Chapter 11

Impact of Corporate Fraud on Foreign Direct Investment?

Evidence From China

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ABSTRACT

The capital market reputation attracts foreign investment. Corporate fraud phenomenon is one of the most crucial aspects that threaten foreign investors. This study investigates the impact of corporate fraud on foreign direct investment FDI. Using data of Chinese listed firms, over the period 2009 to 2017, the results show that corporate fraud is negatively associated with foreign direct investment. This suggests that corporate fraud declines foreign shareholders ratio, and foreign investors avoid investing in a risky environment where their wealth may be expropriated. Further, we explore the impact of having foreign shareholders on corporate fraud. We find that increasing foreign shareholders may help in curbing corporate fraud due to diversified corporate experience and risk-taking behavior. However, the findings remain robust after controlling for the potential endogeneity problem. Our findings have important implications for policymakers and governments as it shows that corporate fraud is a crucial determinant to the cause of foreign direct investment.

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1. INTRODUCTION

The current competition among developed countries to attract foreign investors has resulted in a pool of incentives for foreign investors, including paving the road for them by doing reforms in their markets. China is one of those countries. According to the new economic policy of China, to be a free and opened market has led the government to make relaxed regulations and allow foreign investors to possess shares in Chinese listed firms. To this end, the Chinese government has to gain foreign investors' trust in the capital market of China by improving capital market regulations, law enforcement, corporate governance, and quality of financial reporting. One of the severe threats that threaten investors is corporate fraud. Ethically, corporate fraud represents an ethical failure of management to bide its duties towards investors (Conyon and He, 2016).

The consequences of corporate fraud have been documented in the literature. For instance, economically, fraud firms suffer a decrease in firm value (Karpoff and Lott Jr, 1993), and unfavorable customer behaviors (Klein and Leffler, 1981, Johnson et al., 2014), an unfavorable stock market reaction (Karpoff et al., 2008, Palmrose et al., 2004), an increase in the cost of debt(Graham et al., 2008). Managerially, scholars contend that management turnover increases after fraud revelation(Agrawal and Cooper, 2017). Corporate fraud may cause employees to lose their jobs and pensions(Zahra et al., 2005). In terms of investment decisions, Using survey data from China's context, Niu et al. (2019) find that corporate fraud influences the decisions of household investment where household with more corporate fraud experience is more likely to invest in real estate and less likely to invest in securities. Which suggests that Chinese investors are likely to avoid investing in stock markets and more likely to choose a safe market. In line with this research line, we believe that investigation of the impact of corporate fraud on foreign direct investment is worthwhile and interesting. Especially, empirical evidence regarding the consequence of corporate fraud on foreign direct investment has not existed. Thus, in this study we address the concern question of whether the corporate fraud phenomenon in China affects foreign direct investment or not. Theoretically, the ownership, location, and internalization (OLI) paradigm explain how foreign direct investment work(Dunning, 2015). In addition to the three factors above that drive foreign investors' decisions, we believe that assigning an incremental factor would expand our knowledge of further causes and its influence on foreign direct investment. Thus, given the consequences of corporate fraud, making us expect that corporate fraud is an additional factor that may drive foreign direct investment in the China context. Where foreign investors avoid investing in costly and risky market(Robertson and Watson, 2004).

We focus on China's context because the acute competition of attracting foreign investment faced China along with the severe fraud corporate consequences in this context. Chen et al. (2006) report that the fraud phenomenon is severe in China, since its capital market regulations and law enforcement are weaker than those of developed countries. Further, unlike other developed countries, China is characterized by weak law enforcement and investor protection(Ding et al., 2012), which creates a low level of trust in China's capital market by foreign investors. Therefore, exploring how the likelihood of corporate fraud, in the largest emerging market, drives foreign direct investment in the policy point view is very important. Given the variety of Chinese listed firms' shares (on average around 30% of listed firms' shares owned by the government and its agencies where these shares are untradeable, while the other types of shares (A, B, H) are owned by individuals and are tradeable in two security markets(Xu, 2004), making it more interesting to examine the heterogeneity effect in corporate fraud across different shares' type. Additionally, China is considered to be a free trade market along with the recent reforms in the

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