

Corporate fraud and bank loans: Evidence from China

Yunsen Chen, Song Zhu, Yutao Wang

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ABSTRACT

Receiving punishment from regulators for corporate fraud can affect financing contracts between a firm and its bank, as both the firm's credit risk and information risk increase after punishment. By focusing on Chinese firms' borrowing behavior after events of corporate fraud, we find that firms' bank loans after punishment are not only significantly lower, but are also less than those for non-fraudulent firms. In addition, loan interest rates after punishment are not only higher than before, but also higher than those for their non-fraudulent counterparts. In addition, we find that corporate fraud indirectly destabilizes the "performance-bank loan" relationship. Our results suggest that corporate fraud negatively affects a firm's ability to source debt financing, which provides new evidence about the economic consequences of fraud.

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E

This paper investigates the economic consequences of corporate fraud. This is of particular importance to investors and other market participants because of the rise in corporate fraud in recent years. For example, the acid waste incident involving Zijin Mining in July 2010 was disclosed 10 days after the event, which meant its investors lost the opportunity to sell their stocks in a timely fashion.

F

Prior to this, the firm had already been investigated many times for poor information disclosure. Another example is Wuliangye Yibin, whose stock price fell by over 4% when it was held responsible by the Chinese Security Regulatory Committee (CSRC) for three fraudulent events: non-disclosure of important investment projects and losses, non-disclosure of important securities investment losses and data error on disclosed revenue. Some analysts, however, believe that the three events are old news and had no real effect on Wuliangye. There are many instances of corporate fraud in the Chinese capital market, but many firms have not been affected and have no incentive to correct their behavior.

B

Hence, this research asks: does fraud have negative effects on firms? Most prior research related to the economic consequences of corporate fraud analyze the reason, mechanism and characteristics of corporate fraud (Beasley, 1996; Chen et al., 2005a,b; Dechow et al., 1996; Johnson et al., 2009; Karpoff and Lott, 1993; Karpoff et al., 2008; Zhang and Ma, 2005) and the short-term market reaction (Chen et al., 2005a,b). Because of the limited refinancing ability of equity and debt markets in China, previous papers were unable to determine the long-term economic consequences of corporate fraud. As banks are the most important source of financing for listed companies in China, we can answer this question from the view of firms' borrowing behavior.

G

Disclosure of fraud and receiving punishment from regulators influences the relationship between banks and firms by affecting credit risk and information risk. These events make banks anxious about a firm's future cash flows and earnings, which affects their lending behavior to the firm. By focusing on firms who were punished for fraud in the Chinese A-share market during the period 2000–2007, this paper investigates the effects of punishment on the size and interest rates of bank loans.

A

The results show that, compared with the situation before punishment, firms receive less bank loans and higher interest rates after punishment. In addition, compared with other firms, punished firms also receive less bank loans and higher interest rates. Moreover, corporate fraud also affects bank loans by influencing the relationship between bank loans and corporate performance indirectly. Our results show that punishment for fraud affects a firm's ability to acquire financing.

D

This paper makes three contributions to the literature. First, it provides new evidence on the economic consequence of corporate fraud. Previous papers have focused on the causes, characteristics and short-term market reaction rather than the long-term economic consequences of corporate fraud. This paper, however, investigates the effect of corporate fraud on bank loans by investigating firms' credit and information risks, thus extending research on the economic consequences of corporate fraud.

C

Second, due to the restrictions on equity financing in the Chinese capital market, bank loans are the main financing channel. This provides a good opportunity to examine banks' lending behavior after corporate fraud. Third, there is an upward trend in corporate fraud reported in recent years. Hence, the results of this paper prove that Chinese regulators, such as the CSRC, are not a "toothless tiger" as punishment of firms affects their ability to source debt financing.

IN GROUPS, ANSWER THESE QUESTIONS:

1. Who are the authors of this article? Where and when was it published? What are the key words?

2. What is the purpose of this study?

3. How does the study contribute to the scientific community?

4. Find some more information on the two examples given at the beginning of the article.

5. Write an APA reference for the article.

MULTIPLE CHOICE AND OPEN-ENDED QUESTIONS (10 questions, 2 points each)

1. What is the meaning of the word 'fraud' as used in the article?
 - a) mistake
 - b) financial trouble
 - c) cheating
 - d) advertising
2. What is one of the main consequences of corporate fraud mentioned by the article?
 - a) A fraudulent company may lose all its customers.
 - b) A fraudulent company may not receive bank loans.
 - c) A fraudulent company has to close down.
 - d) A fraudulent company has to pay higher taxes.
3. What does the article say about the level of corporate fraud in China?
 - a) It is increasing.
 - b) It is decreasing.
 - c) It never changes.
 - d) It does not exist.
4. Which one of these aspects of the relationship between companies and banks is affected after the disclosure of fraud?
 - a) stability risk
 - b) management risk
 - c) public relations risk
 - d) information risk
5. What is the meaning of the expression 'toothless tiger' in the last paragraph?
 - a) something that looks harmless but is in fact very dangerous
 - b) something that looks dangerous but is in fact harmless
 - c) something that does not really exist
 - d) something that is very stupid
6. **In your own words**, explain why fraudulent Chinese companies may choose not to correct their behaviour?

7. **In your own words**, explain what negative effects corporate fraud may have on companies.

8. **In your own words**, explain what information/approach of this article makes it different from previous studies.

9. **In your own words**, explain why banks are cautious when dealing with fraudulent companies.

10. **In your own words**, describe how this article may be useful.