Red Flag – Characteristics of Fraudulent U.S.-listed Chinese Companies

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Abstract

The American Institute of Certified Public Accountants (AICPA, 2002) No 99: Consideration of Fraud in a Financial Statement Audit (SAS 99). SAS 99 describes fraud as a purposeful act that results in a material misstatement in financial statements. We performed a literature review and discussed the attributes of 250 US listed Chinese firms such as political connections, reverse merger, location in China, auditor’s reputation and corporate governance in order to build a model to predict red flags. We find that red flag companies have these characteristics. (1) U.S listing via reverse merger. (2) earning management, (3) poor corporate governance. (4) hire small and obscure audit firms, investment banks and law firms to assist in their effort to gain listing. (5) lack accounting standards and (6) political connection. We conclude that US listed Chinese firms displayed these red flags that can identify their potential to commit fraud and misrepresent financial information.

Abbreviations:

Public Company Accounting Oversight Board (PCAOB), Initial Public Offering, IPO

Securities and Exchange Commission (SEC)

Introduction

Sino-Forest Corporation, China Sky One Medical and China Energy Savings Technology are just a few of a long list of corporations which practices financial statements fraud and consequently undermined confidence in U.S. listed Chinese companies. Despite gaining global importance as suppliers, competitors, customers, partners and targets of foreign investment since financial reform started in 1979 (OECD 2005), scandals of U.S.-listed Chinese companies have shaken Wall Street’s confidence in the U.S. listed Chinese companies.
Chinese firms ranked behind only Canadian firms in U.S. stock exchange listings. The number of U.S.-listed Chinese companies grows from 33 in 2001 to 282 in June 2011, at an average annual growth rate of 25% (see Figure 1). Allegations of misleading financial disclosures by U.S.-listed Chinese firms triggered investigations by the U.S. Public Company Accounting Oversight Board (PCAOB), Securities and Exchange Commission (SEC), the U.S. Congress, U.S. courts, hedge funds and the financial press into their financial disclosures and audits, with related investigations underway in Canada (Wall Street Journal, January 24, 2012).

Auditors’ ethical responsibility for detecting and reporting fraudulent reporting has long been the focus of much interest and debate (Gwilliam, 1991; Humphrey et al., 1993 (Louwers et al., 1997; Tsui and Gul, 1996).) The auditing profession over the years has developed its own set of tools to unravel such misrepresentations and to ensure that financial statements are in accordance with generally accepted accounting principles. However, when major fraudulent events have escaped detection by auditors, these standards have often been supplemented with additional rules by the SEC and by the U.S. Congress (Baker et al., 2006).

There are two ways these firms can get listed on US stock exchanges. One is through reverse takeover and another through Initial Public Offering, IPO.1 Fraudulent firms are more likely to gain U.S listing via reverse merger, have higher level of earnings management, autocratic governance structure, higher level of ownership concentration, lower proportion of outside independent directors, and less likely to establish an audit committee. They hire small and low-reputation audit firms, investment banks and law firms to provide listing services. They are politically connected from small or more backward provinces.

1 141 went public via IPO of ARDs and 114 via reverse merger
The purpose of this paper is to examine methods in assessing the risk of fraudulent financial reporting of U.S.-listed Chinese companies using behavioral (Hansen et al, 1996; Bell and Carcello, 2000) and quantitative factors (Green and Choi, 1997; Summers and Sweeney, 1998, Beneish 1999). This paper discuss and proposed factors that could provide early warnings to potential fraudulent practices. The potential users of this methodology include regulatory agencies, audit firms and investors. We perused past academic and non-academic materials to discuss and described the problem in identifying red flag of U.S.-listed Chinese companies.

We developed a list of red flag which is relevant to the Chinese business environment such as political connections, reverse merger, location in China and corporate governance. We combines aspects of the fraud assessment research in accounting from the USA with Chinese characteristics. This would help users to identify and predict company with potential to misrepresent information and involved in fraudulent activities. The research question is whether red flags associated with fraudulent financial reporting can help external auditors in detecting potential fraud scheme in China?

The rest of this article is as follows. In Chapter 2, we review fraudulent financial reporting literature in the US and Chapter 3 discussed characteristics of fraudulent US listed Chinese Firms. Chapter 4 is our conclusion. In chapter 5 is Tables and figures in chapter 6, we provide referencing.

2. Literature Review

Fraudulent financial reporting (FFR) occurs because the top managers reporting accounting numbers intentionally misrepresent underlying economic conditions to advance their own economic interest. Indicators of potential fraud or red flags literature are generally performed for the auditing profession and focus on information that can
only be determined at close contact (Loebbecke et al. 1989; Pincus, 1989; Asare and Wright, 2004). Loebbecke et al. (1989) proposed three main components: conditions, motivation, and attitude.

Determinant of red flags include possession of auditor qualification, external auditing experience, CPA License, prior exposure to red flags, attending conferences on red flags, in house training on red flags (Moyes and Baker, 2009; Hackenbrack, 1993). Audit firm size, the level of auditor industry specialization, the length of auditor tenure, and the experience of the auditor are important in assessing the risk of fraud (Hogan et al, 2008; Knapp and Knapp, 2001; Moyes, Shao & Newsome, 2009). Moyes (2007) found no differences between external and internal auditors regarding the overall perceived level of fraud detecting effectiveness. Wells (2005) discovered that improper disclosure scheme can take place as a form of fraudulent financial reporting. He said improper disclosure involves liability omissions, subsequent events, management fraud, related party transaction, and accounting changes. Farber (2005) finds that fraud firms have poor governance relative to no fraud firms(fewer independent board members, fewer audit committee meetings, fewer financial experts on the audit committee, a smaller percentage of big 4 auditing firms, and a higher percentage of CEOs who are also chairman of the board.

Gramling and Myers (2003) reported that internal auditors tend to emphasize management characteristics as important fraud detecting factors. Their research findings showed that internal auditors perceive factors related to attitude or rationalization conditions as the most important warning sign of possible fraud. (Church et al., 2001) examined unexpected changes in operating income under different conditions and to assess the likelihood of fraud. They found fraud is more likely when income surpassed expectations.

3. Characteristics of fraudulent US listed Chinese Firms

In this chapter we discuss the characteristics of U.S.-listed Chinese companies that is
more likely to get involved in fraudulent activities. We propose these factors as determinant of red flag.

### 3.1 Reverse Merger

U.S.-listed Chinese companies can access the U.S. capital markets mainly through a U.S. SEC-registered public offering (Air Media, CNInsure, Baidu, New Oriental Education). There are two principal U.S. federal statutes which govern securities transactions in the U.S. that is the Securities Act of 1933, as amended (the “1933 Act”) and Securities Exchange Act of 1934, as amended (the “1934 Act”). The process can tedious and costly.

A reverse merger is a transaction in which a private company’s owners gain control of a public company (a shell) by merging it with their private company (Adjei, Cyree and Walker, 2008). The owners of the private company receive the bulk of the shares of the shell and thus the control right of the shell’s board of directors. There are two obvious advantages of reverse merger. First, the cost of going public through reverse merger could be lower than going public through IPO. Therefore, many companies with small scale, short operating history and poor performance choose this avenue to listing. (Adjei, et al., 2008); Second, reverse merger can bypass onerous SEC mandated listing requirements and disclosures for IPO (Arellano-Ostoa and Brusco, 2002), where shady companies that have reasons to avoid public disclosures.

The potential hazard of accounting fraud among reverse merger companies is also greater. First, since reverse merger companies have not undergone rigorous audit at the initiation of the listing, the credibility of their financial reports are suspect at inception. Second, these companies are usually smaller, younger and poor-performing. In order to attract the attention of investors and to raise more capital through a follow up seasoned equity offering, they have the incentive to window dress or even commit accounting fraud.
3.2 Financial information

Previous studies have shown the positive correlation between corporate financial fraud and earnings management (Benish, 1997, 1999; Lee et al., 1999; Dechow et al., 1996; Jones, Krishnan, and Melendrez, 2008). Perols and Lougee (2011) suggest that using income-increasing discretionary accruals over several years cause managers to run out of ways to manage earnings. Therefore, firms that manipulate financial statements over several consecutive years become increasingly pressured to use fraud to manipulate financial statements.

3.3 Corporate Governance

Beasley (1996) finds that larger proportion of independent directors in the board significantly reduces the likelihood of financial fraud. Skousen and Wrigh (2006) on the other hand show that fraud is more commonplace when CEO is also the Chairman of the Board, and when the proportion of insider ownership (management and directors) is lower. DeChow et al. (1996) find that firms manipulating earnings are less likely to have an audit committee. Farber (2005) also uses AAERs as a proxy for the occurrence of fraud and finds fraud firms have fewer financial experts on the audit committee.

Chinese publicly listed companies are often dominated by a single shareholder. It is commonly owned by families or state owned enterprises. This encouraged poor corporate governance.

3.4 Financial intermediaries – Audit firms, investment banks

Financial intermediaries, such as audit firms, investment banks and law firms, play an important role in facilitating Chinese companies go public in U.S. Previous studies have shown there is a positive association between the quality of companies and their intermediaries (Wilson and Grimlund, 1990 Chemmanur and Fulghieri, 1994).
Venture capital firms are postulated to provide monitoring services (Barry et al., 1990), but they may also bring immature companies to market for grandstanding (Gompers, 1996; Lin and Smith, 1998; Lee and Wahal, 2004), and even lead the companies they funded down the slippery slope toward fraud by dressing them up for IPO (Jiang et al., 2011).

### 3.5 Political patronage

Fan, Wong and Zhang (2007) shows that CEOs of 27% of Chinese listed companies have had served as a current or former government bureaucrats.

Political connection could be a double edged sword. On the one hand, political connection may reduce costs of doing business imposed by bureaucrats and regulators, facilitate loans from large state owned banks, and receive other preferential treatments (Khwaja and Mian, 2005; Faccio, Masulis, and McConnel, 2006). On the other hand, the same process that politically connected managers grease the political system breeds not only corruption, but managers without strong moral principle may also have less compunction to defraud investors. That is, we hypothesize these owners/managers are more likely to involve in financial fraud than their unconnected counterpart.

### 4. Conclusions

This discussion paper provides a framework to study factors that could help auditors to detect early warning signal of US listed Chinese firms engaging in fraudulent practices. It takes into account the Chinese characteristics such as location away from Beijing supervision, political connection and reverse merger as means of gaining US listing as signs of potential red flags.

We find that red flag companies have these characteristics. (1) They are more likely gain U.S listing via reverse merger. (2) They appeared to be more profitable but in large part
due to their inflation of profits by earnings management. (3) They have poor corporate governance. (4) They hire small and obscure audit firms, investment banks and law firms to assist in their effort to gain listing. (5) Their headquarters are usually located in provinces where accounting standards are hard to implement (6) They have political patronage.

We conclude that US listed Chinese firms displayed these red flags that can help us to identify their potential to commit fraud and misrepresent financial information.

5. Table & Figures

Figure 1 Number of U.S.-listed Chinese Companies (2001- June, 2011)

Notes: This graph plots the cumulative number of U.S.-listed Chinese companies from 2001 to June, 2011. The sample contains 282 companies that have listed in NYSE or NASDAQ or AMEX by June, 2011 (including those has been delisted).
6. Reference


KPMG Forensic Fraud Survey, (2004), KPMG Forensic Sixth Biennial Survey of Fraud in Australia, pp. 1-35.


