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Taking a holistic view before claiming ‘fraud’

Chen takes a sip of tea in one of his restaurants in China, sighing as he ponders recent events.

Five years ago, like other Chinese entrepreneurs, Chen bought a listed shell company in the United States, on the basis that a backdoor listing was cheaper and faster than an IPO. At first, everything had been going just fine.

Then one day, a short-seller claimed that his company was a fraud, citing that the sales reported in the company’s filings with the State Administration of Industry and Commerce (SAIC) were only a fraction of those in its SEC filings. The stock exchange began its investigation; the company’s auditor refused to comment; Chen’s reputation was tarnished; and the stock price nosedived 70 percent from its peak. Though Chen was sure that no fraud had been committed by him or his board, the mounting pressure led to the delisting of his company.

Fictional as this story is, it is typical of what we are seeing today. Amid investor panic, it is necessary to take a holistic view of the risks in context of the Chinese market. Short sellers and investors claiming to have found ‘fraud’ in a company could be gambling with their portfolios or may be attempting to influence the investment decisions of others. It is usually only those with ‘full’ access to a company’s internal books and records who are in a position to make an informed judgment in this regard. The ability for fraud investigators to provide an independent verification of the facts plays an important role between management and shareholders.

Alternative explanations

There are a number of reasons other than fraud which can explain the discrepancies between the SAIC and SEC filings in Chen’s case including:

- Each legal entity in China is required to file its own annual report with the SAIC, but the report from the parent company is not always consolidated and inclusive of subsidiary sales. To get to the truth, the sales of all subsidiaries from multiple locations would need to be included in order to reach the sales figures reported in SEC filings. Additionally the difference between US

GAAP and PRC GAAP creates discrepancies which should also be considered.

- Since SAIC reports can be accessed by competitors, you need to keep in mind that companies in China may only disclose required minimal financial information in their SAIC filings.
- Companies in China commonly maintain two sets of accounting books: one for financial reporting and one for tax reporting. This is how it may work: you have a meal in a restaurant in China and pay for the meal but don’t obtain a Fapiao (Invoice). Fapiao is the means used by the State Administrative of Tax (SAT) to calculate and collect tax. By not issuing a Fapiao, the restaurant can earn revenue without reporting it to the Government.

As illustrated above, the differences in the respective filings may have been due to a number of reasons other than fraud. For instance, the differences could have resulted from tax evasion – which would raise its own legal and regulatory compliance issues - rather than the revenue inflation which is often found in fraudulent financial statements.

The importance of a thorough investigation

In the case of Chen, if he and his board were of the view that the fraud allegations were invalid and were merely being used to facilitate a takeover attempt or to stimulate short-selling interest, a reputable and experienced financial investigator should have been retained early to evaluate the allegations in order to provide comfort and confidence to investors. If it was a case of inadequate ‘Record Keeping’ under the provisions of the FCPA, then these weaknesses in controls and policies could have been rectified.

Investors can also petition management to initiate such an investigation if they suspect wrongdoing. Class actions are frequently, and swiftly, launched in the US against management if any fraud or breach of fiduciary duties is suspected, and such allegations can often only be confirmed by a thorough, independent internal investigation.

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