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Fraud, Enforcement Action, and the Role of Corporate Governance: Evidence from China

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ABSTRACT. We examine enforcement action in China's emerging markets by focusing on (1) the agents that impose this action and (2) the role played by supervisory boards. Using newly available databases, we find that supervisory boards play an active role when Chinese listed companies face enforcement action. Listed firms with larger supervisory boards are more likely to have more severe sanctions imposed upon them by the China Security Regulatory Commission, and listed companies that face more severe enforcement actions have more supervisory board meetings. Our findings are of interest, as supervisory boards in China are generally perceived to be dysfunctional. This study contributes to the existing literature in three ways. First, we shed light on the effects of supervisory boards whose role in a fraud setting has not yet been examined. Second, the study has important policy implications for governance reform. Finally, our analyses provide the most up-to-date picture of fraud and governance issues in China's ever-growing markets.

KEY WORDS: corporate governance, enforcement, fraud, supervisory boards

Introduction

Fraudulent behavior by listed companies damages the economy in general and capital markets in particular. Siebert (2002), for example, reports that from 2000 to 2002, more than US$7 trillion in wealth was lost in U.S. financial markets due to fraud, leading investors to lose their faith in the integrity of capital markets. As part of an effort to develop healthy capital markets, numerous studies have examined fraudulent behavior, with the intention to shed light on the consequences of fraud and/or to identify proactive mechanisms. The former stream mainly focuses on market/organization reactions. For example, Persons (2006) reports that firms that commit fraud have a significantly higher level of executive turnover and are more likely to replace CEOs if they are not the chairman of the board. The other stream of fraud studies examines corporate governance systems, with the aim of discovering the various mechanisms by which the incidence of fraud can be reduced. The independence of boards and the separation of CEO/chairman duties, among other factors, have been singled out as effective mechanisms to deal with corporate fraud (e.g., Beasley, 1996; Dechow et al., 1996).

These important insights notwithstanding, a great deal still needs to be done to improve our understanding of fraud. For example, it is generally acknowledged that the U.S. and German styles of governance are the best in the world (Shleifer and Vishny, 1997), but the latter is rarely covered; therefore, it would be interesting to know whether German-style governance plays a role in fighting fraud. Similarly, although fighting corruption/fraud is a global war (Everett et al., 2007), little is known about fraudulent behavior in emerging markets. Our study will help to fill in this gap in knowledge by examining the role of supervisory boards, a typical feature of German-style governance, in China, and will contribute to the existing literature in several important ways.

First, as previously mentioned, researchers have examined various components of governance systems to search for effective fraud deterrents, but, unfortunately, the role of the supervisory board has remained untouched. By examining the role of supervisory boards in a fraud setting,[1] we offer insights to both the governance and fraud literature.

More importantly, as China may be the only large emerging market that adopts and implements the German style of governance, our findings on the role of supervisory boards have important policy implications for those jurisdictions that are currently undergoing governance reform. Second, unlike prior research that mainly compares a sample of firms that have committed fraud with a matching, fraud-free sample, this study primarily focuses on the former. There are always cases in which a firm commits fraud that goes undetected, especially in emerging markets in which law enforcement is always an issue; therefore, any so-called matching sample may be contaminated. Focusing on a homogeneous fraud sample allows us to examine our research questions in an improved way. Third, we examine the issue of fraud from an angle different from most previous studies by analyzing different types of fraud and focusing on enforcement measures. More specifically, we explore the sanctions imposed by both government authorities and stock exchanges. To the best of our knowledge, the enforcement actions of the latter have not been investigated before. Finally, China is not only the world's largest emerging market; it is also the fourth largest market in the world. In addition, the country had the largest IPO market in 2007, and its intake of foreign capital is second to none. Having said that, it is important to acknowledge that China is also well known for rampant corruption and fraud (Li and Wu, 2007). Thus, China is an important element in the global chain of anti-fraud efforts. An increasing number of studies have investigated Chinese stock markets, but few have examined the issue of fraud in the country. Firth et al. (2005) made a recent attempt to do so, but our study differs from theirs in several important aspects. For example, they examine auditing fraud, whereas we focus on the fraudulent behavior of all listed companies. In addition, the current study uses 362 observations by employing newly available databases and covering the most recent period, whereas Firth et al. (2005) employ a small sample with 72 enforcement actions. Therefore, our findings provide the most up-to-date picture of fraud in China's ever-growing markets.

We find that, contrary to the conventional wisdom that supervisory boards in China are dysfunctional (e.g., Xi, 2006; Xiao et al., 2004), both the size and meeting frequency of supervisory boards are associated with the extent to which a firm is penalized for fraud. For those that have committed fraud, we find that, consistent with the notion of a monitoring cost/benefit trade-off, a supervisory board with too many members leads to more severe sanctions, and boards meet more often when the firm is facing more severe sanctions. That is, supervisory boards do play an effective governance role, and that role seems to be more salient in the middle of crises.

The remainder of the article proceeds as follows. The next section describes fraud in China. Section "Literature review and hypotheses development" illustrates governance reform by focusing on supervisory boards and then develops our hypotheses. Sections "Data, variables and methodology" and "Results and discussion" present our models and results, respectively, and the final section concludes the article.

Fraud in China's stock markets

Fraud among listed companies in China[2]

Chinese capital markets are well known for fraudulent activities among listed companies. Between 1994 and 2007, for example, 581 enforcement actions were carried out by the China Securities Regulatory Commission (CSRC) and the country's two stock exchanges, and there seems to be a trend of increasing occurrences. In the 7 years from 1994 to 2000, there were only 51 enforcement actions, but in 2001 alone, the number was 72. Since then, the number of identified cases of fraud has kept up this pace. Listed companies in China may be involved in various types of fraud, such as "the inflation of profits, creating fictitious transactions, false disclosures, and expropriating assets from minority shareholders" (Chen et al., 2005, p. 456). A significant portion of fraud convictions by the CSRC and the stock exchanges involves information disclosure, which is an important mechanism by which to ensure the proper development of healthy capital markets. In 2007, for example, there were 81 cases of enforcement, 64 of which were brought against companies for a delay in the disclosure of regular reports, an apparent violation of security laws and government rules. Of those reports that are

disclosed on time in China, many are accompanied by later complementary amendments known as "patching phenomena." Even if reports are not delayed and have no missing information, their quality is sometimes open to doubt.

Anderson (2000) and Feroz et al. (1991) find that U.S. Securities and Exchange Commission (SEC) enforcement actions usually do not represent the entire fraud population in the U.S., because the SEC mainly focuses on cases in which the chance of success is high. Similarly, in China, it is believed that many illegal activities have not been discovered (Liu, 2005). Anderson (2000), for example, identifies several cases in the country in which he believes that scandals were not brought to light. In 2001, the former Chinese Premier Zhu Rongji even suggested that "No Fictitious Records" be the motto of the newly established Shanghai National Accounting Institute (Firth et al., 2005), thus suggesting that fraudulent activities among Chinese firms, especially those among Chinese listed companies, were too serious to be ignored. Therefore, an examination of the issues surrounding fraud in China is of great practical significance.

The motivations for fraudulent behavior have been extensively investigated, and some of them can be applied to the Chinese context. Szwajkowski (1985), for example, examines the possible motives for fraud among firms and finds that external factors, such as regulatory pressure and financial needs, stimulate managerial misconduct. This is also the case in China. For example, if a listed company has been in deficit for two consecutive fiscal years, or if its net assets per share are less than the face value in the most recent fiscal year, then a special treatment (ST) order is activated so as to declare its status as a company that will possibly be delisted.[3] In fear of being given ST status or trying to meet the requirements for a seasoned equity offering (SEO), some firms manipulate their profits. Furthermore, it is believed that the high frequency of fraud among Chinese public companies may also be due to China's economic transition, which began in 1978. Baucus and Near (1991) find that firms that operate in a dynamic, rapidly changing environment, which is a typical feature of transition economies, are more likely to be involved in illegal activities, possibly because the formal and informal rules keep changing, thus providing them with an opportunity to engage in such activities. An examination of the factors that underlie fraudulent activities among Chinese listed companies would be interesting, but is outside the scope of this study.

Legal environment in China

The legal environment in China has been changing due to the country's transition from a planned to a market-oriented economy, but the pace of improvements in this environment seems to be slower than the growth of the private sector (Chen et al., 2005). From the establishment of the Shanghai and Shenzhen Stock Exchanges in 1990 and 1991, respectively, until 1993, capital markets were regulated by local governments and central government divisions based on temporary administrative rules. In 1993, the *Temporary Rules for Stock Issuing and Stock Exchanges Regulation*, the country's first security market regulation, was promulgated by the State Council. Information disclosure, accounting policy, and audit systems were all addressed in this regulation. The *Provisional Regulations against Security Fraud* and *Corporate Law* were then promulgated in 1993 and 1994, respectively, and *Accounting Law* was first issued in 1985 and then revised in 1994. Due to the lack of a security law during the period, however, basic rules were subject to change, and contradictions were often encountered among the different laws and regulations.

On July 1, 1999, the *Securities Law* became effective, which, for the first time, clearly defined various types of fraud, including insider trading and price manipulation, and their corresponding punishments. The *Securities Law* was amended in 2005, and the supervisory power of a government agency (implicitly the CSRC) was strengthened. The 1993 *Corporate Law* underwent three amendments in 1999, 2004, and 2005, and these amendments led to remarkable progress in enhancing the effectiveness of corporate governance mechanisms in China. The CSRC has also issued new rules, based on which it regulates the capital markets. For instance, 2001 saw the dramatically strengthened government regulation of capital markets, leading to this year being labeled the "Capital Market Regulation Year." On January 30, 2007, the CSRC issued its *Rules of Listed Firm Information Disclosure* to delineate the detailed

requirements for company prospectuses, regular reports, and temporary reports, among other types of documents.

There has also been a rich set of laws and rules issued by China's president, the State Council, government agencies, and the Supreme Court. For instance, the latest *Compilations of Laws and Rules Used for Inspection of Securities and Futures*, which was edited by the CSRC, contain more than 1.9 million Chinese characters. However, whether the Chinese authorities have done enough to protect investors, especially small investors, remains open to doubt. Put differently, it is believed that the proper implementation of these laws and rules may still be problematic, despite the existence of a rich set of regulations. La Porta et al. (1998) claim that countries with their legal origins in French civil law, such as China, provide the weakest legal protection for both shareholders and creditors. Furthermore, Allen et al. (2005) find that creditor and shareholder protection in China is worse than that in most of the sample countries included in La Porta et al. (1998), and that the country's legal environment is even worse than that of other major emerging markets. It is with this legal environment as a backdrop that we offer insights into how enforcement actions are carried out. A lack or insufficiency of legal protection leads corporate governance systems at the firm level to play a significant role in protecting shareholders. Our study examines just one of these systems: supervisory boards.

The CSRC and its enforcement actions

Although more investor protection mechanisms have been incorporated into China's *Securities Law*, law enforcement institutions are more important in building investor confidence (DeFond and Hung 2004). In the 1990s, China's security regulation and supervisory institutions included the CSRC, the State Council Securities Commission, the People's Bank of China, the National Planning Committee, the Ministry of Finance, the National System Reform Committee, and the judiciary and local governments. Although the *Securities Law* issued in 1998 did not specify the CSRC as the major enforcement institution, it has actually been acting in that capacity since 1998; between 1994 and 2007, only eight enforcement actions were carried out by other government agencies.

In general, listed firms and their top-management teams that are found guilty of fraudulent activities face three types of legal responsibility: criminal responsibility, administrative responsibility, and civil responsibility. Criminal responsibility is mainly defined in the 1997 version of *Criminal Law*, whereas civil responsibility for security fraud is clarified in the 2005 version of the *Securities Law*. As security fraud may be inevitable during China's economic transition, and such fraud may not be simply black and white, the country's Supreme Court decided in 2001 to downplay the significance of security-related civil cases and suspended all such cases involving security fraud. As indicated by Peng (2007), the U.S. SEC has downsized its workforce by more than 50% over the last five decades due to a steady increase in civil cases, which are dealt with outside the organization. This is not the case in China, however, where civil lawsuits are rare, and administrative responsibility is the most common type of legal responsibility among firms committing fraud. The Supreme Court later dropped its suspension of civil cases, but it does not consider any such cases until the CSRC has completed its investigations and taken effective enforcement actions.

Put differently, although many government agencies may exert supervisory authority, the CSRC plays the dominant role in coping with fraudulent behavior in China's stock markets. Although Chinese listed firms and their top-management teams can be punished by the courts for fraudulent behavior, the CSRC has taken the crucial role in enforcement actions. In fact, it has been given a mandate to do so by the Supreme Court in the sense that no civil lawsuits will be pursued unless enforcement action has been taken by the CSRC. The short history of China's stock markets has seen this organization serve as the main decision maker in enforcement.

The CSRC follows a well-established procedure to pursue cases of fraud. A possible instance of fraud is usually revealed by the Commission's regional offices or its Department of Inspection. The Department of Inspection then conducts an investigation with the approval of the CSRC's principal or one of the Commission's regional offices. When an investigation formally starts, the CSRC sends a

"registered investigation advice note" to the company in question. According to Article 67 of China's *Securities Law*, listed firms are required to make temporary announcements of significant events that may affect their stock price. Previously, however, a CSRC investigation may not have been considered to be a significant event, and, therefore, often no disclosure was made. It was made clear for the first time in 2006 that firms being investigated by the authorities should disclose this fact. Such a requirement was further supported by the *Rules of Listing Firm Information Disclosure* issued by the CSRC on January 30, 2007. Chen et al. (2005) reported that, from 1999 to 2003, unlike their counterparts in the U.S., neither the CSRC nor the firms under investigation disclosed the initiation of that investigation. However, between 2004 and 2007, 116 firms disclosed that they had received such notice from the CSRC.

Before 2002, the CSRC's Department of Inspection made decisions with regard to punishment. After that year, however, the decision maker became the newly founded Administrative Punishment Committee of the CSRC. Various types of enforcement action are available, including an official warning, a monetary fine, the return of illegally raised proceeds, the confiscation of illegal income, the termination of share issuance, and the suspension or termination of securities trading qualifications. The first three types of action are also applicable to the top management involved. For example, in its 1996 annual report, Qiong Minyuan, a public company, reported fictitious profits of RMB 566 million and non-existing capital reserves of RMB 657 million. Upon detection, the company was officially warned by the CSRC that its top management was under criminal investigation, although no monetary fine was imposed (The First Department of Inspection, CSRC, 2004a). In another example, Yin Guangxia, a listed company, inflated its net profits by RMB 771,567,000 between 1998 and 2001, mainly by fabricating sales revenues and ignoring necessary expenses. The CSRC fined the firm RMB 600,000 and brought the relevant members of top management to justice (The First Department of Inspection, CSRC, 2004b).

Due to the aforementioned relatively weak legal environment in China, strong supervisory power is given to government agencies (mainly the CSRC), as discretion is considered important. However, more powerful agencies may not necessarily reduce fraud. Using cross-country banking data, Barth et al. (2007) find that the empowerment of supervisory agencies does not necessarily improve banking industry stability or reduce lending corruption. Their findings offer insights to both emerging markets, such as China, and mature markets, such as the U.S. The CSRC is extremely powerful when it comes to the supervision of listed firms (Peng, 2007), but fraud is still widespread.

Stock exchanges and enforcement actions

Like the New York Stock Exchange (NYSE), China's two stock exchanges are, to a certain degree, self-regulatory organizations. According to the relevant laws and rules, the stock exchanges issue listing rules based on which they impose enforcement action on firms that commit fraud. Both the *Shanghai Stock Exchange Stock Listing Rules* and the *Shenzhen Stock Exchange Stock Listing Rules* became effective in January 1998 and were revised in 2001, 2002, 2004, and 2006; these revisions were then approved by the CSRC. If listed firms violate these listing rules, then the exchanges may simply warn them without disclosing any information to the media. However, the exchanges may also condemn these firms, with that condemnation disclosed to newspapers, which also have official background. If members of the top management are involved in any wrongdoing, they will be subject to the same enforcement action by the exchanges. Earlier listing rules also include monetary penalties (Chen et al., 2005), although the stock exchanges currently have no authority to impose fines.

Compared to enforcement by the CSRC, the actions taken by the stock exchanges are mild. In cases of serious violations, the CSRC takes over and investigates further. This is made very clear in the listing rules. For example, ST Danke, a listed company on the Shanghai Stock Exchange, failed to disclose its 2002 annual report before the deadline, which is an obvious violation of the listing rules. The Shanghai exchange warned the company, and, in addition, the CSRC filed a notice of investigation on August 5, 2003. On March 9, 2004, it imposed a fine of RMB 100,000, among other penalties.

In summary, Chinese listed companies that commit fraud are punished by the two stock exchanges and/or the CSRC, depending on the severity of the violation. Minor and/or less severe violations go to the stock exchanges, whereas the CSRC is responsible for punishing more severe fraudulent activities. Put differently, the stock exchanges are the final enforcement agent when the violation is mild, but the CSRC will further punish those companies that commit more severe types of fraud. Therefore, in China's stock markets, the agency that imposes sanctions serves as an accurate proxy of punishment type: more or less severe. This institutional arrangement, which has rarely been covered in the prior literature, presents us with an opportunity to examine whether an important governance mechanism (i.e., the supervisory board) helps listed companies to mitigate the effects of enforcement actions.

Literature review and hypotheses development

Governance reforms and the supervisory board

China's listed companies have a unique governance structure in the sense that both the U.S. style of a single board and the German style of a two-tier board are incorporated; as a result, Chinese public companies have a board of directors and a supervisory board. The 1993 *Corporate Law*, promulgated after the establishment of the two stock markets, confers a monitoring function upon the supervisory board, whose members are representatives of both shareholders and employees. Although the Chinese supervisory board resembles Germany's two-tier board structure, the two differ in several important aspects (Xi, 2006). For example, this board in China does not appoint or evaluate managers, but rather serves as a monitoring organ.

According to the 1993 *Corporate Law*, the supervisory board has two major functions: (1) to supervise directors and management and (2) to examine the financial affairs of the company. Therefore, a properly functioning supervisory board is expected to curb the misconduct of directors/top management, help control risk, and protect the interests of shareholders, especially those of small shareholders.[4] The relatively short history of China's capital markets, however, has seen supervisory boards play a minimal role in terms of monitoring (Xi, 2006). Stated differently, a supervisory board can best be described as an honored guest, a friendly advisor, or a censored watchdog (Xiao et al., 2004). Even the then vice chairman of the CSRC commented that "the supervisory board may give the illusion of certain checks and balances in the listed company when none existed" (Firth et al., 2006). Several factors may have contributed to the lack of effectiveness among supervisory boards, including, among others, a lack of information that is crucial to the exercise of their monitoring duties, a lack of expertise to fulfill these duties, and a lack of legal support to take action (Xi, 2006).

Having said that, it is worth noting that recent evidence seems to suggest that the failings of supervisory boards may be exaggerated. For example, the supervisory boards of Chinese listed companies are required by the CSRC to disclose reports of their monitoring activities. Investors seem to value these reports, as a company's failure to provide one in its 1998 annual report led to a negative market reaction (Dahya et al., 2003). In another study, Firth et al. (2007) find that a supervisory board affects the informativeness of earnings for Chinese listed companies. They show that "larger and more active supervisory boards improve the earnings-returns association, reduce absolute discretionary accruals, and have higher quality financial statements" (Firth et al., 2007, p. 493); therefore, they conclude that supervisory boards "do play an important role" (ibid.), at least in improving earnings' informativeness. It appears that the proper functioning of a supervisory board may depend on the research setting. This board may function well in certain aspects, such as improving earnings quality, but it may be compromised when it comes to its monitoring role.

We believe that supervisory boards have improved their functioning/monitoring role since 2001. First, the CSRC strengthened its supervisory role in that year, which accordingly became known as the "Capital Market Regulation Year." As a result, individual companies have responded by improving the role played by their supervisory boards. Second, a series of laws, amendments, and regulations have recently been enacted with the

objective of protecting the interests of shareholders by enhancing the monitoring of listed companies. Supervisory boards, as important monitoring organs, have benefited from this improved legal environment. Finally, governance reform, especially that with regard to the enhancement of monitoring functions, continues. For example, the 1993 *Corporate Law* underwent three amendments in 1999, 2004, and 2005 by the National People's Congress Standing Committee, and these amendments have led to remarkable progress in terms of this enhancement. For example, the 2005 *Corporate Law* addressed several important constraints that prevented supervisory boards from functioning properly. First, these boards now have the power to propose the dismissal of directors who engage in questionable activities and to sue directors and members of top management who commit fraud. Second, they have gained improved access to information and now have sufficient resources to fulfill duties that are outside their expertise by seeking independent professional advice, with the company bearing the expense. Third, members of supervisory board are now allowed to ask questions and make suggestions when they attend board meetings (Xi, 2006).

This change in environment presents us with an opportunity to re-examine the role of supervisory boards. As mentioned previously, the functioning/ monitoring role of these boards may depend on the research context; therefore, we decided to examine them by focusing on one important setting: fraud. We are interested in discovering whether supervisory boards play an active role in the middle of a crisis.

The effect of supervisory board size

As described previously, supervisory boards serve as monitoring organs in Chinese listed companies; that is, members of supervisory board monitor the behavior of the board of directors and top management. The functioning of these boards, however, depends on the context, including the legal environment, the level of access to information, the expertise of the members of supervisory board, and the resources available (Xi, 2006). Therefore, mixed results have been presented on the effects of supervisory boards (e.g., Dahya et al., 2003; Firth et al., 2007). In this study, we do not examine the effects of these boards on the prevention of fraudulent behavior. Instead, we investigate the role they play once fraud has been committed. That is, we examine the ability and/or functioning of supervisory boards before and during crises. These boards may not work effectively in some listed companies when they are operating smoothly, but when they face penalties by regulators and/or the stock exchanges, the supervisory boards are more likely to respond by fulfilling their duties. Therefore, a focus on the functioning of supervisory boards during crises may enable us to better observe and understand this important monitoring organ whose role has been overlooked since its inception.

Board size is found to be related to board performance, because size may influence its knowledge base (Karamanou and Vafeas, 2005). Karamanou and Vafeas (2005) found that firms with larger boards are more likely to update earnings forecasts and have fewer forecast biases. In terms of board monitoring, however, this may not be the case. Although the literature on supervisory boards is scant, a variety of studies of boards of directors offer insights into this matter (e.g., Jensen, 1993). Monitoring is costly, and internal conflict, which usually results from a large-sized board, may actually jeopardize its effectiveness. In other words, it appears that the larger the size of the board, the worse its performance may be. Jensen (1993) first argued that larger boards may be less effective. Yermack (1996) provides empirical evidence that small boards lead to superior financial performance. Furthermore, Del Guercio et al. (2003) find that funds with smaller boards have lower expense ratio, which measures board effectiveness, and Cheng et al. (2008) show that smaller boards are more valuable, as they improve firm performance, especially before the passage of anti-takeover laws. In the case of supervisory boards, one of a proper size may be more effective in coping with a crisis, thus reducing the impact of any enforcement actions taken by regulators or the stock exchanges, whereas a larger board may increase the likelihood that fraudulent behavior is more severely punished. Given our aforementioned suggestion that more serious types of enforcement actions are taken by the CSRC, we hypothesize that fraudulent behavior by firms with a larger supervisory board is more likely to be penalized by the CSRC, rather

than by the stock exchanges. Hypothesis 1, stated in an alternative form, is thus as follows.

H1: Supervisory board size affects the extent to which fraudulent behavior in firms is penalized, such that firms with a larger supervisory board are more likely to be penalized by the CSRC.

The effect of supervisory board meetings

It is well documented that a board's activities and vigilance affect the effectiveness of its functions, but it is difficult, if not impossible, to measure these two constructs (Chen et al., 2006). As a result, the number of board meetings is usually adopted as a proxy of a board's oversight activities and vigilance. More frequent board meetings presumably lead to a higher level of oversight, thus improving the effectiveness of board monitoring. At the same time, however, the increased frequency of board meetings may also be a signal that a firm is in trouble, as firms that engage in fraudulent activities may also be more likely to hold meetings to solve various issues (Chen et al., 2006). Put differently, more frequent board meetings may not be a leading factor in oversight; instead, they may result from abnormal/illegal activities. Similar evidence is provided by Vafeas (1999), who finds that poor performance leads boards of directors to meet more often. As CEOs usually control the agenda of board meetings, and outside directors may be occupied with routine tasks, Jensen (1993) even suggests relative board ineffectiveness. In a similar vein, we argue that the meeting frequency of a supervisory board may also be subject to this dual explanation.

For fraudulent firms, this frequency may be a signal that supervisory boards are working diligently to cope with a crisis; as a result, improved oversight and vigilance will lead to less severe sanctions being imposed by the CSRC or the exchanges. Alternatively, as the case of boards of director meetings suggests, the increased frequency of supervisory board meetings may also just be an indication that firms are more likely to be severely penalized, thus leading to the need for more meetings. As Chen et al. (2006) have documented both possibilities for a board of directors' monitoring role, we develop the following hypothesis on the role of supervisory boards.

H2: Supervisory board meetings have an impact on the severity of enforcement.

Data, variables, and methodology

Consistent with prior studies, we use data from CSMAR, SINOFIN, and WIND, three databases that are extensively used in China-related studies. Research papers based on these databases have been published in all types of academic journals. We double-check the data from both SINOFIN and WIND to identify instances of firm fraud. Enforcement information has been available since the inception of China's stock markets, but we focus on enforcement since 2000 in consideration of the availability of other variables. A total of 362 observations of fraud are included in our sample. The other variables are from CSMAR.

Furthermore, we include a comparative matching sample that consists of 327 firms that did not commit fraudulent activities.[5] In order to form this matching, fraud-free sample, we make use of two criteria: firm size measured by total assets and industry effects. For each firm included in the original sample, we find a matching firm within 20% of its size that is in the same industry. If there is more than one matching firm for each firm, we select the one with the firm size closest to the original. This allows us to test whether there are any differences in the characteristics of the supervisory boards in fraud firms and those in matching, fraud-free firms.

The dependent variable used in the cross-sectional analysis is the binary variable AGENT, which indicates whether a company was punished by the CSRC or by the stock exchanges. The variable AGENT has a value of 1 in the former case and zero in the latter. As previously discussed, enforcement actions taken by the CSRC are believed to be more severe.

To test our hypotheses, we use the monitoring-related characteristics/activities of supervisory boards as independent variables, including SBMeeting and SBSize. SBMeeting is a variable that indicates the

number of meetings held by a supervisory board annually, and SBSize measures the number of members on this board. For further analyses, we also use the lagged values of these independent variables in the last year. These lagged variables are indicated by the form "variable-lag." This form also applies to the control variables discussed below.

We include three groups of control variables. First, five variables are employed to measure other characteristics of the supervisory board, including the gender of the supervisory board chair (SBC-Gender), the age of the supervisory board chair (SBCAge), the length of tenure of the supervisory board chair (SBCTenure), the shares held by the supervisory board chair (SBCShare), and the turnover status of the supervisory board chair (SBCTurnover). The second group measures the characteristics and activities of the board of directors, including the number of independent directors (IDSize), the size of the board (BoardSize),[6] the number of meetings held by the board annually (BoardMeeting), and a dummy variable, BCCEO, which indicates whether the chairman of the board of directors is also the CEO of the company. Finally, we use seven control variables to reflect firm-level attributes, including the dummy variable GOV, which indicates whether the government or a government representative is the largest shareholder; the dummy variable FOR, which takes a value of one for firms in with the largest shareholder is foreign; the Herfindahl index (HHI) for the 10 largest shareholders, excluding the largest one; firm size, measured by the natural log of the total book value of assets (LNTA); risk, measured by the debt–asset ratio (DTA); accounting profitability, measured by the return on assets (ROA); and TRADE, measured by the ratio of the number of tradable shares over that of total shares.

As the dependent variable AGENT is a dummy, we use the logit model

$$\text{AGENT} = a_0 + a_1 \cdot \text{SBMeeting} + a_2 \cdot \text{SBSize} + a_3 \cdot \text{Control Variables} + \varepsilon$$

to answer the research questions

Potential curvilinear relationship between dependent and independent variables is also tested by including the squared terms of SBMeeting and SBSize.[7] For further analyses, we also run the logit model using several sub-samples based on two different criteria. The first criterion is the size of the supervisory board. According to agency theory, if the board is too small, then it may not be able to perform its monitoring function well, but if it is too large, then it may generate a high agency cost. Therefore, we form two sub-samples, one in which the supervisory board in the pre-enforcement year had four or fewer members and the other in which it had more than four. One of the reasons to choose four members as the cut-off value of the variable SBSize is based on the descriptive result, an average of 4.07 members on supervisory boards in fraud firms. The second criterion is the number of meetings held by the supervisory board. Two sub-samples are formed, one with a value of SBCMeeting higher than 2, and the other with a value lower than or equal to 2. This is consistent with the CSRC regulatory requirement that a supervisory board have at least one supervisory board meeting per half year.

Results and discussion

Table I[8] presents our descriptive analysis. Panel A reveals the distribution of enforcement across years and the two enforcement agents. There were 67 enforcement cases in 2001, of which 38 were carried out by one of the stock exchanges and 29 by the CSRC. The number of law enforcement cases was lowest in 2003, with 45 cases, and highest in 2006, with 71. It is also worth noting that, prior to 2003, more cases were taken on by the exchanges than by the CSRC. However, from 2004 to 2006, more were pursued by the CSRC. It seems that the fraudulent behavior of firms became more severe after 2003.

Panel B shows that of the 362 observations, 47.50% of the firms were punished by the CSRC, and the rest by one of the two stock exchanges. The average supervisory board meeting frequency (SBMeeting) was 3.88 times in the year the enforcement action was taken. The average size of the supervisory boards (SBSize) was 4.07,[9] and 38% of them had a supervisory board chair turnover (SBCTurnover) in the enforcement year.

We also present the comparison between the two samples, the original sample consisting of the fraud

TABLE I

Descriptive analysis

Year	Enforcement by stock exchange	Enforcement by CSRC	Subtotal
Panel A: Distribution of the dependent variable, Agent			
2001	38	29	67
2002	32	18	50
2003	24	21	45
2004	29	31	60
2005	34	35	69
2006	33	38	71
Total	190	172	362

Variable name	All firms			Fraud firms			Matching firms[a]			*t*-Statistics
	Mean	Std. Dev.	*n*	Mean	Std. Dev.	*n*	Mean	Std. Dev.	*n*	
Panel B: Comparison across subsamples										
AGENT	0.475	0.500	362	0.475	0.500	362			0	
SBMeeting	3.697	1.753	687	3.875	1.897	360	3.502	1.558	327	2.803***
SBSize	4.132	1.367	689	4.072	1.315	362	4.199	1.421	327	−1.218
SBCTurnover	0.375	0.485	640	0.380	0.486	329	0.370	0.484	311	0.265
SBCGender	0.854	0.353	637	0.879	0.326	323	0.828	0.378	314	1.833*
SBCAge	48.355	8.084	626	48.284	8.173	320	48.428	8.002	306	−0.222
SBCTenure	556.916	379.146	640	536.967	384.876	329	578.019	372.443	311	−1.37
SBCShare	18,042	206,766	629	9478	85,083	322	27,024	282,821	307	−1.064
BoardSize	9.456	2.192	689	9.406	2.276	362	9.511	2.099	327	−0.625
BoardMeeting	7.943	3.217	688	8.640	3.304	361	7.174	2.936	327	6.124***
IDSize	2.584	1.274	688	2.554	1.288	361	2.618	1.260	327	−0.655
BCCEO	0.126	0.332	685	0.146	0.354	362	0.102	0.303	323	1.746*
HHI	0.021	0.026	689	0.023	0.025	362	0.019	0.027	327	2.102**
FOR	0.007	0.085	689	0.008	0.091	362	0.006	0.078	327	0.335
GOV	0.289	0.454	689	0.276	0.448	362	0.303	0.460	327	−0.766
TA (in Millions RMB)	1570	1860	686	1570	2090	359	1560	1560	327	0.072
LNTA	20.730	0.938	686	20.695	0.972	359	20.768	0.900	327	−1.02
ROA	-0.099	0.490	686	−0.206	0.654	359	0.019	0.096	327	−6.141***
DTA	0.048	0.076	686	0.049	0.080	359	0.046	0.071	327	0.645
TRADE	0.421	0.130	689	0.431	0.123	362	0.409	0.135	327	2.319**

***$p < 0.01$, **$p < 0.05$, *$p < 0.10$.

[a]Matching firms are non-fraudulent firms formed using certain criteria. In our study, non-fraudulent firms are in the same year and industry, and are of similar size (±20% of fraudulent firms' total assets).

firms only and the matching sample, in Panel B of Table I. By comparing the variable means of these two samples, we find that the former firms have significantly more supervisory board meetings and board of directors meetings than the matching firms. Both differences are significant at the 1% level, as indicated by *t*-statistics of 2.80 and 6.12 for SBMeeting and BoardMeeting, respectively. These preliminary results indicate that both types of boards may play critical governance roles in firms that commit fraud. In general, the ownership concentration measured by HHI in the fraud-firm sample is significantly higher than that in the fraud-free sample at the 5% level, and a higher percentage of the fraud firms have board chairs who are the same as their CEOs (BCCEO), with a 10% level of significance. These show that some of the major characteristics of the corporate governance mechanisms in the two

samples are also different. The results presented in Table I also tell us that the firm profitability of the fraud firms, as measured by ROA, is significantly lower than that of the matching firms at the 1% level and that the fraud firms tend to have more tradable shares (TRADE) at the 5% significance level.

As shown in Table II, when we use SBMeeting and SBSize in the current year as the independent variables, we find a positive relationship between the variable AGENT and the variable SBMeeting at the 1% significance level, thus suggesting that fraud firms that meet more frequently are more likely to receive enforcement sanctions from the CSRC, which are more severe than those imposed by the stock exchanges.[10] This is puzzling, because more meetings should enhance monitoring and therefore reduce the possibility of more severe punishment. Consistent with Chen et al. (2006), we interpret this

TABLE II

Results based on the full sample

	Characteristics of supervisory boards in the enforcement year		Characteristics of supervisory boards prior to the enforcement year	
	Coefficient	Std. Err.	Coefficient	Std. Err.
SBMeeting	0.220***	0.085		
SBMeeting-Lag			0.110	0.110
SBSize	0.121	0.110		
SBSize-Lag			0.271**	0.130
SBCTurnover	−0.896*	0.460		
SBCTurnover-Lag			0.416	0.344
SBCGender	−0.014	0.391	−0.421	0.481
SBCAge	0.004	0.017	0.007	0.019
SBCTenure	−0.001*	0.001	0.000	0.000
SBCShare	0.000	0.000	0.000	0.000
BoardSize	0.071	0.066		
BoardSize-Lag			0.104	0.076
BoardMeeting	−0.044	0.042		
BoardMeeting-Lag			0.037	0.045
IDSize	0.197*	0.116		
IDSize-Lag			0.086	0.132
BCCEO	0.547	0.380	0.446	0.423
HHI	0.000	0.001	0.001	0.001
GOV	−0.338	0.305	−0.255	0.362
FOR	1.544	1.342	0.873	1.346
LNTA	−0.560***	0.168	−0.568***	0.192
ROA	0.176	0.222	0.128	0.252
DTA	0.939	1.726	2.035	2.088
TRADE	1.962	1.239	2.219	1.495
Constant	9.302***	3.403	7.545**	3.738
n	272		210	
LR χ^2	31.91		26.13	
Prob > χ^2	0.0225		0.0968	
Pseudo-R^2	0.0848		0.0898	

See foot note 8.

$^{***}p < 0.01$, $^{**}p < 0.05$, $^{*}p < 0.10$.

positive relationship as reverse causality; that is, a more severe punishment may cause supervisory boards to meet more frequently. The existence of the two possibilities is discussed in our hypothesis development section, and our empirical analysis seems to support the latter.

We then ran the logit model using lagged values of the independent variables and some of the agency variables, such as SBMeeting-Lag, SBSize-Lag, SBCTurnover-Lag, BoardSize-Lag, BoardMeeting-Lag, and IDSize-lag, to capture the monitoring effects. The empirical results show that fraudulent firms with a larger supervisory board tend to have sanctions imposed on them by the CSRC, and the positive coefficient is significant at the 5% level. One additional member on a supervisory board increases the probability of receiving sanctions from the CSRC by 27%. This indicates that the monitoring costs may dominate the positive monitoring effects of a supervisory board in firms that commit fraud.[11] The higher agency costs in these firms may be a source of more severe fraudulent activities; therefore, they are more likely to be punished by the CSRC. In addition, the lagged values of SBMeeting do not affect the dependent variable AGENT significantly, although the coefficient is positive. Firm size is shown to be significantly negatively (at the 1% level) related to the dependent variable AGENT.

As stated in section "Data, variables, and methodology," we formed sub-samples based on two criteria. We ran the logit models using these sub-samples, and the results are presented in Table III. The first criterion is the size of the supervisory board. For firms whose supervisory board is composed of four or fewer members, neither SBMeeting-Lag nor SBSize-Lag is significantly related to the dependent variable AGENT at the 5% significance level. For firms with more than four supervisory board members, however, SBSize-Lag is positively related to the dependent variable, and its coefficient is significant at the 5% level; one additional supervisory board member increases the probability of being punished by the CSRC by 36%. The marginal effect of SBSize-Lag is higher in this sub-sample than it is in the full sample (27%) presented in Table II. This finding further supports our previous explanation of the costs of monitoring. The empirical results also show that firms with a larger board of directors and those with a higher HHI tend to be punished by the CSRC, whereas firm size is negatively related to the dependent variable.

The second criterion for forming the sub-samples is the frequency of supervisory board meetings. According to CSRC requirements, a firm should have at least one supervisory board meeting every 6 months. Of the sample firms that had more than two supervisory board meetings in the year before the enforcement action, those with more supervisory board members are significantly positively (at the 5% significance level), related to the dependent variable AGENT. In other words, the probability of being punished by the CSRC increases by 76% when a supervisory board has one additional member. Again, our finding here indicates that, consistent with the board literature (e.g., Jensen, 1993), a large supervisory board may actually jeopardize the effectiveness of monitoring. As the members of supervisory boards in China usually represent different shareholders with different stakes in the listed company, internal conflict among these members (e.g., Xi, 2006) may be the reason, at least in part, for more severe penalties being imposed.

Conclusions

Using a relatively comprehensive dataset, we examine the issue of fraud in China's emerging markets from the corporate governance perspective. Unlike prior studies in this field, we explore the effects of supervisory boards, an important, yet forgotten, governance mechanism. Furthermore, we examine the enforcement actions taken by the CSRC and the stock exchanges. Given the rarity of security-related civil lawsuits in China, the CSRC has served as the country's main enforcement authority, whereas the stock exchanges take care of mild violations.

The conventional wisdom is that the supervisory boards of Chinese listed companies are dysfunctional. However, our results suggest that these boards do react to and attempt to cope with enforcement actions. The findings that supervisory boards meet more often when their firms face more serious penalties and that more members on a supervisory board lead to a lower degree of effectiveness have important policy implications for Chinese authorities and for other jurisdictions that are undergoing governance reforms.

TABLE III

Results based on the sub-samples

	Sub-samples based on supervisory board size				Sub-samples based on supervisory board meeting frequency			
	SBSize-Lag ≤ 4		SBSize-Lag > 4		SBMeeting-Lag ≤ 2		SBMeeting-Lag > 2	
	Coefficient	Std. Err.	Coefficient	Std. Err.	Coefficient	Std. Err.	Coefficient	Std. Err.
SBMeeting-Lag	1.915*	1.018	0.241	0.161	0.050	0.147	0.251	0.202
SBSize-Lag	0.145	0.279	0.363**	0.164	0.594	0.661	0.762**	0.381
SBCTurnover-Lag	0.449	1.360	0.297	0.389	0.254	0.481	0.399	0.610
SBCGender	−1.893**	0.873	0.705	0.759	0.251	0.620	−0.694	0.978
SBCAge	−0.050	0.052	0.016	0.023	−0.030	0.028	0.024	0.034
SBCTenure	−0.001	0.001	−0.001	0.001	−0.001	0.001	0.000	0.001
SBCShare	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000
BoardSize-Lag	0.410**	0.188	−0.017	0.096	−0.032	0.140	0.250**	0.118
BoardMeeting-Lag	0.029	0.141	−0.017	0.054	0.033	0.066	0.074	0.082
IDSize-Lag	0.229	0.389	0.176	0.161	0.411	0.260	0.012	0.190
BCCEO	2.616*	1.485	−0.096	0.508	0.670	0.632	0.674	0.699
HHI	0.001	0.002	0.001	0.001	−0.002	0.001	0.003**	0.001
GOV	0.200	0.880	−0.852*	0.473	−1.117*	0.604	0.485	0.569
FOR	0.082	2.007	–	–	1.773	1.563	–	–
LNTA	−0.561	0.448	−0.714***	0.249	−0.635**	0.306	−0.838***	0.314
ROA	0.956	1.328	0.110	0.276	0.247	0.382	0.364	0.462
DTA	5.161	4.275	1.719	2.771	0.382	3.407	1.738	3.194
TRADE	2.063	4.010	1.820	1.796	3.310	2.255	1.001	2.460
Constant	5.186	8.792	10.321**	4.959	10.393	6.747	7.468	6.044
n	58		151		111		99	
LR χ^2	22.12		26.37		20.51		31.50	
Prob > χ^2	0.2266		0.0679		0.3050		0.0173	
Pseudo-R^2	0.2761		0.1260		0.1333		0.2295	

See foot note 8.
***$p < 0.01$, **$p < 0.05$, *$p < 0.10$.

Our findings offer significant implications on the establishment of professional ethical codes for various agencies serving as monitoring organs, including supervisory boards and independent directors. Both monitoring organs are described as decorations to the overall governance mechanism in China; our findings that supervisory boards respond only for fraudulent firms provide supporting evidence that they passively react to enforcement actions. Put differently, only when an enforcement is imposed by the authority will the monitoring organs be forced to react, possibly because they may face more ethical concerns or legal consequences after a fraud is detected. To the extent that frauds detected only reflect a part of the total frauds committed, the lack of proactive actions from the monitoring organs may seriously deepen agency conflicts in the market, and harm the economy. To the best of our knowledge, no formal professional ethical codes about supervisory boards have been established/implemented in China; therefore, it is difficult to measure the effectiveness and diligence level of supervisory boards. Given that investors rely on, to a large extent, monitoring organs to protect their interest, our study sheds light on how to motivate monitoring organs to proactively, rather than passively, engage in fighting against fraudulent activities.

Future studies may further examine the mechanisms by which a supervisory board plays a role in improving governance. As the effectiveness of governance mechanisms depends on the context, an

investigation of supervisory boards in other countries would improve our understanding of this important element. Our study examines the role of supervisory boards in fighting against frauds using archival data from existing databases. Data limitation prevents us from considering more factors that could have an effect in our examination,[12] such as the demographic data of CEOs, the actual number of acts of fraud, which are difficult to measure, and the characteristics of enforcement agencies/officers. The connection of enforcement agencies/officers, for example, may influence the extent to which they are devoted to fraud enforcement; they could be more likely to target some firms rather than others, which may in turn influence the likelihood that one firm is subject to enforcement actions.

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Notes

[1] Our study focuses on supervisory boards, as supervisory boards represent an important governance element, but their role is rarely examined, especially in fighting frauds. Furthermore, in China's capital markets, the board of directors is directly involved in operation (e.g., Chen et al., 2006), while supervisory boards are monitoring organs; therefore, supervisory boards' role in a fraud setting may be different from that of the board of directors. It is worth pointing out, however, that our examination of the role of supervisory boards, after controlling for other governance factors including the board of directors, does not suggest that supervisory boards play a more important role in a fraud study than the board of directors. As discussed before, the board of directors has been found to play a crucial role in curbing fraudulent activities, as evidenced by prior studies (e.g., Beasley, 1996; Dechow et al., 1996).

[2] We thank an anonymous referee for raising this point. The term "fraud" can refer to accusations of fraudulent activities, convictions of fraudulent activities, or actual fraudulent activities. In this article, we focus on convictions of fraudulent activities by the CSRC and the stock exchanges. We can identify the first step the CSRC takes to investigate a possible instance of fraud by a firm, but as the firm may be innocent, we do not focus on accusations. Furthermore, it would be very difficult, if not impossible, to determine actual fraudulent acts (Chen et al., 2006); therefore, we follow prior literature by examining enforcement actions imposed by authorities (e.g., Dechow et al., 1996).

[3] After 2004, a firm will be labeled as ST if its net assets per share are negative.

[4] The supervisory board is different from the audit committees, although both play a monitoring role. The supervisory board co-exists with the board of directors, and is a separate monitoring organ outside the board of directors. Audit committee, on the other hand, is one of the several operating committees established under the board of directors. The board of directors delegates "responsibility for the oversight of management's financial reporting" (p. 548) to audit committees, which in turn monitor the internal and external audit functions to improve the credibility of financial reporting (Beasley and Salterio, 2001). In China, the General Principles of Corporate Governance for Listed Companies was issued by the China Security Regulatory Commission (CSRC) in 2002, and suggests that listed firms set up operating committees under the board of directors. Some companies have established operating committees, such as audit committees and strategic committees. The CSRC suggests that these committees consist of independent directors, especially those with accounting expertise. The requirement, however, is not mandatory; as a result, many firms have not yet established operating committees.

[5] The authors would like to thank an anonymous referee for his/her comments on the inclusion of a matching sample.

[6] We used the information available from 2001 to 2005 of all the companies listed in the Chinese stock markets, and found that the board size, on average, slightly decreased from 9.94 directors to 9.66 directors.

[7] Results indicate that, at least, the non-linear relationship between the dependent variable AGENT and one of the independent variables, SBSize, is significant. The results are available upon request.

[8] The dependent variable AGENT is a dummy variable, with 1 (0) denoting an enforcement imposed by the CSRC (stock exchanges). SBMeeting (SBMeeting-Lag) represents the meeting frequency in (before) the enforcement year. SBSize (SBSize-Lag) refers to the size of supervisory board in (before) the enforcement year. SBTurnover (SBTurnover-Lag) is a dummy variable, indicating whether there is supervisory board chair turnover in (before) the enforcement year. SBCGender, SBCAge, SBCTenure, and SBCShare refer to the gen-

der of the supervisory board chair, the age of the supervisory board chair, tenure of the supervisory board chair (in days), and shares held by the supervisory board chair, respectively. BoardSize (BoardSize-Lag) denotes the number of board members in (before) the enforcement year, BoardMeeting (BoardMeeting-Lag) reflects the meeting frequency of board of directors in (before) the enforcement year, and IDSize (IDSize-Lag) measures the size of independent directors in (before) the enforcement year. BCCEO is a dummy, with 1 (0) representing that CEO and the chair of board of directors are (are not) the same person. The Herfindahl index (HHI) measures the shares (in percentage) held by the 10 largest shareholders excluding the largest one. GOV (FOR) is a dummy variable indicating whether the government or government representative (foreign shareholder) is the largest shareholder. The natural log of total book value of assets (LNTA) measures the firms' size, ROA refers to the return on assets measuring the profitability, risk is measured by the debt–asset ratio (DTA), and TRADE measures the ratio of the number of tradable shares over that of total shares.

[9] Using the full sample with all the companies publicly listed in the Chinese stock markets, we find that the supervisory board meeting frequency and board meeting frequency are significantly positively correlated. So are the board size and the supervisory board size. These correlations can also be observed using the subsample with firms that experienced enforcement. To some extent, these results indicate that the board of directors and supervisory boards may react similarly to fraudulent activities caught by the administration. Given that issues about board of directors have been well addressed in the literature, we focus on those about supervisory boards in this study.

[10] We thank an anonymous referee for pointing out that similar patterns exist in a North American setting. For example, board committees do not meet often prior to the enforcement year, but meet more frequently when the enforcement is imposed.

[11] One anonymous referee indicates that board committees in a North American setting are usually larger prior to the enforcement, but are reduced in size when facing enforcement. Our findings suggest a similar pattern.

[12] We thank an anonymous referee for raising this point.

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