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Corporate Transparency and Financial Reporting in China: a panel discussion

Session Chair: Joseph Piotroski, Stanford
Graduate School of Business

Panelists:

- Kevin Chen, HKUST
- Bin Ke, Nanyang Business School
- T.J. Wong, Chinese University of Hong Kong

Corporate Transparency and Financial Reporting in China

- What is the status?



Lee et al. (2012) identified a list of 32 Chinese RM fraud cases cited by the SEC, U.S. media, or short sellers since 2010

Appendix A. Chinese reverse mergers identified as fraudulent by the media, short sellers or the SEC since 2010

Name	Date of reverse merger	Last exchange prior to citation/report	Date of trading halt	Added to Pink Sheet	Delisted (Form 25)	Registration revoked by the SEC	In sample?
Advanced Battery Technologies, Inc.	2004/04/21	NASDAQ	2011/11/15	2011/11/30	2011/12/16	-	Yes
A-Power Energy Generation Systems, Ltd.	2007/02/09	NASDAQ	2011/06/27	2011/09/26	2012/04/13	-	No ^a
China Agritech, Inc.	2005/02/03	NASDAQ	2011/03/14	2011/05/20	2011/07/13	2012/10/17	Yes
China Integrated Energy, Inc.	2007/10/23	NASDAQ	2011/04/20	2011/06/15	2011/11/10	-	Yes
China Century Dragon Media, Inc.	2010/04/30	AMEX	2011/03/21	2011/06/17	2011/10/07	-	Yes
China Changjiang Mining & New Energy Company, Ltd.	2008/02/04	OTCBB	-	2011/04/07	-	-	Yes
China Education Alliance, Inc.	2004/12/13	NYSE	2011/12/21	2011/12/29	2012/01/11	-	Yes
China Electric Motor, Inc.	2009/05/06	NASDAQ	2011/03/31	2011/06/14	2011/10/06	-	Yes
China Green Agriculture, Inc.	2007/12/26	NYSE	^d	-	-	-	Yes
China Intelligent Lighting and Electronics, Inc.	2010/01/15	AMEX	2011/03/24	2011/06/17	2011/07/19	-	Yes
China Marine Food Group	2007/11/23	AMEX	^e	-	-	-	Yes
China MediaExpress Holdings, Inc.	2009/10/15	NASDAQ	2011/03/11	2011/05/19	2011/12/16	2012/08/28	No ^a
China North East Petroleum Holdings Limited	2004/03/29	AMEX	2012/03/01	2012/06/21	2012/07/06	-	No ^a
China Ritar Power Corp.	2007/02/16	NASDAQ	2011/04/18	2011/06/23	2011/07/05	-	Yes
China Valves Technology, Inc.	2007/12/18	NASDAQ	2012/07/13	2012/09/21	2012/09/21	-	Yes
China-Biotics, Inc.	2006/03/23	NASDAQ	2011/06/15	2011/07/01	2011/07/11	-	Yes
CleanTech Innovations, Inc.	2010/07/02	NASDAQ	2011/03/02	2011/03/02	2011/12/16	-	Yes
Duoyuan Printing, Inc.	2006/10/06	NYSE	2011/04/01	2011/04/04	2011/10/06	-	Yes
Fuqi International, Inc.	2006/11/20	NASDAQ	2011/03/29	2011/03/29	2011/06/03	-	No ^a
Heli Electronics Corp.	2010/06/15	OTCBB	-	2011/03/25	-	2012/03/02	No ^b
Jiangbo Pharmaceuticals, Inc.	2007/10/01	NASDAQ	2011/05/31	2011/08/04	2011/10/06	-	Yes
Keyuan Petrochemicals, Inc.	2010/04/22	NASDAQ	2011/04/01	2011/10/07	2012/04/13	-	Yes
Orient Paper, Inc.	2007/10/30	AMEX	^f	-	-	-	Yes
Puda Coal, Inc.	2005/07/15	AMEX	2011/04/11	2011/08/18	2011/09/12	-	Yes
RINO International Corp.	2007/10/05	NASDAQ	2010/11/17	2010/12/08	2010/12/20	-	Yes
ShengdaTech, Inc.	2006/03/31	NASDAQ	2011/03/15	2011/06/10	2011/12/16	-	Yes
Sino Clean Energy Inc.	2006/10/18	NASDAQ	2012/05/21	2012/09/25	-	-	Yes
Subaye, Inc.	12/21/2000	NASDAQ	2011/04/07	2011/06/24	2011/11/10	-	No ^c
Universal Travel Group	2006/07/12	NYSE	2011/04/11	2012/05/07	2012/04/26	-	Yes
Wonder Auto Technology, Inc	2006/06/22	NASDAQ	2011/05/06	2011/09/12	2012/01/06	-	Yes
Yuhe International, Inc.	2008/03/12	NASDAQ	2011/06/17	2011/07/21	2011/12/16	-	Yes

Source: Lee, Li and Zhang (2012), Stanford University working paper

Accounting fraud by domestic IPO applicant

- 湖南万福生科2013

- 万福生科持续五年**财务造假**
- 万福生科通过预付账款导出现金给粮食经纪人，再通过经纪人打回现金虚增收入，最终在建工程调整虚增资产
- 平安证券最严可能遭暂停保荐资格的处罚
- 一位接近万福生科中介机构的人士表示，面对万福生科的恶意造假，中介机构其实很难发现万福生科的造假行为

巨轮末路

来源于 财新《新世纪》 2014年第20期 出版日期 2014年05月26日

被遮掩的20艘大船交易，潜伏百亿表外负债，即将成为第一家退市央企的长航油运，再爆重大财务丑闻



China Changjiang National Shipping (Group) Corporation (CSC)

What can we conclude so far?

- It appears China's financial reporting system is (almost) broken
- The billion dollar question: How can we fix the system?



Uncharted waters



- Any reform proposal could bring unintended consequences (e.g., the Shanghai Free Trade Zone)
- Prior (U.S.-based) research may offer little guidance for China's future reforms
 - China's unique institutional environment
 - Endogeneity concern
- Opportunities for researchers interested in China

What has happened on the ground?

- China has done a lot of reforms with an aim to increase the quality of accounting information but they failed most of the time
 - The devil is in the details

Select examples

- The overhaul of the accounting standards (1998, 2001, 2007)
- Significant changes to the auditing standards and audit profession since early 1990s
 - The disaffiliation program in 1998-2000
 - A series of independent auditing standards and implementation guidelines in 1995-2004
 - “Forced” consolidation of audit firms since 2000

How should we improve China's financial reporting quality: a conceptual framework

- Cost and benefit analysis at the firm level
- Strongest reporting system \neq the most optimal reporting system
- More broadly: strongest corporate governance \neq the most optimal corporate governance
 - Financial reporting is a small part of a firm's overall corporate governance system

Strongest corporate governance \neq the most optimal corporate governance



Strongest governance

How should we improve China's financial reporting quality: a conceptual framework

- Cost and benefit analysis at the society level
- Cost and benefit analysis at the society level \neq cost and benefit analysis at the firm level
- Therefore, it is possible that an optimal corporate governance system from a firm's perspective \neq an optimal corporate governance system from a society's perspective

How should we improve China's financial reporting quality: a conceptual framework



马云的交易

2013年09月26日 15:34 来源于 [财新网](#) | [评论 \(0\)](#)

用合伙人结构上市的更重要使命，是把已经从老股东那里夺过来的权合法化。姑且假设此举已经通过程序的话，那么这事还剩一个关键是对价

财新记者 王烁

阿里巴巴与香港交易所谈判上市结构，经久未决。香港交易所总裁[李小加](#)特地刊发[《投资者保障杂谈》](#)一文，在文中分饰多角，从传统先生、创新先生、披露先生、大基金先生、小散户女士、务实女士、道德先生、未来小姐、程序先生等多角度总结了近日就是否应豁免[阿里巴巴](#)以[合伙人](#)制度上市而引发的种种观点，非常精彩。

How should we protect investors in China?

– a tentative framework

	Free market approach	Government-led approach
Internal governance	Board structure (cell1)	Regulation on executive pay (cell3)
External governance	Shareholder activism (cell2)	Legal system (cell4)

Investor protection: China's unique challenges

- China's culture, history, and political system
- Weak country-level investor protection system
- Extremely high ownership concentration
- The dominance of SOEs

China is different



The view of one Chinese billionaire, Zong Qinghou



- 问：您平常会看管理方面的书吗？
- 答：我不去看那些管理理论的书，因为那些管理理念都是美国的。人家理论也是有道理的，但毕竟**国情不一样，文化不一样，发展的阶段不一样。照搬硬抄肯定也不成功**。有的书是一句话写成一本书，看完之后也不知道在说什么。
- 你要从人性方面去考虑怎么管人。中国人是最难管，因为中国人聪明，而且**中国人都想当皇帝**，都想当老板。我一个是严格管理，我要他们怕我但不恨我；第二你也要考虑他(的利益)。我们现在是激励机制和竞争机制相结合。

So where is the road to the bright future?



- Insight from some of my own recent research

Audit quality in China

- How much faith should you place on the audits of the mainland Big Four?
- Is there any benefit from requiring H firms to be audited by Hong Kong-based Big Four?
 - Starting in 2010, companies cross-listed in Hong Kong are no longer required to prepare two sets of books and to be audited by Hong Kong-based auditors

The effect of China's weak institutional environment on the quality of Big Four audits

Bin Ke

Nanyang Technological University

Clive Lennox

Nanyang Technological University

Qingquan Xin

Chongqing University

Our specific research question

- Do mainland Big Four provide the same audit quality for pure A firms and AB firms versus AH firms?
 - Pure A firms and AB firms are listed on mainland only
 - AH firms are listed on both mainland and Hong Kong stock exchanges
 - AH firms were required to prepare the H-share financial statements audited by firms registered in Hong Kong and the A-share financial statements audited by firms in mainland China

A quote from the KPMG website

- “Global capability and consistency are central to the way we work. By providing global organizations with the same quality of service and behavior around the world, we can work with them wherever they choose to operate”

A quote from the China Business Journal

- For a long time, there has been an unspoken rule among the Big Four accounting firms in mainland China: If an audit client will go to Hong Kong for stock listing, a mainland Big Four firm will assign a strong audit team to conduct the audit. However, if the audit client will be listed on a mainland stock exchange, the Big Four will assign a weaker audit team to conduct the audit

A quote from the China Business Journal (continued)

- The main reason for such behavior is not because of the differences in the quality of audit clients across the two markets, but because of the differences in the ability and toughness of securities regulators across the two markets

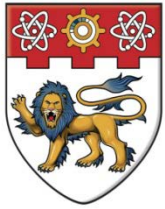
What do we find?

- Big Four assign their less experienced auditors to companies that are listed only in China compared with clients cross-listed in Hong Kong
- The Big Four are less likely to issue modified audit reports and they charge lower audit fees for clients that are listed only in China
- Companies listed only in China have larger earnings inflation than do companies cross-listed in Hong Kong
 - 南橘北枳 (nán jú běi zhǐ)

IPO quality in China

- China's IPO market is a mess
 - There is too much government control
 - Rampant accounting frauds involving IPO applicants
- What should we do to improve the efficiency of China's IPO market?
 - Is moving away from government control the way forward?

一抓就死，一放就乱？

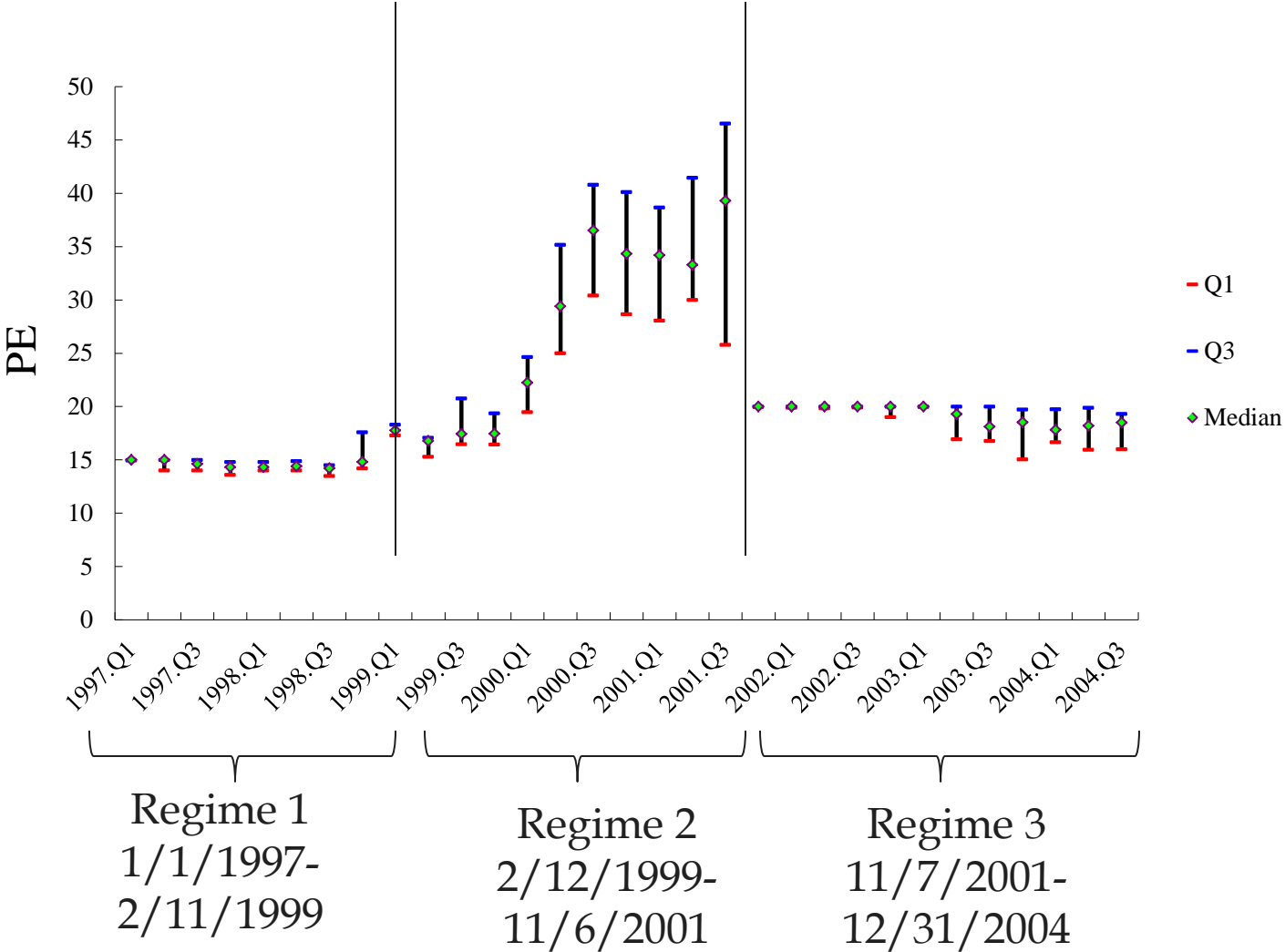


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IPO Pricing Mechanisms and Financial Reporting Quality

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Figure 1. PE multiples used in IPO offer prices



IPO定价重回行政管制

2014年06月06日 18:54 来源于 财新网

投行人士接到指令：不能超募，定价不能高于行业平均市盈率，不许老股发售，否则不能封卷

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【财新网】（记者 蒋飞 特派香港记者 郑斐）6月IPO窗口临近，监管部门对发行价格的窗口指导同样有回归的迹象。多位投行以及接近监管部门的人士告诉财新记者，已经通过发审会的企业被要求不得超募，且发行价格水平不得高于行业平均市盈率，老股发售也原则上不再允许。

Our research question

- How do alternative IPO pricing approaches affect IPO firms' reporting quality?
 - The government-based approach versus the market-based approach

What do we find?

- IPO firms' financial reporting quality is higher when IPO offering prices are determined by the market-based approach
- We find no evidence that the market-based approach leads to greater inflation of IPO offering prices than the government-based approach
- IPO firms' initial financial reporting quality affects long-term financial reporting quality

The future is bright

- For researchers interested in China/ Asian economies
 - Because there are too many important issues waiting for us to tackle in Asia