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Kenneth Rapoza
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Accounting Scandals Galore, China Not Enron-Bound

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By KENNETH RAPOZA

Small to mid-sized Chinese companies are under attack for accounting scandals. But the big names will have to watch out with how they report. If they are caught in fraudulent acts, they aren't sent to China's version of Club Fed. They're executed.

China has always had its fair share of naysayers, but last week's decision by one mid-sized Connecticut broker dealer to ban margin trading on Chinese equities has vindicated them. Is corporate China run by a bunch of CEOs like Kenneth Lay of the infamous Enron?

On June 8, Interactive Brokers told clients that it would not allow them to buy some Chinese stocks on margin. The news made it to CNBC. China equities underperformed its big emerging market peers, and the MSCI Emerging Markets index, over the next two days over accounting fears. The margin ban went into effect on Monday.

Accounting scandals are plagueing small to mid-cap companies, some of which have been allegedly set up as shell operations rolling over revenue to family members rather than to shareholders. The big six auditing firms are in the cross hairs of a growing number of lawsuits. Deloitte Touche Tohmatsu is one of them. It's being sued by Starr Investments, a fund set up by ex-AIG chief executive Maurice Greenberg, for its involvement in auditing the books of China Media Express (CCME) .

Under pressure, Deloitte was forced to cancel its client relationship with China Media — a $72 million outdoor advertising company — because it could no longer verify China Media management's claims. Their change of heart came only after Muddy Waters Research, a boutique investment research firm founded by hedge fund manager Carson Block, accused China Media with misrepresenting its financials. The media picked up on it. Deloitte was served their legal notice on June 2.

"Deloitte was asleep at the wheel," says Reed Kathrein, a lawyer at Hagens Berman representing shareholders in the China Media case. "Based on what I know, China's market basically accepts what management says and their auditors don't investigate it or question it, even when they know it makes no sense," he says.

Nearly one third of securities fraud cases on file in the last 60 days are Chinese companies, most of them microcap stock fraud cases. Puda Coal Inc.(PUDA), Universal Travel Group (UTA), Artificial Life (ALIFE), Subaye (SBAY), SkyPeople Fruit Juice (SPU), Deer Consumer Products (DEER), Gulf Resources (GFRE), Fushi Copperweld (FSIN)...the list is long.

“There has been a huge explosion of cases in the last quarter,” says Andrei Rado, a plaintiff lawyer at Milberg LLP. Milberg is suing Chinese companies Puda Coal and China Integrated Energy (CBEH). There were around 24 securities fraud cases brought against Chinese companies traded in New York in 2010. At least a dozen new cases have already been taken on in the first quarter.

Some of these companies have entered the US market through reverse mergers so they didn’t have to go through the rigorous Securities & Exchange Commission filing requirements of an initial public offering. “The fraud that Enron and WorldCom committed in the 90s and early 2000s was more sophisticated. These guys are much bolder in what they do,” says Rado. “Some of these companies are a complete sham,” he says.

On June 2, Muddy Waters was at it again, writing in a note to clients that Sino-Forest, a Chinese based timber company listed in Toronto, had filed two different claims on its timber acreage, and overstated its revenues as a result.

Hedge funds were heavily invested in a lot of these microcap, off-radar names. But for lawyers trying to get to the bottom of this muddy river, the discovery phase on these cases, a legal term to define interviewing witnesses and documents to prove wrong-doing, is never easy from a US office when those who have the information are all in China. The Chinese are not always willing to cooperate with the US legal system.

One insider said that a case against the $441 million Chinese owned Canadian Solar (CSIQ), traded on Nasdaq, will likely be dismissed as immaterial. Investors said the company reported $5 million in revenues in order to pump up its secondary offering, then dump the shares shortly afterwards. Another company, China Green Agriculture (CGA), came back with a huge rebuttal against plaintiffs recently. Another New York law firm involved in the case expects it to be dismissed.

For the broader Chinese equity market, these accounting scandals might not be death by a thousand cuts. But what it does is shed a light on the fact that

Chinese companies are not playing by the same rules. There are dozens of mini-Enrons and WorldComs run by Chinese managers. But there are also the major large cap name brands, who may not be entirely cooking the books, but survive by off-balance sheet, unaccounted for loans and cash. In short, no one knows what Chinese companies are really worth. Yet, many companies, like internet search engine Baidu (BIDU), are trading at nearly 50 times forward earnings. No one seems to mind, either.

"This account issue is not a new problem," says Paul Dietrich, Chairman of Foxhall Capital Management. "I've been investing in China since the 80s and we'd see five different sets of financials. You have to do your due diligence. If you think you can rely on audits, you're fooling yourself."

100 Mini Enrons vs Ancient Chinese Secret

There is outright fraud, and there is a shadow financing system in China — loans that are often never paid back, and counted as profit, or used in corruptive practices. This practice occurs upstream as well, in the large cap names.

China is so heavily subsidized, that as much as 30% of the average company's profits is derived from the government, says Usha C. V. Haley, a chaired professor of international business at Massey University in Auckland. She's writing a book about Chinese subsidies for Oxford University Press.

It is next to impossible for a business to succeed in China unless it is linked to the government, either the central government in Beijing, or provincial governments, the states that are looking to expand their local economies. The provinces are the biggest providers of subsidies and what Haley calls "policy loans" — shadow financing that comes from the big four state run banks to fund certain job-creating development projects.

In 2002, there were next to nothing in off-balance sheet loans. By 2010, it hit 3.8 billion Chinese yuan, according to Haley's research.

The Chinese government and pro-China investors would argue that the country has a lot of mouths to feed, 1.4 billion to be exact. Government loans – on or off the books — isn't exactly fraud, despite being unaccounted for. The country needs jobs and so authorities may be willing to overlook certain things so long as companies are producing jobs. China needs those jobs because it needs to tax workers to help pay for a social safety net it wants to create for its aging population. As they are creating jobs, it works for elite politicians signing the paperwork.

"I find these arguments all very simplistic," says Haley. "There is a wide discrepency in income in China nowadays, especially between urban and rural society. Income is not trickling down to the lower classes. Where is all this money coming from? Tax evasion. Fraud. And when you go on up the trails of government, it all starts to look like a large shell game."

For William Gamble, perennial critic of China and president at Providence based consultancy, Emerging Market Strategies, it would be easier to tell the age of a Chinese gymnast than who truly owns a China company. "The corporate records are not always available. Free access to any information in China depends on your family or party connections," says Gamble. "The Chinese lack the most important element necessary for timely, complete and accurate information: they lack free speech. Without an active press or freedom of speech there is no way to determine who is actually telling the truth and there are few economic disincentives to actually tell the truth. No government anywhere can police itself. And the Chinese government lacks any legal limitations including any limitations for companies to commit fraud."

China's trying and should at least get a C for effort, maybe even an A, depending on who you ask. The National Audit Office of China said recently that it found 17 state enterprises had overstated their earnings. Some reported subsidies as dividend income. One example of accounting fraud up-market was Sinosteel, a $4 billion company that misrepresented its sales figures between 2007 to 2009 by $306.5 million. The goverment fired the company's chief executive Huang Tianwen in May.

"The good news is that government regulators are cracking down on these guys," says Dietrich. "It's going to take some time. It's a very big problem. But when you screw up within big name companies that the government considers the face of China overseas, like a Baidu, or a big bank, you will pay. And you will pay with your life."

Wen Mengjie, a 50-year-old, former director of the information technology department of the Beijing branch of the Agricultural Bank of China, was executed in Sept. 2007 for accepting bribes totaling 10.73 million yuan.

Wang Liming, a former accounting officer at China Construction Bank, worked with others to steal 20 million yuan from the bank using fake papers. He and his accomplice, Miao Ping, another bank official, were executed in 2004.

Bribes and outright theft is not the same as inventing revenue numbers. It's not the same as using government loans and counting it as profits that ultimately, through market forces of supply and demand for Chinese equities, pumps up share prices.

Despite the National Audit Office's recent revelations, Chinese accounting practices still do not synchronize with the generally accepted accounting principals of the US. "Book-keeping practices differ greatly especially when dealing with subsidies and relations with state-owned enterprises. So, I am unsure how reassuring this new attitude is going to be," says Haley. She will be speaking about China at *The Economist* magazine's High Growth Markets Summit in September.

One thing is for sure, the US stock market declined on the scandals of Enron, WorldCom and Tyco. China's accounting woes, even at the microcap level, presents China with systemic risks that only a handful of people, including Gamble, have been warning about for years. Now, it's in the air. For how long depends on how many more cases are built against China companies, and how many big, brand name China companies are served with class-action lawsuits, and charged with fraud.

China critics agree that the country's economy, and its mainland and Hong Kong equity markets, won't collapse because of these new scandals. It won't collapse because of the ancient Chinese secret of off-book lending and subsidies. The reason is simple, says Gamble in an email from Amman, Jordan. "China is not a market economy. It will slow and social unrest will rise," he forecasts.

For David Semple, Director of International Equity at Van Eck Global in New York, the mini-Enrons are bad enough, but he won't discount China because of them.

"The negativity on China stems from a very selective use of statistics," he says. Another favorite target of China bears is the real estate market, with empty apartments in some cities having US investors worried about a severe housing bubble caused by bad, if not fraudulent loans to developers. Those are some examples of Semple's cherry-picked stats.

"There are long term economic issues that China needs to address and no one believes that China can grow as fast as previously, but to listen to the naysayers that China will have some kind of crisis would be misguided," he says.

China's government knows it is big business. Its role in the world economy is akin to that of the US, so major fraud of any kind could conceivable have ramifications outside its borders. But as the pragmatic communist China grows and receives praise from Western capitalists hungry for growth, it knows that it owes a lot of its success to the West. Europe and the US havemade China the number one labor market and manufacturing center in the world. China's growth, perhaps with help from subsidies and policy loans that disappear if not repaid, is one of the lead supports of high commodity prices. To keep investors on board, China will have to play by the rules or risk losing investor confidence. If that happens, the global community and Wall Street may quickly start to look at China as some sort of Ponzi scheme, and no self-respecting Asian nation is going to take that sitting down.

See: **Is Sino Forest a Sino Fraud?**