

CORPORATE GOVERNANCE STANDARDS IN CROSS-BORDER INVESTING: LESSONS LEARNED FROM CHINESE COMPANIES LISTED IN THE UNITED STATES

*Hugh Grove, Maclyn Clouse**

Abstract

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, and some of these Chinese firms have subsequently been delisted by U. S. stock exchanges. 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.

Keywords: Corporate Governance Standards, Cross-Border Investing, China, the USA

** Accounting and Finance Professors, respectively Daniels College of Business, University of Denver, 2101 S. University Blvd. Denver, Co 80208*

Email: mclouse@du.edu

1. Introduction

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. The 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.

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. An important lesson learned from the 2007-2010 crisis is that the world's financial and economic markets are now interrelated

to a much greater extent. For example, the financial and economic problems of a relatively small country like Greece have caused major problems for the European Union, as well as the United States stock market. As another example, the failures and near failures of some United States financial institutions had major adverse consequences for the financial markets in the rest of the world.

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, and some of these Chinese firms have subsequently been delisted by U. S. stock exchanges. 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.

2. Major U.S. Listed Chinese Company Frauds

On April 4, 2011, Luis Aguilar, one of the five commissioners of the U.S. Securities and Exchange Commission (SEC), reported that there were 150 reverse merger transactions between 2007 and early 2011 in which Chinese companies merged with U.S. domiciled shells to obtain a listing on a U.S. stock exchange. A reverse merger or RTO is a backdoor strategy in which a Chinese or other non-public company buys a public U.S. shell company and assumes its stock ticker, thus avoiding an S-1 registration statement for an IPO as required by the SEC and related expensive investment bank and other fees. A shell company is practically extinct but it is incorporated and, in some cases, its listed stock is maintained by an owner or speculator for sale to an interested party.

Shell companies are marketed to Chinese companies as a quick and easy way to obtain an overseas listing without SEC scrutiny. An example of such scrutiny was the Groupon IPO. The SEC required three revisions or amendments to Groupon's S-1 registration statement, primarily to eliminate the gross (versus) net revenue method and to eliminate Groupon's newly created profitability metric: Adjusted Consolidated Segment Operating Income (ACSOI) which really meant just keep adding back enough expenses until a net loss is converted into a net profit! Groupon's estimated IPO of \$30 billion subsequently became an actual IPO of \$16.5 billion.

The following five major Chinese IPO and RTO companies had listed on U.S. stock exchanges, and they represented approximately 20% (\$4.1 billion) of the \$21 billion market capitalization (cap) destruction by Chinese companies listed in North America. These five firms were all mentioned in an article about five major short sellers who published research reports exposing Chinese financial reporting fraud. One of these short sellers, listed as Muddy Waters Research, said that his success had made him and his wife a target for threats, and he had recently moved his main base to the West Coast from Hong Kong but did not exactly say where. Also, he increased security measures, including removing his firm's phone

number from the Muddy Waters Research website and listing a false address..

The five Chinese companies analyzed in this paper are Longtop Financial Technologies, China MediaExpress, Harbin Electric, China-Biotics, and Deer Consumer Products. The only IPO was Longtop as the other four companies were RTOs. 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. 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. Brief circumstances of each of the five firms follow.

3. Longtop Financial Technologies Ltd.

On October 23, 2007, 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. It provided technology services and created both standardized and custom-designed software for banks in China, including three of the four largest state-controlled banks: China Construction Bank, Agricultural Bank of China, and Bank of China. Morgan Stanley led a 2009 secondary offering of more shares. In November 2010, Longtop's market capitalization peaked at \$2.4 billion (56 million shares at \$42.86).

On April 26, 2011, Andrew Left of Citron Research, a short seller, published a report on his website, accusing Longtop of widespread fraud: "Citron introduces a story that has all the markings of a complete stock fraud - with off balance sheet transactions that created outsized margins and management with backgrounds unsuitable to run a public company. The most obvious risk factor in the China space, and the factor that has linked so many of these collapsed stocks, is obviously that the story is too good to be true. In this report, Citron outlines several concerns which should be considered by the auditors as they prepare Longtop's annual audit. It is the opinion of Citron that every financial statement from its IPO to this date is fraudulent...read on to understand."

Major topics in Citron's report were margins far in excess of competitors, an unconventional staffing model, key management background misdeeds, non-transparent management transactions, and a note to analysts: "Citron says do what you are paid to

do...Start ANALYZING. The last thing Wall Street needs is more discounted cash flow analysis based on asking for management's forecasts. Citron challenges you to answer these concerns without starting with the phrase: after discussions with management. Do Longtop's margins truly pass the smell test in cost-competitive China? Does the staffing story make perfect sense to you? How about management's stock gifts? If not, what are the risks of massaged revenue recognition and/or the ugly implications of related party impacts on acquisitions, cost accounting, and stock transactions?" Citron's report also noted nonsensical answers the company had given which left critical investors thinking "they are just making it up as they go along." Also, Citron and other short selling research firms were asking why Longtop needed such large amounts of cash and they were even questioning whether such cash existed.

On April 28, 2011, Longtop's Chief Financial Officer (CFO) tried to reassure financial analysts that the fraud claims were bogus. He wrapped himself in the prestige of his company's auditor, Deloitte, a "Big 4" audit firm, saying that those who questioned Longtop were "criticizing the integrity of one of the top accounting firms in the world." He also said that his relationship with Deloitte was "very close, third only to his relationship to his family and the CEO."

On May 4, 2011, Longtop's CFO resigned his post as head of the audit committee of the heavily anticipated Renren IPO. Also, a Morgan Stanley analyst wrote: "Longtop's stock price has been very volatile in recent days amid fraud allegations that management has denied. Our analysis of margins and cash flow gives us confidence in its accounting methods. We believe market misconceptions provide a good entry point for long-term investors." At the time of these reports, Deloitte was in the process of completing its Longtop audit for the fiscal year ending March 31, 2011. It had previously given unqualified or clean audit opinions to Longtop for six consecutive years and apparently was well on its way to providing a seventh clean opinion.

On May 9, 2011, Citron Research posted another Longtop report: "How could anyone charged with verifying the accuracy of Longtop's Financials look at these documents and dismiss the reasonable concern (not to mention professional skepticism) that Longtop's largest expense line item is being transacted through a related party with full transparency?...Lastly, it is Citron's opinion that believing an unrelated third party ran your human resource business to make \$30,000 a year (according to filings) is as crazy as believing that a Chairman of a company would just give away \$80 million in stock to his employees because money doesn't really mean that much to him (as per the CFO's explanation). We hope this can end any debate as to whether the company has been deceiving its investors. It is not the time to host any more conference calls or cover ups. The excuses have run their course. It is now

time to confess, let the auditors figure out the necessary restatements, and let the real Longtop Financial Technologies stand up."

On May 17, 2011, Deloitte did not say why but expanded its procedures related to cash, the largest balance sheet item. Cash totaled \$423 million or 57% of Longtop's assets. Within hours of beginning this new round of cash confirmations to bank headquarters, rather than to the local branches that had previously confirmed Longtop's cash balances, Longtop stopped the confirmation process and told the banks that Deloitte was not really its auditor. Despite these Longtop efforts, Deloitte learned that Longtop did not have the cash it claimed and that there were also significant bank borrowings not included on Longtop's books. In the U.S., electronic audit confirmations have been adopted by more than 8,000 accounting firms and all of the Top 10 banks. In China, the Big 4 and other auditing firms and the Big 4 banks need to get together to work out a system for online confirmations.

On May 20, 2011, Longtop's chairman told Deloitte's Eastern Region Managing Partner that "there were fake revenue in the past so there were fake cash recorded on the books." The chairman did not answer when questioned as to the extent and duration of the discrepancies. When asked who was involved, he answered: "senior management." Such irregularities resulted in Deloitte resigning and the NYSE suspending trading of Longtop's stock. The final trade on the NYSE was at \$18.93 for a market capitalization of \$1.1 billion versus the peak of \$2.4 billion just six months earlier.

On May 22, 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. The reasons for our resignation include: 1) the recently identified falsity of Longtop's financial records in relation to cash at bank and loan balances and also now seemingly in the sales revenue, 2) the deliberate interference by the management in our audit process, and 3) the unlawful detention of our audit files. These recent developments undermine our ability to rely on the representations of the management which is an essential element of the audit process; hence our resignation."

May 25, 2011, a lawsuit, alleging Longtop overstated profit margins and concealed adverse facts, was filed by the New York-based Rosen Law Firm. This firm had previously filed about 20 investor suits against Chinese companies listed in the U.S. by reverse mergers or reverse take-overs (RTOs). At least 370 reverse merger companies had obtained U.S. listings since 2004.

On August 29, 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.

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. The SEC previously had filed a subpoena enforcement action against Deloitte Touche Tohmatsu CPA Ltd. in Shanghai for failing to produce documents related to the SEC's investigation into possible fraud by Longtop, the audit firm's longtime client.

4. China MediaExpress Holdings, Inc.

On October 18, 2007, 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.

On December 4, 2009, the company engaged Deloitte Touche Tohmatsu, Hong Kong, a Big 4 audit firm, to serve as its independent auditor, effective immediately upon this same-day dismissal of its prior auditors, who had issued clean audit opinions on the 2008 and 2007 financial statements.

On March 10, 2010, Deloitte issued a clean audit opinion for the 12/31/2009 financial statements. However, Deloitte was not engaged to re-audit the 2008 or 2007 financial statements but only to review the retrospective adjustments to the 2008 and 2007 financial statements to revise earnings per share calculations which it said were appropriate. Also, the nine month, September 30, 2010, financial statements were the last ever issued to the SEC by China MediaExpress.

On January 28, 2011, China MediaExpress shares traded at a 52-week high of \$23.97. Australian short seller, John Hempton, noted a key red flag for China MediaExpress: how exactly could such a simple business model earn the company \$31 million on \$57 million in revenue for the third quarter of 2010? He called it, "the fattest margin and fastest growth Media Company I have ever seen."

On January 30, 2011, Citron Research explicitly called China MediaExpress a "phantom company." While digging into industry reports on mass transit advertising in China, Citron found no references to China MediaExpress. Articles that listed industry competitors didn't list China MediaExpress, despite the fact that the company claimed \$155 million in revenue for the nine months ended September 30,

2010. The company also claimed double the revenue per television screen as its competitors.

On February 3, 2011, the short seller, Muddy Waters Research, alleged more improprieties. Among them, it said the company only booked \$17 million in revenue for 2009 with the SAIC (State Administration for Industry and Commerce of the People's Republic of China) while reporting \$95.9 million in its 10-K report to the SEC. It also said that the company was lying when it claimed to have a deal with Apple.

On February 7, 2011, the company released a letter, basically reaffirming its financial statements and operating practices.

On March 11, 2011, NASDAQ halted trading in China Media Express shares, pending a company announcement.

On March 13, 2011, another short-seller, The Financial Investigator, posted a video that it claimed was a tour of the China MediaExpress offices. The video featured sleeping employees, empty offices, and a business that was not the growth machine that China MediaExpress claimed.

On March 14, 2011, 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.

On May 1, 2011, NASDAQ delisted China MediaExpress's shares.

On March 1, 2012, the SEC deregistered China MediaExpress's securities.

On January 31, 2013, a Hong Kong arbitration panel ruled that China MediaExpress was a fraudulent enterprise and awarded a shareholder \$77 million in damages.

On June 1, 2013, the SEC charged China MediaExpress and its CEO with misleading investors. The SEC asserted that the company misrepresented its cash on hand: the 2009 annual report reported cash of \$57 million but was actually \$141,000 and in the third quarter of 2010, the cash was reported as \$170 million but was actually \$10 million. The company's audit committee hired a forensic accountant from Hong Kong to investigate and the company's CEO offered a \$1.5 million bribe to the investigator which was rejected and reported to authorities.

5. Harbin Electric, Inc.

On 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. The company had manufacturing facilities in Xian, Weihai, Harbin, and Shanghai,

China. It was a development stage company until 2005.

On October 1, 2010, the Harbin Electric CEO and a private equity firm made a \$750 million buyout offer to take the company private.

On June 16, 2011, Citron Research posted a report on Harbin Electric, claiming a buyout loan fraud and the documents to prove it. It said that the future of Harbin's stock price was currently propped on the crutch of a purported \$24 per share buyout offer from its Chairman/CEO who owned 40% of the common stock. It stated that the Harbin Chairman/CEO had a history of fraudulent loan guarantee documents. It claimed the offer was a sham with the CEO obtaining a signature loan for \$400 million to buy out the remaining 60% of publicly-held shares at a 40% premium. The purported lender bank, China Development Bank, had become associated with China stock frauds, most recently the Sino-Forest fraud. Citron questioned what bank would provide hundreds of millions of dollars in high-risk financing to fund a huge premium to pay off U.S. investors. Citron said that Harbin Electric's SAIC filings showed losses for both 2009 and 2010 while its SEC filings showed profits of \$20 million and \$77 million, respectively. Citron also claimed that the company had significantly understated its liabilities and overstated its revenues in SEC filings as compared to its SAIC filings.

On June 25, 2011, Asian Times reporter also questioned this buyout offer, saying the NASDAQ stock price was still stubbornly stuck at about \$15 per share. He pointed out that in recent months, bashing and shorting Chinese RTOs had become something of a cottage industry. As a result of RTO transgressions, investigations, and short-sellers' attacks, Bloomberg's Chinese Reverse Merger Index had declined over 40% in the last year. He wrote that "for some Chinese RTOs, the trip to Wall Street has turned into a prolonged swim in a sewer of suspicion, innuendo, disdain, and exposure and prospects of U.S. financing that, if available, would be grudging, onerous, and expensive. It is therefore not too surprising that Harbin Electric's CEO might decide to extract his company from the RTO morass by taking it private."

On September 22, 2011, another short seller wrote about the customer footnote in Harbin Electric's 2010 annual report, saying that his firm reads such footnotes to seek insights about revenue concentration and potential threats to corporate balance sheets and cash flow statements from problematic receivables. He found that Harbin did not have the customer volume that was claimed in this footnote which disclosed that Jiangsu Liyang Car Seat Adjuster Factory was its second largest customer, accounting for 10% (\$22 million) of 2009 revenues and 16% (\$19 million) of 2008 revenues. This short seller hired an American investigator living in Beijing to conduct interviews with this customer, posing as a buyer for a fictional American auto parts wholesaler.

He found out that this customer barely did any manufacturing of electric car-seat adjusters and that what little electric business it did was primarily with a China-based unit of Johnson Controls. This customer said that 98% of its business was selling manual, not electric, car-seat adjusters and its total sales were \$27 million in 2009 and \$30 million in 2010. Thus, the electric motor sale to this customer that Harbin asserted "represents a big disconnection."

On November 1, 2011, NASDAQ suspended trading of Harbin Electric stock and filed a notification of removal of listing and registration with the SEC.

On November 3, 2011, Harbin Electric completed closing of its going private transaction and became a privately-held company. No final details of the \$750 million transaction were provided.

On December 1, 2011, the company's auditor, Frazein Frost, agreed to be shut down by the SEC without admitting guilt. This firm had issued clean audit opinions for Harbin's financial statements from 2006 through 2010. The SEC said the reason for the auditor shut-down was improper professional conduct in connection with the annual audits and quarterly reviews of the company's financial statements.

6. China-Biotics, Inc.

On August 10, 2006, China-Biotics became a public company in the U.S. after completing an RTO and was in the development stage until 2007. It was a Shanghai-based maker of probiotic yogurt cultures.

On August 30, 2010, Citron Research issued a very negative report on China-Biotics which stated: "It would be easy to look at the gross discrepancies between the company's SAIC and SEC filings. It would also be possible to show pictures of the half-finished over-budget manufacturing facility side-by-side with company claims that it was already in production or the photos of their current production facilities the size of a bathroom where the acidophilus pills drop out of a machine two by two. Most compelling, it would be simple to question how a company who sells the bulk of their product through distributors, who then purportedly resell them to Wal-Mart (as claimed by China-Biotics), can generate EBITDA margins of 40-45% when their competition is at 27% max."

On September 14, 2010, Citron Research issued another report. It said that it had been writing about stock fraud the last nine years and admitted that it has made research mistakes but has never been wrong about a fraud. Thus, "Citron is confident to state China-Biotics is a fraud. If we are lying, then please sue us and we will prove it in court. Or, put out a press release defending yourself and explicitly blame Citron Research, and we will sue you proactively to prove that you are committing securities fraud on the investing public." Citron questioned the network of 111 retail stores claimed by China-Biotics in years'

worth of SEC filings and determined that their list of "branded stores" were not stores; 95% of them were just supermarkets and retail outlets that carried China-Biotics products on small shelf space or did not carry such products at all. Citron then hired two private investigators to take pictures and prove what Citron knew. Citron noted that China-Biotics claimed to

have \$160 million in the bank in its June 2010 SEC filing yet reported interest income of just \$87,876 (0.0005%) while interest rates on free cash balances in China earn 1% for 3 month to 1 year term deposits. Citron also noted large differences in the 3/31/2008 SAIC and SEC filings which were too large just to be due to different reporting standards as follows:

	<u>SAIC</u>	<u>SEC</u>
Cash	\$ 100,000	\$ 64,300,000
Accounts Receivable	1,000,000	13,200,000
Revenues	500,000	42,300,000
Gross Profits	200,000	30,000,000
Net Income	(1,200,000)	17,500,000

Such large discrepancies between SAIC and SEC financial reports have served as warning signs or red flags for potential fraud among other Chinese companies as well. Citron concluded: "As far as lying to the Chinese government but not the SEC, you want us to believe that management who lives and pays taxes in China, where white collar crime can be punishable by death, will lie to the Chinese government but they will not lie to the SEC?"

For example, Zeng Chengjie, a Chinese businessman, was executed on July 12, 2013 by lethal injection for illegal fundraising and financial fraud. He allegedly defrauded more than 57,000 investors out of \$460 million of which he had already returned \$280 million, or 60%, at the time of his execution, as compared to Bernie Madoff's lifetime jail sentence for his \$50 billion Ponzi scheme.

On September 15, 2010, China-Biotics released a press release commenting on its stock. The company didn't defend their alleged stores claim explicitly but instead stated that there were "market rumors" and blamed the shorts for stock price declines, similar to Enron's strategy. Citron commented: "Don't forget the old adage: at every poker game there is a sucker, and if you don't know who the sucker is, it is you!"

On June 15, 2011, NASDAQ halted trading in China-Biotics stock when the company failed to file its 10-K annual report with the SEC.

On June 24, 2011, China-Biotics's CFO resigned and its auditor, BDO Limited, also resigned, citing irregularities it discovered that "likely constitute illegal acts." BDO said that its auditors, attempting to review online bank records, were directed by staff of China-Biotics to "access a suspected fake web site" that supposedly belonged to the bank in question where the company kept one of its major cash accounts. In its 3/31/2010 balance sheet, the company had reported \$156 million in cash which was approximately 150% of its market cap. Also, BDO stated that the company had forged sales documents and misstated interest income and failed to take "appropriate remedial actions." BDO had been the company's auditor for the last three financial years, March 31, 2008-2010, and had issued clean

audit opinions for all three year but refused to certify the March 31, 2011 numbers. Also, on this day, NASDAQ delisted the China-Biotics stock.

On July 18, 2011, an investor lawsuit was filed against China-Biotics.

On October 8, 2013, China-Biotics asked the SEC to reinstate its securities registration which was revoked in 2012 by the SEC because the company failed to file some of its required financial reports. The company said it had hired a new auditor, filed all of its missing reports, and was now fully up-to-date in its filings. An attorney from the SEC's enforcement division urged the SEC commissioners not to reinstate the company, saying that the company had refused to identify when its filings would become current and had taken over a year to fix these issues. As of June, 2013, the SEC had filed more than 65 fraud cases and deregistered the securities of more than 50 companies, including China-Biotics.

7. Deer Consumer Products, Inc.

On September 10, 2008, Deer Consumer Products, Inc. became a public company in the U.S. after completing an RTO. The company was a manufacturer of blenders, juice makers, soymilk makers, and rice cookers. Its auditor was Goldman, Kurland and Hohidin LLP, a favorite auditor for Chinese RTOs per Alfred Little, a short seller.

On June 1, 2009, the company was up listed to NASDAQ. It had been a development stage company in 2007.

On March 9, 2011, Alfred Little issued his first report on Deer Consumer Products. He wrote that the company had impossibly high gross margins and operating margins at the same time as very low selling expenses. Also, the return on investment was impossible on a \$40 million plant. He had hired an independent third party research group in China. They counted the number of brands and prices at various Suning stores, mentioned as one of Deer's product sellers in its December, 2010 financial statement notes. The researchers found that Deer products were not available at these stores. Also, Little challenged Deer's revenue recognition policy

on a "commission basis" at other distributors' stores and asserted that Deer should wait to recognize revenue until its products were sold in these stores, not at the point of shipment to these stores, which he called "channel stuffing" and not permissible under U.S. generally accepted accounting principles (GAAP). Accordingly, he noted a disconnection between net income and operating cash flow.

On March 14, 2011, Alfred Little issued his second report on Deer Consumer Products. He claimed Deer had substantially inflated both sales and profit margins and had failed to disclose direct competition from entities related to its chairman. His report was organized into the following sections: high profit margins are impossible, extensive 10-city, 60-store channel check confirms very weak domestic retail sales, questionable revenue recognition inflates sales and accounts receivable, 2009 SAIC filing shows a much smaller and less profitable business, and direct competition from Deer's chairman who is an unconsolidated related party.

On March 21, 2011, Alfred Little issued his third report on Deer Consumer Products. He wrote: "Virtually every fraudulent company I have uncovered finds ways to steal money from its U.S. investors. Deer appears to be no exception." In its 10Q filed November 10, 2010, Deer disclosed that it had purchased \$22.2 million of land use rights for construction of a new factory (inflated to \$23.2 million under Intangible Assets). Little stated that his legal team in China discovered that the direct purchaser of this land right use was a new subsidiary recently set up by Deer and that official records showed a purchase price of \$11.3 million, not \$22.2 million. He wrote: "It was insane for Deer to buy land to build a new factory when it still had a lot of excess capacity. Existing facilities can support \$320 million in revenue versus \$174 million revenue estimated for 2010. So it was of little surprise to me to find Deer exaggerated the cost of this land purchase by almost 100%. The money was either diverted (stolen) for some other purpose or the cash never existed in the first place - either scenario at Deer is possible."

On April 30, 2011, a securities class action lawsuit was filed against the company and certain directors and officers. Plaintiffs charged that Deer had misrepresented its financial performance, business prospects, and financial condition to investors, citing inconsistent Chinese regulatory filings versus U.S. regulatory filings and GAAP.

On May 2, 2011, Deer issued its own press release and asserted that it had "evidence of continuing illegal short selling in its stock and also asserted that its common stock has been manipulated in collusion among naked short sellers." The press release also asserted that the class action lawsuit was part of the attempted manipulation. Deer further asserted that "the supposed analyst, Alfred Little, is a fictitious character whose phony identity is a disguise

used by one or more illegal short sellers in the short seller sale scheme." Deer claimed that the purported reports of Alfred Little were "published in collusion with short sellers to intentionally create fear in the general public to drive down Deer's share price." The press release also asserted that all of the allegations in the supposed Alfred Little reports were false and that the company intended to seek sanctions against the law firm that filed the lawsuit.

On September 6, 2011, Chinese officials confirmed that both Harbin Electric and Deer Consumer Products committed multi-million dollar land fraud. Both companies had listed their land right uses under intangible assets, starting in 2007 for Harbin Electric and 2010 for Deer.

On August 13, 2012, NASDAQ halted trading in Deer Consumer Product shares. Alfred Little had hired an independent third party to visit Deer's two Yangjiang factories. He took pictures and noted that there was no sign of any production activity or workers, other than security and maintenance personnel.

On October 2, 2012, NASDAQ delisted Deer Consumer Product shares for the following reasons: 1) Deer had made false and misleading disclosures regarding the operational status of its manufacturing facilities in Yangjiang, China, 2) Deer had failed to provide complete responses to NASDAQ staff's questions regarding the Company's customers, suppliers, and shippers, and 3) Deer was involved in a scheme to illicitly transfer corporate funds to a group of stockbrokers through a bogus consulting contract.

On March 10, 2013, an investor filed a class action lawsuit against Deer's auditor, Goldman Kurland and Mohidin, who had issued clean audit opinions for Deer's financial statements in 2007 through 2010. The lawsuit alleged that Deer's revenues were overstated in 2009 and 2010.

On April 1, 2013, a partial settlement of the securities class action lawsuit against Deer was reached for \$2,125,000.

8. 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. (New York Stock Exchange Commission on Corporate Governance, September 23, 2010, available at <http://www.nyse.com/pdfs/CCGReport.pdf>.) The specific principles that apply to the analysis of the five Chinese companies in this paper are listed below.

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

value. Thus, policies that promote excessive risk-taking for short-term stock price increases, and compensation policies that do not encourage long-term value creation, are inconsistent with good corporate practices.

2. 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. Management's role in corporate governance includes, among other things, establishing risk management processes and proper internal controls, insisting on high ethical standards, ensuring open internal communications about potential problems, and providing accurate information to both the board of directors and the shareholders.

3. 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.

4. Transparency is an essential element of corporate governance.

9. 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. In addition to fraudulent statements and activities, there were deliberate attempts to conceal the truth. There was no instance of any board involvement to correct any of the activities. Some of the evidence that supports these conclusions is detailed below for each of the five companies.

Longtop Financial Technologies Ltd

There were allegations of widespread fraud in the financial statements, including the misrepresentation of cash on hand, as well as borrowings not shown on the books. The Chairman of the Board admitted to the auditor that there had been fake revenue and fake cash, but he would not answer specific questions, other than blaming senior management. There were non-transparent management transactions. The auditor resigned; one reason stated was that management interfered with the audit process.

China MediaExpress Holdings, Inc.

There were differences in the performance numbers reported to the U.S. SEC and the China SAIC. There were large misrepresentations of cash on hand and other accusations of fraud, including videos showing no activity at the corporate office. There were allegations of industry reports that did not confirm the magnitudes of their presence in the industry and their revenues. When their auditor hired a forensic accountant to investigate the accusations and allegations, the CEO offered a bribe to the investigator.

Harbin Electric, Inc.

There were differences in the performance numbers reported to the SEC and to SAIC. There were allegations that they did have the customer volume that they reported. The Chinese government confirmed that they were involved in a multi-million dollar land fraud. There were claims that a buyout offer from the Chairman/CEO was fraudulent. In addition to having the influence and control that he did as both the Chairman and the CEO, he also owned 40% of the common stock; this can cause concerns about too much power for one person to have. Their auditor was shut down by the SEC for improper professional conduct regarding audits and quarterly reviews.

China-Biotics, Inc.

There were extremely large differences in the performance numbers reported to the SEC and SAIC. As was true in all the instances when these numbers were different, the numbers reported to the SEC were always better, which would help to keep the stock price up. There were questions about their margins and revenues and the ability to generate the revenues. The Chinese government confirmed that they were involved in a multi-million dollar land fraud. Their CFO resigned, and their auditor resigned after having issued three years of clean audit reports.

Deer Consumer Products, Inc.

There were differences in the performance numbers reported to the SEC and SAIC. There were allegations of non-existent sales distribution channels which raised questions about revenues, selling expenses, and margins. There was no sign of production at any of the production facilities. The Chairman was a related party in entities that were in direct competition with the company.

Lessons Learned

Most investors recognize that 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. This paper has shown the importance of corporate governance standards in cross border investing. These 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.

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. Also, the NYSE, NASDAQ, and other major global stock exchanges now have corporate governance listing requirements that follow these principles. ("Corporate Governance Listing Requirements: Protecting Investors From Fraudulent Financial Reporting," K. Aljifri, H. Grove and L. Victoravich, Corporate Ownership and Control, 2014, Winter, Volume 11, Issue 2.) 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.

References

1. "The Missed Red Flags on Groupon," A. R. Sorkin, The New York Times, October 17, 2011.
2. "The Shorts Who Popped a China Bubble," D. Bases, R. Vlastelica, C. Baldwin, and M. Bendeich, Reuters, August 5, 2011.
3. Citron Research Report, "Citron Reports on Longtop Financial," April 26, 2011.
4. "The Shorts Who Popped a China Bubble," D. Bases et.al., Reuters, August 5, 2011.
5. "The Audacity of Chinese Frauds," F. Norris, The New York Times, May 26, 2011.
6. Citron Research Report, "Longtop Financial Final Proof of Undisclosed Related Party Transactions," May 9, 2011.
7. "Auditing Cash in China," P. Gillis, China Accounting Blog.com, April 20, 2011.
8. "The Audacity of Chinese Frauds," F. Norris, The New York Times, May 26, 2011.
9. "Longtop Teaches Deloitte How to Discover A Chinese Stock Fraud. Again," B. Bishop, digicha.com, May 22, 2011.
10. "China-Biotics Mentioned Negatively At Citron Research," R. Nachman, Benzinger.com, August 30, 2010.
11. "Another Day...Another Chinese Scam Stock," M. Weinschenk, Wall Street Daily Insider, March 16, 2011.
12. "Another Day...Another Chinese Scam Stock," M. Weinschenk, Wall Street Daily Insider, March 16, 2011.
13. Citron Research Report, "Harbin Electric: Loan Fraud and the Docs to Prove It," June 16, 2011.
14. "Another Sewer Swim for Harbin Electric," P. Lee, Asia Times, June 25, 2011.
15. "Harbin Electric: The Annuals of Fraud," R. Boyd, seeking alpha.com, September 22, 2011.
16. Citron Research Report, "China-Biotics is a Fraud—Now Sue Citron—We Dare You," September 14, 2010.
17. "China's Bernie Madoff Was Executed for Fraud--and Nobody Told His Family," R. Lu, The Atlantic, July 16, 2013.
18. Citron Research Report, "China-Biotics is a Fraud—Now Sue Citron—We Dare You," September 14, 2010.
19. "China-Biotics Fraud Casting Doubt on All Chinese RTOs," I. Bezek, seeking alpha.com, June 24, 2011.
20. "Deregistered Chinese Company Asks U.S. SEC for a Second Chance," S. Lynch, Reuters, October 8, 2013.
21. "Deer in Headlights: Latest Alleged Chinese Reverse Merger Fraud," T. Durden, zerohedge.com, March 9, 2011.
22. "The Problems With Deer Consumer Products," A. Little, seekingalpha.com, March 17, 2011.
23. "Deer Consumer Products Report," A. Little, sbwire.com, March 21, 2011.
24. "Are Short Sellers Fabricating the Accounting Fraud Allegations Involving U.S.-Listed Chinese Firms?" dandodiary.com, May 3, 2011.
25. "Chinese Government Officials Confirm HRBN and DEER Committed Multi-Million Dollar Land Fraud--Time for U.S. Regulators to Act," A. Little, labemp.wordpress.com, September 6, 2011.
26. "Deer Consumer Products Shares Halted After Factories Idled," A. Little, seekingalpha.com, August 14, 2012.
27. "The Bell Tolls For Deer Consumer Products," A. Little, seekingalpha.com, October 10, 2012.