The sources of recent financial fraud among Chinese overseas listed companies.

From Mythology to Scan

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A rash of accounting scandals concerning Chinese companies in 2012 has led to a systematic dive in the share price of Chinese companies listed in overseas markets, including mainly the stock exchanges in the US, Hong Kong and London. Till today, 50 China-based companies have been delisted from US exchanges and more than 40 individuals or companies have been sued for fraud or under the US Securities and Exchange Commission (SEC) investigations. In comparison with the Golden era of the Chinese-Concept in overseas markets, in particular from 2007 to 2011[1], when Chinese firms succeeded about 100 IPOs in the US, investors might now feel that this is inconceivable and raise questions such as: How can the "Chinese Magic" bubble turn into a "Chinese scandal"? What are the source and the race of this problem?

« Doors wide open to the fast-growing Chinese firms »

1. Initial Public Offering (IPO) is a common dream for Chinese entrepreneurs

At the end of 2012, more than 2,490 Chinese companies have been listed in Shanghai and Shenzhen stock exchanges with a total market capitalization of 3'880 billion USD. This number is, however, negligible compared to the tremendous capital needs expected by Chinese firms. China's rapidly growing economy, with an average annual growth of more than 10.2% over the last two decades, has given birth to a large number of private small companies and startups. For diverse reasons, small private firms have difficulties obtaining bank funding and raising equity from domestic capital markets. On the contrary, overseas markets in Hong Kong and the US have their doors wide open to the fast-growing Chinese firms. The financial appetite of Chinese firms, in particular those small private ones, is satisfied by the channel of "overseas IPO". In addition, for those that cannot fulfill the listing qualifications under the Chinese system of issuing criteria, the US may provide them with alternative opportunities to raise money.

Over the past decade, a huge industry has emerged to help Chinese companies to go public in the US. The main players along this industry chain are, however, neither the company founders nor the executives and accountants, but numerous intermediaries, or so-called "gatekeepers"; firms or individuals that help find and bring Chinese businesses to US exchanges, including stock promoters, law firms, investment banks, consultants, auditors, as well as the representatives of overseas stocks in China. These firms have offices mainly based in Beijing, Shanghai, Hong Kong and New York, and they offer small Chinese companies the chance to realize their dreams of raising money from US investors. As said by one listed company's CEO: "these experts and intermediaries are more active and motivated in helping our company to IPO since their remuneration first depends on whether the company can be listed or not, and secondly how much the P/E multiples are". In case the corporation's performance does not meet the listing requirement, these intermediaries will use their creative tools to make up the listing application document, to push the IPO pricing up and consequently maximize their own benefits. Very often, intermediaries use more creative packaging tools, beyond accounting solutions, to « bridge » these Chinese firms with the US equity market.

One creative solution is a "reverse takeover" or "reverse merger", in which a company goes public by taking over a shell company traded in the US. This circumvents much of the regulatory scrutiny involved in a traditional initial public offering; often referred to as the "IPO Express" in Chinese. Consequently, accounting treatment and documents serve for the purpose of reverse takeovers and meeting the SEC requirements, which is the main source and motivation for accounting fraud.

2. Why does accounting fraud occur frequently in Chinese companies listed in the US?

It seems controversial and surprising that the recent accounting scandals should

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be subject to China-based firms listed in the US notably because of the severe SEC regulations and obligations of applying international accounting standards. Several aspects are relevant to this issue.

The under-developed accounting profession

Although all Big-4 auditing firms have developed their affiliations in China, a majority of Chinese middle and small firms hire local accountants or auditors who might not have sufficient competence and knowledge of IFRS and US GAAP. Furthermore, many "old accountants", who were educated under the prior accounting systems based on the Soviet Socialist economy[2] are still active in the profession.

Low efficiency of corporate governance

Over the last decade, in response to the WTO entry, Chinese authorities have made great efforts in strengthening corporate governance of Chinese publicly listed firms. But the small private firms are beyond the reach of the governance guidelines of these authorities. The motivation to make the IPO dream come true can easily lead to accounting manipulation. Moreover, managers of those overseas listed companies may have more opportunities to manage earnings since the monitor mechanisms are difficult to access for supervisors and investors.

Questionable auditing quality

Due to the low independence, limited skills, and incompetence of auditors, the auditing quality in China is questionable. Furthermore, firms can easily obtain fickle accounting evidence, invoices, and other official proof or documents from the "black market", which increases the difficulties for auditors to uncover the reality.

Regulation gap between the US and China

There exist many layers of regulation gaps between the US and China. The most recent case, Longtop Financial Technologies –a Chinese technology company listed on the NASDAQ–, revealed the legal conflict in auditing between the two countries. Under Chinese law and regulations, the auditors of Chinese firms are prohibited from providing related audit working papers to foreign regulatory authorities. Thus, US regulators could not get enough information to monitor or punish the Chinese auditors.
In 2007, China adopted the new accounting standards, which converged with the International Financial Reporting Standards (IFRS). However, the convergence to IFRS cannot automatically stop accounting fraud, as claimed by an anonymous CFO from one of the listed companies, "accounting standards only change the face of financial reporting but not the fundamental practice".
So far, the accounting fraud of overseas Chinese firms has warned the investors who are fascinated for Chinese miracle. But investors should not consider all Chinese firms as fraudulent. Moreover, the overseas listed companies represent only a small proportion of the Chinese economy. It is not wise to go to another extreme: Chinese firms are too dangerous to invest in. As one Chinese idiom says, "We shall not use one leaf to blind the whole scenery".

[1] From 2007 to 2011, there were, respectively, 29, 4, 10, 39, and 12 Chinese firms making IPOs in US markets.

[2] The accounting system implemented in China before 1993 is fundamentally different from international practice.

« Accounting standards only change the face of financial reporting but not the fundamental practice »

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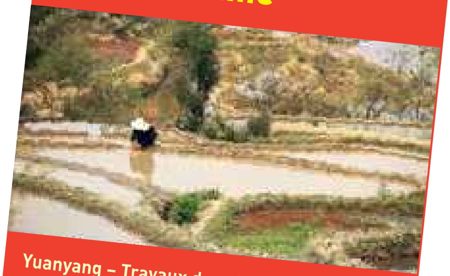
Vues de Chine



Yuanyang – Travaux dans les rizières en terrasses
Au Yunnan, les Hani forment une des nombreuses minorités ethniques vivant en Chine. Ils se consacrent à la culture du riz et sont réputés pour leur art de travailler les rizières en terrasses, avec une parfaite maîtrise de leur irrigation.

Vues de Chine

Femme Yao
Les Yao résident dans les terres montagneuses du sud-ouest de la Chine depuis plus de 2000 ans. Les paysannes Yao ont cette caractéristique de ne couper leurs cheveux que deux fois dans leur vie, leur longueur étant un critère de beauté. Parfois, elles ajoutent des cheveux déjà coupés ou qu'elles ont reçus de leur mère ou de leurs grand-mères.