing need	0.00	(0.00)		
Independent director ratio	0.12	(0.14)		
Management ownership	-0.08	(0.07)		
Sales growth	-0.00	(0.01)		
Leverage	0.13**	(0.05)		
Market development	-0.02	(0.01)		
<i>Ex-Ante Factors</i>				
Firm size	-0.14**	(0.03)	0.13*	(0.07)
Firm age	-0.00	(0.02)	-0.01	(0.02)
Firm performance	-1.12	(0.76)	-0.78	(1.05)
Foreign auditor	-0.70	(0.45)	0.73	(0.57)
State ownership	-0.07	(0.29)	-0.19	(0.32)
Foreign ownership	3.98	(5.51)	-4.52	(5.12)
CEO central government tie	0.10	(0.38)	-0.13	(0.48)
Provincial official factional tie	0.29	(0.24)	-0.32	(0.24)
Provincial official retirement	-0.34**	(0.17)	0.40**	(0.18)
Social unrest	-0.22*	(0.13)	0.25*	(0.14)
National industry support	-0.26***	(0.10)	0.27**	(0.12)
<i>Ex-Post Detection Factors</i>				
CEO turnover			0.07***	(0.03)
Industry litigation			-0.06	(0.05)
Annual stock return			-0.03	(0.02)
Abnormal ROA			0.65	(0.40)
Abnormal return volatility			0.73**	(0.34)
Industry dummy variables	Included		Included	
Year dummy variables	Included		Included	
Constant	2.79**	(1.31)	-1.51	(1.59)
Observations	21,005		21,005	
Chi-squared	708.62		708.62	
Log pseudolikelihood = -3528.94				

Robust standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1. Standard errors adjusted for 2,744 clusters in firm.

Table 8. *T*-Test Results of Fraud Detection Duration in the Fraud Subsample

Detection duration time (year)		Difference	<i>t</i> -statistics	<i>p</i> -value
Factional province 1.64	Non-factional province 1.69	0.05	0.70	0.24
Retiring province leader 1.55	Non-retiring province leader 1.84	0.28	4.00	0.00
High social unrest 1.31	Low social unrest 1.90	0.59	8.72	0.00
State support 1.58	Non-state support 1.73	0.15	2.19	0.01

CHAPTER 6. DISCUSSION AND CONCLUSION

Implication for a Broader Set of Misbehaviors: Corruption

This study extends current research related to the mechanisms of corporate corruption by showing that political factors have separate effects on fraud detection by government regulators and fraud committed by managers. I theorize and demonstrate that the fundamental political factors embedded in China's transition economy and its RDA political system affect both the enforcement behavior of regulators and the fraudulent behavior of managers.

I find empirical support for the theory that political factors drive regulators' fraud detection and managers' fraud commission, and managers can enhance their desire to commit fraud or, inversely, disengage from fraudulent actions, depending on how political factors affect regulators' selective enforcement tendencies and the capability and willingness of local officials to intervene in the local economy. The findings show that, by and large, provincial leaders' factional affiliation with the current national president will deter regulators' fraud detection under their jurisdiction and encourage local firm managers' propensity to engage in fraud. Conversely, provincial leaders' closeness to retirement, local social unrest, and national industry support are all positively associated with the likelihood of fraud detection while negatively affecting the likelihood of fraud commission.

The theoretical framework and the findings are consistent with prior research on the RDA system, highlighting the pitfalls of centralized bureaucracy as one of the underlying drivers of regulatory malfunction (Xu, 2019). That is, despite anti-corruption campaigns, no matter how aggressive or extensive they may be, as long as fundamental political institutions keep producing conflicting incentives among central and subnational governments and regulators broadly across the levels of bureaucracies and without independent law enforcement, local protection against

financial fraud and occurrences of selective enforcement are unavoidable. This means that a centralized regulatory system may not function effectively in eradicating fraud commissions. Instead, when political calculations enhance regulators' lack of independence, their enforcement is limited by local government capability and motivation to protect fraudulence by local firms. Moreover, regulators' selective enforcement patterns can be perceived by managers and thus may encourage additional fraudulent actions because managers may believe that they are protected by influential political leaders.

Simply put, some fraud may be diminished in specific industries and regions where enforcement is intense, while more fraud may occur in other areas where regulators turn a relatively blind eye. This explains why financial fraud remains overall pervasive and rampant even under an aggressive anti-corruption campaign. In this sense, this study speaks to corporate financial fraud and serves as a preliminary integrated political and organizational framework that addresses the essential underlying driving mechanisms of the commission and detection of corruption as a whole.

Corruption, the "illicit use of one's position or power for perceived personal or collective gain" (Ashforth et al., 2008: 671), including fraud, bribery, kickbacks, and graft involving managers and officials, has long been eroding many aspects of Chinese society and spreading harmful influences for businesses, both domestically and globally. Pervasive corruption has raised severe concerns among Chinese stakeholders, political leaders, and managers from abroad in tightly interwoven political and business relationships with China, as China has become the world's second-largest economy. Because of the fundamental threat to the legitimacy of China's political meritocracy system, the CCP has engaged in the battle, making corruption their top priority in 2012 (Zúñiga, 2018). However, according to multiple international organizations,

there is evidence that China's overall corruption level remains high (Transparency International, 2019). This remaining high level of corruption (see Figure 4) is, I believe, related to pitfalls related to the fundamental political institutions that tend to drive selective enforcement and corrupt behavior.



Figure 4. China's Corruption Perception Index by Transparency International (2012-2020)⁷

Corruption, the abuse of public power for private gains (Kaufmann et al., 2006), in essence, represents a decision to pursue opportunistic behavior, possibly explained using the pressure, opportunity, and rationalization aspects of those organizational actors who engage in corrupt behavior. I maintain that the *Fraud Triangle*, in this case, can also support the understanding of the driving factors behind many types of corruption as opportunistic behavior

⁷ Transparent International's CPI ranks 180 countries by their perceived levels of public sector corruption based on the view of experts and businesspeople. A CPI score of 100 denotes very clean and a 0 denotes highly corrupt. China's 2020 CPI score is 42, below the average score of 43, indicating its ineffective tackling of corruption.

(e.g., bribery, embezzlement, and graft). As with firm managers, any other type of organizational actor--public or private--could be affected by pressure, opportunity, and rationalization, possibly making them more or less likely to engage in corrupt behavior. The commission and detection of this corrupt behavior will also be affected by the incentive mechanisms in bureaucratic institutions where conflicts between different government agencies abound and the incentive mechanisms in a judicial system that lacks independent law enforcement (Xu, 2019).

As described by the “fragmented authoritarianism” framework, China’s institutions in the RDA regime are fragmented and complicated because policy outcomes are governed by the parochial interests of and the bargaining between government actors who implement the policy (Lieberthal & Oksenberg, 2020; Mertha, 2009). Law enforcers’ selective enforcement behavior, shaped by political interests and bargaining, can further distort anti-corruption policy outcomes in a context in which there are significant institutional barriers between economic sectors and discrimination against private firms, despite their roles as driving forces of China’s economic growth (Xu et al., 2017). The environment, unfriendly to private firms, is toughened by the increasing advancement of the state sector and the retreat of the private sector (*guojin mintui* 国进民退) (Wei, 2020; Xu, 2015). Under this trend, the defining institutional factors that would shape regulatory effectiveness with respect to corrupt behaviors may continue to produce undesired policy outcomes that continue to distort the behavioral patterns of entrepreneurs and government actors and eventually impede needed institutional reforms.

Contributions

This study contributes to the literature on corporate corruption in several ways. First, it contributes to financial fraud research by offering an integral political framework that explains the political influence on the two latent processes of corporate financial fraud: fraud detection

(i.e., regulators' enforcement behavior) and fraud commission (i.e., managers' fraudulent behavior). Bridging the view of political science and that of management to holistically explain how political factors simultaneously influence the two latent processes underlying corporate financial fraud, this study enhances the broader understanding of corruption by facilitating the understanding of the formation of corporate misconduct/corruption, thus highlighting the importance of judicial independence to the rule of law in combating corrupt behavior.

The study's second contribution lies in answering the call for the "need to know more about how relationships among national, regional, and local offices of governments vary and affect organizational fields and their occupants." (Ring et al., 2005: 313). This study extends knowledge of how political influences promote/impede incentives of different national and subnational government entities/actors. It also explicates under what conditions the incentives of these government entities/actors become congruence or collide with one another. By parsing out the political effects on politicians' congruent/conflicting incentives, we can facilitate the understanding of how these incentives further affect managerial misconduct.

Third, this study further addresses the partial observability issue of corporate financial fraud research by examining the political effects on both fraud commission and fraud detection. Doing so offers insights into discovering the mechanisms behind other management research efforts with partially observable binary outcomes determined by two latent processes (Gong & Johnson, in press).

Finally, given the pervasive impact of corporate financial fraud on the economy and society globally, this study provides essential practical insights for various stakeholders such as policymakers, domestic and foreign investors, and due diligence-based equity research firms. The Fraud Triangle framework I have built on to analyze managers' propensity to engage in

fraudulent behavior is initially designed for use by practitioners and regulators to examine financial fraud in the accounting literature. In this sense, this study broadens the practicality of the Fraud Triangle in several ways. First, the study highlights the vital role of the independence of law that could become deficient and ineffective under certain conditions in any economic context, either developed or emerging. When designing the regulatory system, national policymakers need to carefully consider political institutions and their influence on distorting regulators' motivation and capability. Second, the study provides one caveat to domestic and foreign investors, that although certain political factors may offer protection and resource allocation to firms, they may, on the other hand, enhance managers' propensity to commit fraud. Third, for due diligence-based equity research firms, this study offers a holistic view that combines political impact on both regulators and managers.

Limitations and Future Research

While the major limitation of this study is that we may be unable to fully observe political influences, I believe that the use of proxies--politicians' factional affiliation and retirement, social unrest, and national industry support--can help us logically capture bureaucrats' political incentives and actions of importance to both the commission and detection of corporate financial fraud.

Since this study is situated in China, the findings of the four specific political influences on fraud may not entirely apply to all emerging and developed economies. However, conflicting incentives of government actors and selective law enforcement of regulators as well as their mutual influence on managerial behavior pervasively exist in many political and economic contexts. To a certain extent, this prevalence speaks to the generalizability of this study.

This study also suggests several potential directions for future scholarly inquiry regarding corruption and firm misconduct research. First, future research may examine whether there are

other salient mechanisms through which various political/economic/individual factors affect the misconduct of politicians and organizations. For example, how do the more covert (but perhaps more influential) type of ties (e.g., the nexus of self-interests) between regulators, subnational governments, and firm managers affect law enforcement and managerial misconduct? These covert ties might have more salient effects on fraud commission and fraud detection than the factors I focused on in this study. Second, future research may explore additional ways to capture the fidelity of political influences that matter to law enforcement and the commission of misconduct. For example, in addition to overlapping education and work experiences and birthplaces, there may be other factors that more accurately capture politicians' factional affiliations with the national leader.

Conclusion

In summary, this study has provided significant insight into our understanding of the political effects on corporate financial fraud and corruption in a broad sense. Taking advantage of the context of China's transition economy, this study extends literature related to firm misconduct by synthesizing the political mechanisms underlying regulators' selective enforcement and managers' engagement in financial fraud, providing evidence that demonstrates the importance of holistically examining the political driving factors of government actors' incentives and managerial misbehavior.

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