Foreign Residency Rights and Corporate Fraud

In China, criminal fugitives are on the rise. Weakness of China’s passport power, indexed by the number of countries waiving visas for Chinese nationals, may motivate fraud-committing individuals to obtain foreign residency as an exit route, given that extraditions seldom occur. Prof Li Zhen, Musim Mas Chair Professor in Sustainability, Professor of Accountancy, NUS Business School, and his colleagues examined whether persons (natural persons or family who directly or indirectly own > 50% of shares of firms) with foreign residency rights (FRR) are more likely to engage in corporate fraud in China.

“Homo economicus” suggest that agents commit crime when the expected utility of payoff exceeds the expected disutility of being caught and punished. With foreign residency rights, surveyed persons have a lower expected cost for their fraudulent activities and are hence more likely to commit corporate fraud. Professor Li then put forward his hypothesis that, a controlling person with foreign residency right is more likely to commit corporate fraud. The examination includes only publicly listed companies as they are required to disclose relevant information, though such behaviour may exist in other types of companies.

Professor Li posited that the positive association between FRR and fraud is suggestive of two potential mechanisms. One is that surveyed persons with FRRs are more likely to commit fraud. Alternatively, surveyed persons who have committed fraud are more likely to seek FRRs. To differentiate between these two potential mechanisms, Professor Li examined the two mechanisms that will produce different predictions, and found that the positive associations between FRR and fraud are stronger on regions with weaker legal environment, supporting the causality of FRR to fraud. Such a finding is robust to an estimation of a bivariate probit model that incorporates undetected fraud.

In the cross section analysis, higher managerial ownership, greater analyst coverage and higher institutional holdings mitigate this association. The link, however, diminishes in the more recent years after high-profile extraditions of businessmen and regulatory focus on foreign residency rights in the political sector. Professor Li concluded that a lower expected probability of getting caught and punished associated with executives with foreign residency rights induces corporate fraud.

In conclusion, firms with surveyed persons who have foreign residency right are more likely to engage in corporate fraud. It further cautions investors including shareholders and creditors who consider investing in these firms. For the Chinese regulators, this finding is a red flag for them to detect potential culprits. The governments of foreign countries should keep a lookout for residency applicants with possibility of engaging in commercial frauds in their home countries. This research also offers reason for extradition agreements.

This summary reflects the personal opinion(s) of the seminar speaker(s) and should in no way be attributed to the East Asian Institute.