

RGC Ref. No.: UGC/FDS11(25)/B01/16 <hr/> (please insert ref. above)

**RESEARCH GRANTS COUNCIL
COMPETITIVE RESEARCH FUNDING SCHEMES FOR
THE LOCAL SELF-FINANCING DEGREE SECTOR**

FACULTY DEVELOPMENT SCHEME (FDS)

Completion Report
(for completed projects only)

<p><u>Submission Deadlines:</u></p> <ol style="list-style-type: none"> 1. Auditor's report with unspent balance, if any: within six months of the approved project completion date. 2. Completion report: within 12 months of the approved project completion date.
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Part A: The Project and Investigator(s)

1. Project Title

Economic Consequences of the Anti-Corruption Campaign in China

2. Investigator(s) and Academic Department(s) / Unit(s) Involved

Research Team	Name / Post	Unit / Department / Institution
Principal Investigator	MAN, Paul Ho-yin / Assistant Professor	Faculty of Management and Hospitality / Technological and Higher Education Institute of Hong Kong
Co-Investigator(s)	CHENG, Peter Shu-tong / Professor	No affiliation
Others		

3. Project Duration

	Original	Revised	Date of RGC / Institution Approval <i>(must be quoted)</i>
Project Start Date	1 Jan 2017	-	N/A
Project Completion Date	31 Dec 2019	30 Jun 2020	12 Dec 2019
Duration <i>(in month)</i>	36 months	42 months	12 Dec 2019
Deadline for Submission of Completion Report	31 Dec 2020	30 Jun 2021	12 Dec 2019

Part B: The Final Report

5. Project Objectives

5.1 Objectives as per original application

1. Examine the economic consequences of President Xi's anti-corruption campaign on the operating environment of politically-connected firms in China.
2. Investigate the impact of President Xi's anti-corruption campaign on the level of earnings management of politically-connected firms in China.

5.2 Revised objectives

Date of approval from the RGC: N/A

Reasons for the change:

5.3 Realisation of the objectives

(Maximum 1 page; please state how and to what extent the project objectives have been achieved; give reasons for under-achievements and outline attempts to overcome problems, if any)

Prior studies on the effect of anti-corruption campaign on individual firms have produced inconsistent results. To buttress our understanding of the effects resulting from the implementation of anti-corruption campaign, we first evaluate the economic consequences of anti-corruption campaign on the operating environment of politically-connected firms in China. We then investigate if the impact on firms' operating environment, if any, is associated with changes in firms' level of earnings management.

As part of President Xi's anti-corruption campaign, the Chinese government launched "Rule 18" in 2013 and banned all government officials to work concurrently in enterprises. The release of Rule 18 resulted in a wave of resignations of bureaucrat directors and provided a natural setting for us to fulfill our objectives. For the first objective, we began by testing if there are significant differences on the medians of operating environment variables (innate factors): firm size, length of operating cycle, incidence of negative earnings, volatility of operating cash flow, and volatility of shares' trading volume of politically-connected firms between pre-Rule 18 (2011 – 2012) and post-Rule 18 (2014 – 2015) periods. Results from the Wilcoxon signed-rank tests indicate

that firms with resigned directors due to Rule 18 have lower volatility in sales in post-Rule 18 period. As for corrupt firms, they are found to be associated with lower volatility in operating cash flow upon the release of Rule 18. We then extend our investigation on the economic consequences of anti-corruption campaign on the operating environment of impacted firms by regressing various measures and components of accrual quality (*AQ*) on the dummy variable *CONRESIGN* together with sets of innate, financial, governance, and return volatility control variables for both pre- and post-Rule 18 periods. The dummy variable *CONRESIGN* was assigned the value of 1 if the sample firm was politically-connected in pre-Rule 18 period but has all politically-connected directors resigned in post-Rule 18 period. Using a set of year, industry and propensity score-matched sample of firms with no political connection as our control group, regression results indicate that *CONRESIGN* firms are associated with lower *AQ* (i.e., higher reporting quality) in post-Rule 18 period as compared to firms with no political connection. More importantly, partitioning of *AQ* shows that such an improvement in reporting quality is sourced from the innate component of *AQ*. In other words, firms impacted by Rule 18 have improved reporting quality which is driven by a more favorable operating environment. In addition, by regressing individual firms' industry-adjusted earnings to price ratio on *AQ*, *CONRESIGN*, the interaction term *AQ* x *CONRESIGN* together with sets of innate, financial, governance, and return volatility control variables for both pre- and post-Rule 18 periods, we find that *CONRESIGN* firms are associated with lower cost of equity as compared to firms with no political connection in the post-Rule 18 period. Similarly, the lower cost of equity is sourced from the innate component of *AQ*, meaning that investors demand a lower return from firms with terminated political connection due to an improved operating environment.

Prior literature has documented that *AQ* is driven by both the innate features of the firm's operating environment as well as the discretionary management choice of accounting policies and implementation decisions. In running the above regressions, no significant association is found between the discretionary component of *AQ* and termination of political connection, or cost of equity of impacted firms, in post-Rule 18 period. This is supportive of the proposition that managers of impacted firms, facing an improved operating environment, find no incentive in altering the level of earnings management. A robustness test is run by regressing level of earnings management as proxied by various measures of absolute discretionary accruals on two dummy variables: 1) the dummy variable *CONRESIGN*; and (2) a dummy variable (*POST*) with value of 1 if the sample firm falls into the post-Rule 18 period. An interaction term (*CONRESIGN* x *POST*) involving the two dummy variables together with a set of control variables are also included as independent variables. We do not find any significant coefficient of the interaction term for *CONRESIGN* firms as compared to firms with no political connection. Overall, there is no significant impact of anti-corruption campaign on the level of earnings management of politically-connected firms in China.

5.4 Summary of objectives addressed to date

Objectives (as per 5.1/5.2 above)	Addressed (please tick)	Percentage Achieved (please estimate)
1.Examine the economic consequences of President Xi's anti-corruption campaign on the operating environment of politically-connected firms in China.	✓	100%
2.Investigate the impact of President Xi's	✓	100%

anti-corruption campaign on the level of earnings management of politically-connected firms in China.		
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6. Research Outcome

6.1 Major findings and research outcome

(Maximum 1 page; please make reference to Part C where necessary)

Firms with terminated political connection due to the launch of anti-corruption campaign were found to experience an improved operating environment. Results from tests of medians of innate factors indicate that such firms have lower volatility in sales. Regression results also indicate that these firms have better reporting quality which was driven by a more stable operating environment as proxied by the innate component of accruals quality. Economically, these firms were associated with a lower cost of equity which, again, was driven by the innate component of accruals quality. Overall speaking, our evidence is supportive of the proposition that anti-corruption campaign helps to create a stable and better operating environment for impacted firms.

Tests from similar regressions reveal no significant association between the termination of political connection and the discretionary component of accruals quality for firms impacted by the anti-corruption campaign. No significant association was noted between the cost of equity and the discretionary component of accruals quality for these impacted firms as well. This evidence is consistent with the proposition that firms found no incentive to engage in earnings management after the launch of anti-corruption campaign when they were faced with an improved and more stable operating environment.

6.2 Potential for further development of the research and the proposed course of action

(Maximum half a page)

Evidence from prior literature suggests that the impact of the anti-corruption campaign on individual firms is dependent upon institutional factors such as the degree of development of the financial markets and judicial efficiency. To examine the moderating role of financial market development, we may follow prior studies (e.g., Hope et al. 2020) to use a financial market index to measure the development of financial market and partition our sample based on the median of the province-level financial marketization index. As for judicial efficiency, we may adopt the judiciary-efficiency index developed by the World Bank to measure the effectiveness of law enforcement and partition our sample based on the median of province-level court-efficiency index.

We may also perform additional robustness tests on two potential confounding events that occurred around the event we examine. The first one is the launch of the Eight-Point Regulation on 4 December 2012. The regulation requires government officials to reduce perks and was perceived as the launch of China's anti-corruption reform. The launch of the Regulation led to a huge reduction in firms' travelling and entertainment costs (*T&E*) which are presumably used for corruption. To control for the effects of the drop in *T&E* due to the Regulation, we may add *T&E* as a control variable and re-run our main tests. We may also exclude the year 2012 from our sample to ensure our results are not driven by the Regulation. The second potential confounding event is the market liberalization reform, the Shanghai-Hong Kong Stock Connect, which significantly changed the market segmentation in China. The market liberalization reform introduces foreign investors and is a potential source affecting firms' reporting quality. To control for the effects of the market liberalization, we may include a dummy variable which equals one if the stocks can be directly traded by international investors and re-run our main tests.

7. Layman's Summary

(Describe in layman's language the nature, significance and value of the research project, in no more than 200 words)

The widespread practice of corruption in China in the 80's and 90's has prompted President Xi to launch a series of anti-corruption campaign when he assumed office in 2012. This project examines the reporting environment of impacted firms and the economic consequences of such anti-corruption campaign at individual firm level. Comparing with firms with no political connection, we find that impacted firms are associated with higher reporting quality upon the launch of the campaign. Further investigation reveals that such increase in reporting quality is originated from an improvement in the operating environment of impacted firms. This evidence is consistent with the proposition that anti-corruption campaign helps to create a stable and better operating environment by restoring fair market competition, correcting distorted investment incentives, and reducing transaction costs. With more precise and informative financial reports, investors of impacted firms are found to demand a lower cost of capital as compared to investors of firms with no political connection.

Part C: Research Output**8. Peer-Reviewed Journal Publication(s) Arising Directly From This Research Project**

(Please attach a copy of the publication and/or the letter of acceptance if not yet submitted in the previous progress report(s). All listed publications must acknowledge RGC's funding support by quoting the specific grant reference.)

The Latest Status of Publications				Author(s) (denote the corresponding author with an asterisk*)	Title and Journal / Book (with the volume, pages and other necessary publishing details specified)	Submitted to RGC (indicate the year ending of the relevant progress report)	Attached to this Report (Yes or No)	Acknowledged the Support of RGC (Yes or No)	Accessible from the Institutional Repository (Yes or No)
Year of Publication	Year of Acceptance (For paper accepted but not yet published)	Under Review	Under Preparation (optional)						
Nil									

9. Recognized International Conference(s) In Which Paper(s) Related To This Research Project Was / Were Delivered

(Please attach a copy of each conference abstract)

Month / Year / Place	Title	Conference Name	Submitted to RGC (indicate the year ending of the relevant progress report)	Attached to this Report (Yes or No)	Acknowledged the Support of RGC (Yes or No)	Accessible from the Institutional Repository (Yes or No)
April / 2021 / Singapore	Economic Consequences of Anti-Corruption Campaign in China: An Exploratory Study	The 4 th International Conference on "Advance Research in the Field of Business, Economy and Social Science Research" BESSR-2021 Singapore	No	Yes	Yes	Yes

10. Whether Research Experience And New Knowledge Has Been Transferred / Has Contributed To Teaching And Learning

(Please elaborate)

Data processing and regression techniques have been shared with students enrolling in the Final Year Project module of the Bachelor of Arts (Honours) in Professional Accounting programme.

11. Student(s) Trained*(Please attach a copy of the title page of the thesis)*

Name	Degree Registered for	Date of Registration	Date of Thesis Submission / Graduation
Nil			

12. Other Impact*(e.g. award of patents or prizes, collaboration with other research institutions, technology transfer, teaching enhancement, etc.)*

The China Stock Market and Accounting Research (CSMAR) database was subsequently
 subscribed by the Institute as an additional data source for students' final year projects.

13. Statistics on Research Outputs

	Peer-reviewed Journal Publications	Conference Papers	Scholarly Books, Monographs and Chapters	Patents Awarded	Other Research Outputs (please specify)	
					Type	No.
No. of outputs arising directly from this research project	-	1	-	-	-	-

14. Public Access Of Completion Report*(Please specify the information, if any, that cannot be provided for public access and give the reasons.)*

Information that Cannot Be Provided for Public Access	Reasons
Nil	