New model and evidence of cash tunnelling in Chinese firms

Yi Wei*, Jianguo Chen* and Jing Chi*

Abstract

This study investigates how controlling shareholders tunnelled firm value from Chinese fraudulent companies during the 1998-2010 period, and in which situations controlling shareholders were more likely to conduct tunnelling. We find that the higher the profitability of the firm, the lower the tunnelling level; the higher the cost of tunnelling, the lower the tunnelling level; the higher the ownership of the top shareholders, the lower the optimal tunnelling level. Tunnelling is simply transferring the company's cash to the top owner's personal account; such that this will eventually become a loss to the company. This analysis supports the prediction that fraudulent owners choose a "soft" account to record a vacant asset at the time of the cash transfer and the record will be maintained there as long as possible. The softness feature of an account makes it easier to manipulate and its appearance as a loss much later in its financial reports makes tunnelling more difficult to uncover in the annual auditing process. Given the divergence between controlling shareholders and minority shareholders, understanding the factors and process of tunnelling can influence the likelihood of expropriation by controlling shareholders.

* School of Economics and Finance, Massey University

Corresponding Author: Yi Wei, 06 3569099 ext 85629, W.Yi@massey.ac.nz

October 2014