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THE SOCIAL STRUCTURE OF FINANCIAL FRAUD: EVIDENCES FROM A UNIQUE CHINESE DATASET (SUMMARY)

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THE SOCIAL STRUCTURE OF FINANCIAL FRAUD:
EVIDENCES FROM A UNIQUE CHINESE DATASET

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Principal Topic

Unethical behavior of organizations, such as financial fraud, has attracted enormous attentions from both organizational theorists and management scholars. However, we still know very little on this topic. One major challenge is that fraudulent behaviors are usually unobservable to outsiders such as governmental regulators and academic researchers. Cases caught by the public’s eyes are only the tip of the iceberg and thus any research with a focus on them will unavoidably run into the issue of selection bias.

Method

My research takes advantage of an atypical dataset from China that provides a unique opportunity to identify financial fraud among 270 technology ventures. The data contain two sets of financial books that are assumed to report the same set of financial information for each firm but discrepancies often happen as firms are tempted to underreport their financial performances in one book (to hide wealth) but to exaggerate their performance in another book (to win governmental grant). I use these discrepancies to identify which firms are manipulating their data and to what extent they are doing it.

I propose that there is a social structure under financial fraud. As organizational actors are embedded within a network of relationships (Granovetter, 1985), these ongoing relationships provide the constraints and opportunities that help explain unethical behavior of organizations (Brass, Butterfield, and Skaggs, 1998). To be specific, I look at the relationships among the founders of a given venture and the relationship between the founders and the local community. I also examine how market dynamics such as competition interacts with the social factors.

Results and Implications

Empirical analyses show the following patterns: 1) Single-owner firms are more likely to misrepresent their financial data; 2) firms of multiple owners are more likely to misrepresent their data when the founders share strong network ties (such as family members or coworkers) with each other; 3) firms whose founders are weakly embedded in the local society (e.g. migrants who grew up and worked in other regions) are less likely to misrepresent data; and 4) market dynamics has different impacts on local and migrant entrepreneurs: higher competition adds incentives for local entrepreneurs to cheat but adds pressures for migrant entrepreneurs to behave more honestly. These results suggest that local entrepreneurs may enjoy certain “grey advantages” over migrant entrepreneurs.

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1 Not all of these 270 firms are included in this study as the author is still coding the information on some of these firms.