Corporate Governance Standards in Cross-Border Investing: Lessons Learned from Chinese Companies Listed in the United States

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In the United States, many of the standards for corporate governance regulation and enforcement have been developed after major scandals and financial crises. The Sarbanes Oxley Act of 2002 was passed in response to the corporate and accounting scandals in 2000-2002 involving firms such as Enron, Tyco International, Adelphia, and WorldCom.

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- The Sarbanes Oxley Act set new or enhanced standards for boards, management, and public accounting firms. These standards dealt with certifications of the accuracy of the financial statements, the independence of outside auditors, and an increased oversight role for boards of directors.

- Eight years later in 2010, the Dodd Frank Wall Street Reform and Consumer Protection Act was passed in response to the financial institution failures and financial crisis of 2007-2010. This act brought changes to financial regulation to promote financial stability by improving the accountability and transparency in the financial system and by protecting financial consumers.

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- Unfortunately, neither of these acts completely prepared the U.S. for the corporate governance, control, and risk management issues that have come with increased globalization.
- The impacts and the associated problems of this increased globalization are now evident in the world's investment markets. As more and more stocks of foreign companies are listed on international exchanges, the risks of the lack of corporate governance, control, and risk management are increased.

- For example, while foreign firms that list on a United States stock exchange have to comply with Sarbanes Oxley and Dodd Frank, the regulations of their home countries may dilute some of the regulatory protection expected from these United States acts.

- This paper will examine five Chinese company stocks that have been listed on United States exchanges with either initial public offerings (IPOs) or reverse mergers, often called reverse take-overs (RTOs). Their shares were initially well received in the market, especially as China's economy continued to grow at rates much higher than the rest of the world's countries, with increasing stock prices creating significant gains for their investors.

- However, in spite of these firms' apparent compliance to the U. S. regulations, there is now evidence of fraud, poor auditing, and a lack of corporate governance and control. The resultant stock price declines have led to billions of dollars of losses for investors.

- In this paper, we will show that had auditors, boards of directors, and financial analysts been more diligent and responsible, these problems could have been identified earlier than they were. Perhaps some of the investors' losses could have been prevented.

Major U.S. Listed Chinese Company Frauds

Company	Original Listing Date	Result
Longtop Financial Technologies	October 23, 2007 NYSE (IPO)	August 29, 2011 Delisted
China MediaExpress	October 18, 2007 NASDAQ (RTO)	May 1, 2011 Delisted
Harbin Electric	August 20, 2005 NASDAQ (RTO)	November 3, 2011 Became privately-held
China-Biotics	August 10, 2006 NASDAQ (RTO)	June 24, 2011 Delisted
Deer Consumer Products	September 10, 2008 NASDAQ (RTO)	October 2, 2012 Delisted

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- As a result of possible Chinese financial reporting frauds, some of these companies were delisted by U.S. stock exchanges, some of their auditors quit, investors filed class action lawsuits, and the U.S. SEC pursued investigations.
- Longtop represented over one-half ($2.4 billion) of the $4.1 billion market cap destruction by these five companies and over 10% of the $21 billion market cap destruction by Chinese companies listed in North America.

NYSE Key Corporate Governance Principles

- In 2010, the NYSE-sponsored Commission on Corporate Governance issued a report that identified key corporate governance principles for boards of directors as well as management and shareholders. Written in the context of the significant developments in corporate governance and control since 2000, the report addresses the roles and responsibilities of boards of directors, management, and shareholders. These principles now have been adopted by the NYSE, NASDAQ ,and other world exchanges.

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NYSE Key Corporate Governance Principles

- The specific principles that apply to the analysis of the five Chinese companies in this paper are listed below.

➢ The board's fundamental objective should be to build long-term sustainable growth in shareholder value.

➢ While the board of directors' responsibility for corporate governance is well-recognized, less so is the critical role played by management, which has the primary responsibility for creating a culture of performance with integrity.

➢ Good corporate governance should be integrated as a core element of a company's business strategy and not be viewed simply as a compliance obligation.

➢ Transparency is an essential element of corporate governance.

Did the Five Chinese Companies Violate the NYSE Key Corporate Governance Principles?

Unfortunately, the answer is a resounding yes! For all five of the Chinese companies, there were numerous examples of business practices that were unsustainable, and many of them were also fraudulent. In all five companies, management did not create a culture of performance and integrity. They also did not have the proper internal controls, nor did they exhibit ethical standards. Corporate governance did not appear to be part of their business strategy. Transparency did not exist.

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Longtop Financial Technologies Ltd.

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Longtop Group

- Widespread fraud in the financial statements
- Misrepresentation of cash on hand
- Borrowings not shown on the books
- Fake revenue and fake cash
- Non-transparent management transactions
- Management interference with the audit process causing the auditor to resign

China MediaExpress Holdings, Inc.

- Differences in the performance numbers reported to the U.S. SEC and the China SAIC
- Large misrepresentations of cash on hand
- Videos showing no activity at the corporate office
- Industry reports that did not confirm the magnitudes of their presence in the industry and their revenues
- A bribe offered by the CEO to a forensic accountant hired to investigate accusations and allegations of fraud

Harbin Electric, Inc.

哈尔滨电机厂有限责任公司
HARBIN ELECTRIC MACHINERY COMPANY LIMITED

- Differences in the performance numbers reported to the SEC and to SAIC
- Questions about the customer volume that they reported
- Involvement in a multi-million dollar land fraud
- Too much power for the Chairman/CEO to have
- An auditor shut down by the SEC for improper professional conduct

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China-Biotics, Inc.

- Extremely large differences in the performance numbers reported to the SEC and SAIC
- Questions about their margins and revenues and the ability to generate the revenues
- Involvement in a multi-million dollar land fraud
- Resignation by their CFO and their auditor

Deer Consumer Products, Inc.

- Differences in the performance numbers reported to the SEC and SAIC
- Allegations of non-existent sales distribution channels which raised questions about revenues, selling expenses, and margins
- No sign of production at any of the production facilities
- The Chairman's relationship in entities that were in direct competition with the company

Lessons Learned

Cross-border investing brings additional risks, such as exchange rate risk, political risk, the risk of different accounting systems, and the risk of gathering information about a company that may be thousands of miles away. There is one more risk that must be considered as well. Corporate governance standards and their enforcement may vary across countries. A foreign-based company whose stock is listed on a U.S. exchange has to comply with that exchange's rules and regulations regarding corporate governance and control. However, the exchange's influence can all be negated if there are not strong corporate governance and control efforts in the home country.

Lessons Learned

- The five Chinese companies analyzed in this paper had poor auditing, boards that did not get involved, and boards and management that violated the NYSE's key corporate governance principles.

- Cross- border investors need to realize that it is also necessary to identify the risk of ineffective corporate governance and control in the foreign home country. If any reminder of this strategy is necessary, just ask the shareholders of these five Chinese companies about their $4.1 billion loss of wealth because of this additional risk.

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China-Biotics, Inc.

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APPENDIX

Longtop Financial Technologies Ltd.

October 23, 2007

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Longtop Group

August 29, 2011

May 22, 2011

November 11, 2011

Longtop Financial Technologies Ltd. went public on the New York Stock Exchange (NYSE) and sold 10.4 million American depositary shares at $17.50 per share, raising $182 million. By the end of the first day, the stock had risen to $32.40 per share. Goldman Sachs and Deutsche Bank led this initial public offering (IPO) with Deloitte Touche Tohmatsu, a “Big 4” audit firm, serving as the auditors. Longtop was a Chinese software developer and technology services provider based in Xiamen, China.

Longtop Financial Technologies Ltd.

October 23, 2007

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Longtop Group

August 29, 2011

May 22, 2011

November 11, 2011

Deloitte sent a resignation letter to the chairman of Longtop's Audit Committee who was also the CFO of NYSE-listed Xinyuan and a director of NASDAQ-listed eLong. Deloitte wrote that "we bring these significant issues to your attention in the context of our responsibilities under Statement on Auditing Standards (SAS) No. 99, Consideration of Fraud in a Financial Statement Audit."

Longtop Financial Technologies Ltd.

October 23, 2007

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August 29, 2011

May 22, 2011

November 11, 2011

The New York Stock Exchange delisted Longtop Financial Technologies Limited finding that the American depositary shares were no longer suitable for continued listing and trading.

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Longtop Financial Technologies Ltd.

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Longtop Group

- October 23, 2007
- May 22, 2011
- August 29, 2011
- November 11, 2011

The SEC charged Longtop with failing to comply with its reporting obligations because it failed to file an annual report for its fiscal year that ended March 31, 2011. Furthermore, Longtop's independent auditor stated in May 2011 that its prior audit reports on Longtop's financial statements contained in annual reports for 2008, 2009, and 2010 should no longer be relied upon.

China MediaExpress Holdings, Inc.

October 18, 2007

March 11, 2011

March 14, 2011

May 1, 2011

March 1, 2012

January 31, 2013

June 1, 2013

China MediaExpress Holdings, Inc. did a reverse merger, or reverse take-over (RTO), to become a publicly traded company in the U.S. Its business consisted of placing television screens on Chinese buses in China and selling advertising on such screens. It was in the development stage until 2009.

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China MediaExpress Holdings, Inc.

Both the company's CFO and Deloitte resigned. Based upon these resignations, the company then filed a notice of late filing for the 12/31/2010 financial statements with the SEC. China MediaExpress shares then traded at $11.88. Subsequently, the company admitted that Chinese branch bank managers had falsified cash confirmations, just like the Longtop scandal.

October 18, 2007

March 11, 2011

March 14, 2011

May 1, 2011

March 1, 2012

January 31, 2013

June 1, 2013

NASDAQ halted trading in China Media Express shares, pending a company announcement.

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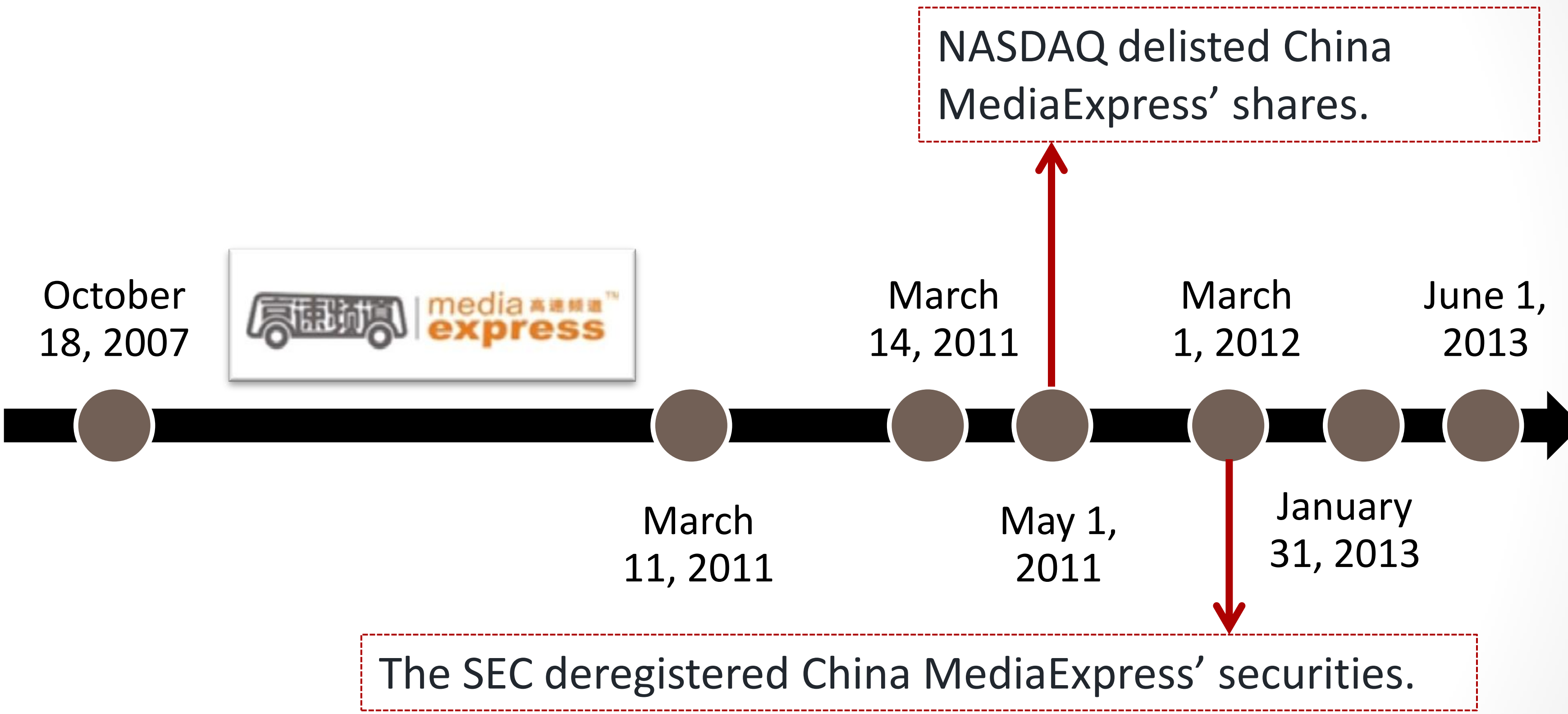
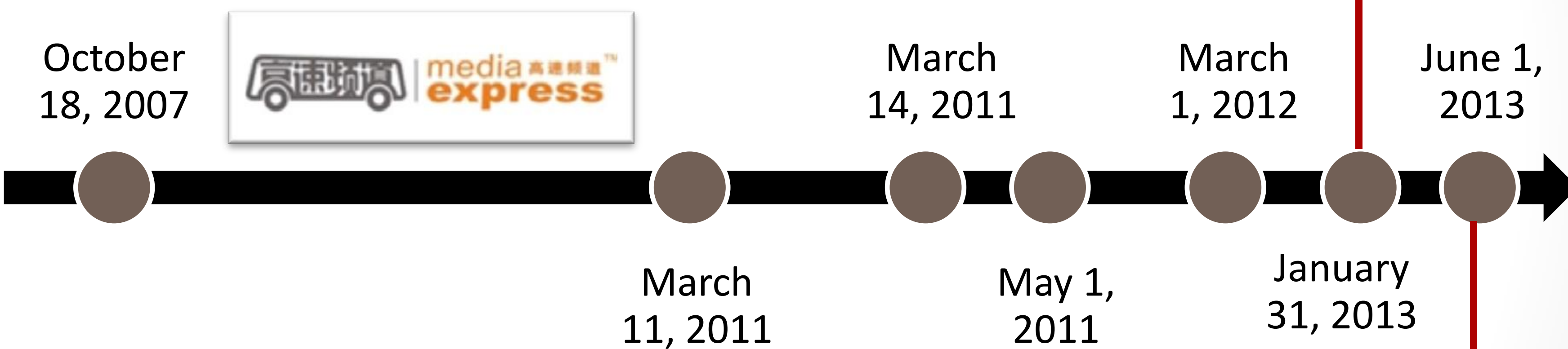
China MediaExpress Holdings, Inc.



China MediaExpress Holdings, Inc.

A Hong Kong arbitration panel ruled that China MediaExpress was a fraudulent enterprise and awarded a shareholder $77 million in damages.



The SEC charged China MediaExpress and its CEO with misleading investors.

Harbin Electric, Inc.

哈电集团

哈尔滨电机厂有限责任公司

HARBIN ELECTRIC MACHINERY COMPANY LIMITED

August 20, 2005

Harbin Electric became a public company in the U.S. after completing an RTO. Headquartered in Harbin, China, Harbin Electric developed and manufactured electric motors, including rotary motors, linear motors, and specialty micro-motors.

November 1, 2011

NASDAQ suspended trading of Harbin Electric stock and filed a notification of removal of listing and registration with the SEC.

November 3, 2011

December 1, 2011

Harbin Electric, Inc.

哈尔滨电机厂有限责任公司
HARBIN ELECTRIC MACHINERY COMPANY LIMITED
哈电集团

August 20, 2005

November 1, 2011

November 3, 2011

Harbin Electric completed the closing of its going private transaction and became a privately-held company. No final details of the $750 million transaction were provided.

December 1, 2011

The company's auditor, Frazein Frost, agreed to be shut down by the SEC without admitting guilt.

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China-Biotics, Inc.

China-Biotics, Inc.

August 10, 2006

China-Biotics became a public company in the U.S. after completing an RTO.

June 15, 2011

NASDAQ halted trading in China-Biotics stock when the company failed to file its 10-K annual report with the SEC.

June 24, 2011

China-Biotics's CFO resigned and its auditor, BDO Limited, also resigned, citing irregularities it discovered that "likely constitute illegal acts." NASDAQ delisted China-Biotics' shares.

Deer Consumer Products, Inc.

September 10, 2008

Deer Consumer Products became a public company in the U.S. after completing an RTO.

September 6, 2011

Chinese officials confirmed a multi-million dollar land fraud by Deer.

August 13, 2012

NASDAQ halted trading in Deer Consumer Product shares.

October 2, 2012

NASDAQ delisted Deer Consumer Product shares.

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