CORPORATE GOVERNANCE AND CHINESE GHOST CITIES

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Abstract

Sir David Tweedy, the former chair of the International Accounting Standards Board, observed: "The scandals that we have seen in recent years are often attributed to accounting although, in fact, I think the U.S. cases are corporate governance scandals involving fraud" (Tweedy, 2007). This paper will show that many of the recent Chinese cases of fraudulent financial reporting are also really corporate governance scandals involving fraud.

Keywords: Corporate Governance, Ghost Cities, China, Financial Reporting

1. INTRODUCTION

Jim Chanos, the founder of a hedge fund now worth $3 billion, was one of the first analysts to short Enron, Tyco, and U.S. mortgage companies involved in the 2008 financial crisis. His analytical strategy has typically focused upon financial engineering: "We're looking for companies masking bad operations by buying back stock and/or playing accounting games by using pro-forma adjustments" (Weil, 2014). However, additional analyses, which we will link to the investigation of corporate governance in possible Chinese fraud companies, are needed, as a Peking University accounting professor, Paul Gillis, observed: "Accounting fraud in the U.S. is usually from the overly aggressive application of an accounting principle. Accounting fraud in China has usually been situations where large portions of the business simply do not exist" (Kinetz et.al, 2014). Furthermore, as analyzed here, possible fraudulent Chinese companies may have supplied or benefitted from ghost city construction projects which were then dependent upon continued government sponsorship and support of such fixed-asset investments. Due to the opaque or poor disclosures by these companies, one cannot say for sure if they did supply or benefit from such ghost city projects.

Chanos has recently been shorting companies involved in supplying Chinese construction projects as he observed: "China is the only country in the world that knows its GDP growth rate for the upcoming year on the first day of the year. In China's GDP calculations, they don't look at final sales, they look at production. So a condo being built but not sold contributes to GDP" (Tymkiw, 2012). Chanos has been bearish on China since 2009 when he and his team at his Kynikos Associates, which has over $1 billion under investment management, were analyzing commodity prices and the stocks of large mining companies. Chanos said: "Everything we did in our microwork on commodities kept leading us back to China's property market. China's construction boom was driving demand for nearly every basic material. By 2009 in the midst of a global recession, China was building almost 30 billion square feet of new residential and office construction. There are 1.3 billion people in China. In terms of new office space alone, that amounts to about a five-by-five-foot cubicle for every man, woman, and child in the country. That's when it dawned on me that China was embarking on something unprecedented" (Olster, 2010).

2. CHINESE GHOST CITIES

In 2011, an Australian business reporter visited some of China's most infamous ghost cities and malls and wrote a report that broke this ghost city story internationally (Badkar, 2013). In 2013, a "60 Minutes" U.S. television report observed: "We discovered that the most populated nation on Earth is building houses, districts and cities with no one in them…desolate condos and vacant subdivisions uninhabited for miles and miles and miles and miles" (Belvedere, 2013). This same "60 Minutes" report interviewed the CEO of the largest Chinese real estate developer, China Vanke Co. Ltd., a publicly held company which was the second company ever listed on the Shenzhen stock exchange in 1991. This CEO said many developers are deep in debt, projects are being abandoned, and a nightmare scenario could be like America's housing crash but worse (Lubin and Badkar, 2013). This CEO also said that China's property sector was already in a bubble state with some cities seeing a 10-fold increase in prices that have driven the average home buyer out of the market. For example, the cost of a home in Shanghai would be about 45 times the average resident's annual salary (Harjani, 2013). A 2014 report estimated that there were 11 major Chinese ghost cities but the Chinese government had told a Chinese reporter to "quit being a troublemaker" and cease doing ghost city investigations (Duffy, 2014)

In China, fixed asset investment accounts for more than 50% of China's overall Gross Domestic Product (GDP) in 2014 with just the property market accounting for about 20% of GDP (Liang, 2014). No other major economy even comes close. Of that Chinese fixed investment, about one-quarter is attributable to new real estate investment, and new

property sales accounted for 14% of GDP in 2009. Bearish investors on China, like Chanos, question why there are so many apartments and villas which have been bought and paid for but remain empty. One explanation may be that individual Chinese investors are limited in their investment alternatives. Bank accounts have a negative rate of return with inflation estimated to be 3%. Chinese stock markets are much more volatile than well-established stock markets and capital controls limit investment opportunities abroad so that leaves real estate. For example, one investor owns 43 flats in and around Shanghai and he has fully paid for all of them. Vacancy rates for homes constructed in the past five years are at 15% but are projected to rise to over 20% in 2016-2017 (Badkar, 2014).

However, there are many bullish investors on China, opposing these bearish investors. They have cited the examples of Pudong and Zhengzhou, initially ghost cities, which became successfully occupied and developed. Bullish investors have pointed out that Pudong is across the river from Shanghai, which has one of the world's largest ports. The bullish investors say that China is experiencing the greatest urbanization story the world has ever seen and that these ghost cities will soon become thriving metropolitan areas so just remain patient (Lubin and Badkar, 2013). One bullish investor, a chief investment strategist and long-time Asian resident, commented: "The truth is there are large, empty developments all over the world, including the United States. In those countries, ghost cities happen whenever developers may have misjudged demand. The difference is China's ghost cities appear on a grand scale because China itself is on a grand scale. China's ghost cities herald great expectations" (Madison, 2013). Also, the Chinese home real estate market, mostly units in high-rise buildings (see the following picture), are regarded as capital-gains machines, rather than sources of shelter. There are now over 50 million such units which are owned but vacant. The owners/investors will not rent them because used apartments suffer an immediate reduction in value while less affluent investors have bought fractional shares in luxury apartments and town houses (Liang, 2014). Also, the high-end condos cost over $100,000 but the average Chinese household made less than $10,000 a year (Nocera, 2015).

Many of the large Chinese ghost cities are located in the interior provinces of China, such as Inner Mongolia, Qinghai, Henan, Hunan, and Yunnan, well away from the thriving coastal economic regions. One of the most famous ghost cities is Kangbashi, Ordos in Inner Mongolia. It was built for $5 billion during the coal mining boom of 2008-2009 and projected to have one million residents. Then Chinese coal prices fell 20%-30% in 2012 which ended the mining boom and the 2014 city population is now 30,000. More than a dozen 20-story high-rise buildings have no signs of life and many migrant workers are renting vacant office spaces as apartments for as low as $65 a month. Ordos is in the middle of the desert and is running out of groundwater (Badkar, 2014). In contrast, the mayor of Ordos claimed a local GDP growth rate of 13% in 2012, which Chanos pointed out was predicated on the number of real estate project completions, not sales (Spano, 2013).

This ghost city phenomenon in China is facilitated by how local governments, like Ordos, are forced to finance themselves. They are in a perpetual cash squeeze since they have to give the majority of their tax revenue to the central government which often forces them to build infrastructure projects without any central funding. Since the Communist Party owns all the land in China, local governments often seize land from their poorest residents for a minor payment and then sell the land to developers for a much larger price which increases their GDP figures and chances of promotion within the Party (Badkar, 2014).

Another interesting example of a Chinese ghost city is Tianducheng, built for $1 billion as a replica of Paris with a 354 foot Eiffel Tower and a Champs-Elysees boulevard. It was supposed to hold 10,000 people but had only 1,000 by 2013. A more dramatic example is the New South China Mall which was supposed to be the largest mall in the world with 7 million square feet and 2,350 retail stores. It now has a 99% vacancy rate, ten years after completion in 2005. The local government has taken it over and classified it as a national tourist attraction (Badkar, 2013).

Chanos has responded to these bullish investors: "China's on an economic treadmill to hell. It's an economy on steroids. You have an economy that's 50% fixed-asset investment, and not even in the developing world is that sustainable. We've seen this movie before. Whether it was Dubai a few years ago, Thailand and Indonesia during the Asian crisis of the late '90s, or Tokyo about 1989, this always ends badly" (Olster, 2010). In a 2013 presentation, Chanos was still bearish on China and noted a multitude of problems in China, such as economic inefficiencies, real estate and credit bubbles, questionable audited numbers, inflation, ghost cities, money laundering and broad corruption by the ruling elite. He also pointed out that there was now greater leverage in China with borrowing increasing from 15% of GDP in 2008 to 30% of GDP in 2012 (Spano, 2013). In the fourth quarter of 2012, new credit surged to $1 trillion. With an $8 trillion GDP, Chanos observed that that this $1 trillion fourth-quarter amount projected to be $4 trillion on an annualized basis or 50% of GDP which is a real, growing credit bubble (Weil, 2013). In a 2014 interview, Chanos said that at the time of the 2008 U.S. economic recession, construction was only 16% of the U.S. GDP while today in China, construction is 50% of its GDP and also mentioned a new potential ghost city under construction that is a replica of Manhattan. He commented: "China's economy is now on a bigger treadmill to the same destination!" (Duffy, 2014), especially since these construction properties have no chance of generating enough income to pay down the related debt (Nocera, 2015). Similarly, a research director at a Chinese investment company observed that China is riding an "involuntary credit treadmill" where much new government stimulus money has to be "hosed into the economy" just to sustain ever mounting bad debt totals which never seem to get written down in China (Liang, 2014).

Full-year 2014 GDP growth for the Chinese economy was only 7.4%, the slowest pace in over two decades. The real estate market had slumped, dragging down the rest of the Chinese economy

(Barboza, 2015). By December 2014, the slowdown in year-to-date fixed asset investment growth had decelerated to 15.7% which was driven by property investment that fell to -1.9%. While sales in floor space in a sample of large cities, including all tier-1 cites, increased 28%, nationwide sales volume contracted by 4%. With still depressed sales, developers are struggling with funding problems with year-to-date growth of available funds turning negative by -0.1% in December. Given that property investment activity tends to trail sales with a significant lag, UBS (2015) predicted that investment growth will not turn around and GDP growth will only be 7% in 2015. UBS (2015) also recommended that investors stay selective in the property sectors and focus on developers with a strong focus on tier-1 and tier-2 cities as high inventory pressure still persists in tier-3 and tier-4 cities (where the ghost cities exist).

3. CHINESE IPO AND RTO COMPANIES WITH POSSIBLE GHOST CITY LINKS

There were about 500 small Chinese companies with an average market cap of less than $5 billion that listed in U.S. capital markets during 2005-2010, the heyday of double-digit Chinese GDP growth when China had the fastest growing economy in the world. A few Chinese company listings were by an initial public offering (IPO) but most were by a reverse merger often called a reverse takeover (RTO). These smaller Chinese companies found easy access to U.S. capital markets and investors who had become comfortable with the larger Chinese state-owned enterprises and private companies that had previously listed successfully on U.S. stock exchanges. These U.S. investors also had become comfortable or even enamored by the double digit growth rate of the Chinese GDP during the last decade (McKinsey & Co., 2013).

During the early part of this 2000-2010 decade, the Chinese double digit GDP growth had been powered by exports, government infrastructure projects, and government and bank financing. As this phenomenal growth started to slow down in the middle of the decade, it was reenergized by the construction of many new cities, mostly located in the interior of the country, away from the three major Chinese economic areas, all along the eastern seacoast: Bohai Bay Rim where Beijing is located, Yangtze River Delta where Shanghai is located, and Pearl River Delta where Hong Kong is located. Thus, the double digit Chinese GDP growth rate continued just past the end of that decade and helped keep U.S. investors enamored with these small Chinese IPO and RTO companies listing in the U.S. during 2005-2010.

Unfortunately, approximately 100, or 20%, of these 500 Chinese IPO and RTO companies were delisted or suspended by the New York Stock Exchange (NYSE) in 2011 and 2012. These 100 companies caused approximately $40 billion in market capitalization destruction even though the average market cap of each of the 100 firms was $68 million when listing on the U.S. stock exchanges (McKinsey & Co., 2013). As the Chinese GDP growth rate had fallen to single digits in this decade, investors were not as enamored with these small cap Chinese stocks. Also, many of these companies may have had economic activities with the Chinese ghost cities but such links were obscured by the typical opaque disclosures by these companies. With such large market cap destruction of over $40 billion by these Chinese IPO and RTO companies listed in the U.S., one has to ask: where were the Boards of Directors with effective corporate governance principles and practices?

4. TIMELESS CORPORATE GOVERNANCE WEAKNESSES

After the financial crisis of 2008, the NYSE sponsored a Commission on Corporate Governance to identify key corporate governance principles for boards of directors as well as management and investors. The Commission's report (2010) identified the following principles which are listed in an order to match with our own corporate governance research findings (Grove and Cook, 2007):

1. Independence and objectivity are necessary attributes of a board of directors which must have a majority of independent directors per U.S. stock exchanges' requirements. An appropriate range and mix of expertise, diversity, and knowledge is needed on the Board.
2. Management's role in corporate governance includes, among other things, establishing risk management processes and proper internal controls.
3. 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.
4. Management's role in corporate governance also includes insisting on high ethical standards, ensuring open internal communications about potential problems, and providing accurate information both to the Board and to shareholders. Management has the primary responsibility for creating a culture of performance with integrity.
5. 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. A Board should be careful not to adopt a "check the box" mentality when implementing and complying with the numerous governance mandates and best practices. Transparency is an essential element of corporate governance, not only for companies but also for major shareholders who should have appropriate disclosure practices, including their ownership of other securities.

We have designated these five NYSE corporate governance principles as "structural factors" which are matched to our first five corporate governance weaknesses. These five timeless corporate governance weaknesses have existed since the 1970s when major shareholder lawsuits occurred, concerning U.S. external auditors' failures to detect fraudulent financial reporting (FFR) at their clients' companies (Grove et al., 1982). Our five weaknesses are similar to the five NYSE "structural factors" as follows:

1. All Powerful CEO and Insider Board Influence
2. Weak System of Internal Control

3. Focus on Short-Term Performance Goals
4. Weak or Non-Existent Code of Ethics
5. Questionable Business Strategies with Opaque Disclosures

For almost forty years, these five weaknesses or factors have interacted and facilitated FFR in the typical following scenario (Grove and Clouse, 2014). The Chief Executive Officer (CEO) is also the Chairperson of the Board of Directors (COB) and has insider Board influence, possibly even majority control of the Board. Senior management, including the Chief Financial Officer (CFO), then intentionally keeps the company's system of management and internal controls weak. Such weakness facilitates the achievement of short-term performance goals which are a key focus of senior managers concerning their executive compensation packages. There is a weak or non-existent code of ethics which also facilitates the achievement of these short-term performance goals as does the use of questionable business strategies. When such performance results are reported, they are often discussed with opaque disclosures while key performance manipulations are just hidden in the financial statements.

We have designated the last five of our ten corporate governance weaknesses as "behavioral factors" which are often facilitated by and follow the first five "structural factors" in FFR cases as follows:

6. Senior Management Is Uncomfortable with Criticism
7. Insider Stock Sales
8. Senior Management Turnover
9. Independence Problems with the Company's External Auditors
10. Independence Problems with the Company's Investment Bankers

The starting point for this sequence of "behavioral factors" often occurs as external users, primarily financial analysts and investors, are frustrated with the questionable business strategies and opaque disclosures and ask tough, probing questions. Often the CEO and other senior managers respond by attacking the questioner since they have insufficient, legitimate answers. They are not used to such tough questions from their less than independent or inadequate Boards of Directors. Meanwhile, they are quietly selling their own shares of the company's common stock. Then they "vote with their feet" by unexpectedly leaving the company, usually for the personal reason or excuse of "spending more time with my family." Finally, also facilitating FFR, there are independence problems with "watch-dogs" of the free market system, external auditors, and investment bankers. These entities may compromise their independence or integrity to earn additional fees from their client companies. Thus, the interaction of these ten timeless corporate governance weaknesses, typically in the "structural" and "behavioral" sequence listed above, has facilitated FFR by public companies (Grove et al. 2011, Grove and Cook, 2007).

These ten "structural" and "behavioral" factors are elaborated with corporate examples from major FFR and other companies in the Appendix which also includes strategies to correct each weakness from four fundamental guidelines for good corporate governance: strategic, control, integrated, and situational (Hilb, 2008). Each "structural" factor of corporate governance is further analyzed by Warren Buffett, who has over forty years of experience on various Boards of Directors and was voted the leading investor of the last Century. Appropriate guidelines are also cited from NYSE public company listing requirements for corporate governance.

5. CHINESE IPO AND RTO COMPANIES AND THEIR CORPORATE GOVERNANCE PRACTICES

Again, with market cap destruction of over $40 billion by these Chinese IPO and RTO companies listed in the U.S., one has to ask: where were the Boards of Directors with effective corporate governance principles and practices? Ineffective and deficient corporate governance practices are now cited from possible fraudulent Chinese IPO and RTO companies that may have supplied or benefitted from Chinese ghost city projects. Again, due to opaque or poor disclosures, one cannot say for sure if these companies did supply or benefit from such projects. The analysis is organized by the prior sequence of the five "structural" factors and the five "behavioral" factors of corporate governance.

6. ALL POWERFUL CEO AND INSIDER BOARD INFLUENCE

On October 23, 2007, Longtop Financial Technologies Ltd. did an IPO on the NYSE and sold 10.4 million American depositary shares at $17.50 per share, raising $182 million. 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. Thus, Longtop could have indirectly benefited from the ghost city projects which these banks helped to finance. In November, 2010, Longtop's market capitalization peaked at $2.4 billion.

In April, 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. It is the opinion of Citron that every financial statement from its IPO to this date is fraudulent…read on to understand" (Left, 2011).

In May, 2011, Longtop's chairman told its auditor, Deloitte Touche Tohmatsu (Deloitte) that "there were fake revenue in the past so there were fake cash recorded on the books." Branch bank managers had signed fake cash confirmations which was only discovered when the auditor subsequently sent the cash confirmations to the home office of the bank. 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 (Norris, 2011).

On August 29, 2011, the NYSE delisted Longtop Financial Technologies Limited finding that the American depositary shares were no longer suitable for continued listing and trading. Thus, Longtop destroyed $2.4 billion in market capitalization (cap). A class action lawsuit was successful with damages of $882 million awarded to shareholders but, by then, Longtop's CEO and senior management had fled back to China, and Longtop did not even defend itself in the lawsuit (Stanford Law School, 2014).

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. Thus, the company could have indirectly benefitted from the ghost city projects when related apartments were being furnished. On March 9, 2011, Alfred Little, a short seller, 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 (Little, 2011). On October 2, 2012, NASDAQ delisted Deer Consumer Product shares and a partial settlement of the securities class action lawsuit against Deer was reached for $2,125,000. From its stock price peak, Deer had destroyed $374 million in market cap.

The following corporate governance variables, relating to all powerful CEO and insider board influence, the first NYSE "structural" factor, had a significant, negative impact on financial performance and market cap for both Longtop and Deer:

- CEO duality (the CEO was also the COB): Longtop did not have this duality factor but Deer did.
- Board of Directors entrenchment (only staggered re-elections of the Board versus all Board members re-elected every year): Longtop did have staggered, entrenched board elections and Deer Board members held one year terms or until their successors had been qualified and elected.
- Older Directors (over 60 years of age): Longtop's COB was over 61 years old (one of six Directors) and one of Deer's directors was 66 years old (one of five Directors).
- Short-term compensation mix (cash bonuses and stock options versus long-term stock awards and restricted stock): it was implied at Longtop since the COB gave away $80 million in stock to employees along with 25,000 restricted share units; Deer used base salaries plus equity compensation which were not disclosed.
- Non-independent and affiliated Directors (larger percentages of such directors versus independent directors): Longtop had 3 of 6 or 50% non-independent, senior management directors: the COB (founder), the CEO, and a Business Division manager. Also two other directors resigned in 2009 and were not replaced. Deer had 3 of 5 or 60% possible non-independent directors: the COB/CEO, the CFO, and a university aerospace automation professor. Both NYSE and NASDAQ require listed companies to have a majority of independent directors.
- Ineffective risk management committees: neither Longtop nor Deer had such a committee but Deer did delegate risk management to its audit committee.

7. WEAK SYSTEM OF INTERNAL CONTROL

On October 18, 2007, China MediaExpress Holdings, Inc. did an 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. Such advertising could have benefited from real estate developers who were trying to attract Chinese investors to buy apartments and luxury homes in the ghost city projects during that time period.

During January and February, 2011, various short sellers were questioning China MediaExpress. An Australian short seller noted a key red flag: 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" (Weinschenk, 2011). Another short seller, Citron Research, called China MediaExpress a "phantom company." While digging into industry reports on mass transit advertising in China, he 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. A third short seller, Muddy Waters Research, said the company only booked $17 million in revenue for 2009 with the State Administration for Industry and Commerce of the People's Republic of China (SAIC) while reporting $95.9 million in its 10-K report to the U.S. Securities and Exchange Commission (SEC). Citron also said that the company was lying when it claimed to have a deal with Apple. Another short-seller, The Financial Investigator, posted a video that claimed to be 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 (Bases et. al, 2011).

On March 14, 2011, both the company's CFO and its auditor, Deloitte, resigned and subsequently the company admitted that Chinese branch bank managers had falsified cash confirmations, just like the strategy used in the Longtop scandal (Weinschenk, 2011). In May, 2011, NASDAQ delisted China MediaExpress's shares. In January, 2013, a Hong Kong arbitration panel ruled that China MediaExpress was a fraudulent enterprise and awarded a shareholder $77 million in damages.

In June, 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 then 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. From its stock price peak, China MediaExpress had destroyed $792 million in market cap. A class action lawsuit was successful with damages of $535 million awarded to shareholders but China MediaExpress's CEO and senior management had fled back to China, and the company did not even defend itself in the lawsuit, just like the Longtop scandal (Stanford Law School, 2014).

Similarly, China Shenga Tech, a Chinese RTO chemical company, had serious discrepancies regarding its bank balances and customer confirmations per its auditors who resigned (Norris, 2011). A successful shareholder lawsuit cited false cash and customer confirmation letters and counterfeit, forged certificates of deposit. Similarly, China-Biotics, another RTO company, directed its auditors to a fake bank website for cash confirmations. Subsequently, China Shenga Tech and China-Biotics destroyed $272 million and $380 million in market cap, respectively.

8. FOCUS ON SHORT-TERM PERFORMANCE GOALS

Typically, the all-powerful senior management intentionally has kept the company's system of management and internal controls weak. Such weaknesses facilitated the achievement of short-term performance goals which were the focus of senior managers in line with their executive compensation packages. Examples included bonuses based upon revenue and net income targets and stock options kept in the money by higher stock prices in the short-term. These first three "structural" weaknesses have contributed to significant market cap destructions of almost $14 billion by the fourteen Chinese IPO and RTO companies cited in this paper as follows:

Table 1. The fourteen Chinese IPO and RTO companies

Company (millions)	Market Cap Destruction
Sino-Forest	$5,000
Longtop Financial	2,408
Tianhe Chemical	1,900
Douyuan Global Water	960
Kaisa	900
China MediaExpress	792
Chen Zhou Mining	500
China Integrated Energy	490
Gulf Resources	442
China-Biotics	380
Deer Consumer Products	374
China Shengda Tech	272
Keyuan Petrochemical	265
Harbin Electric	118
Total	$14,801

9. WEAK OR NON-EXISTENT CODE OF ETHICS

Another non-ethical, bribe situation occurred that was similar to the China MediaExpress CEO offering a $1.5 million bribe to a Hong Kong forensic accountant hired by the company's audit committee. Kaisa was a property developer in China that did an IPO in Hong Kong and raised $450 million in 2009 and also issued $2.5 billion in offshore bonds. In a 2010 corruption trial in southern China, the Kaisa chairman and co-founder confessed to paying a $130,000 bribe to a judge to gain favorable treatment on a Kaisa property deal. This chairman resigned in December, 2014 for "health reasons" and is now in Hong Kong which has a separate legal system. He refuses to return to mainland China. Kaisa's possible 2015 bankruptcy is estimated to return 2.4 cents on the dollar to bond investors and its common stock is down 88% for a possible total market value destruction exceeding $2.7 billion for both bonds and stock (Barboza, 2015).

On December 12, 2006, Gulf Resources became a public company in the U.S. by doing an RTO with a Delaware company that from 1993-2006 had been a U.S. business owning, leasing, and operating coin and debit card photocopy machines, fax machines and microfilm reader-printers. However, this RTO company was now in the business of manufacturing and trading bromine, crude salt, and related chemical products in the Chinese chemical industry. There was a subsequent 2012 class action lawsuit (settled in 2014 for $2.1 million) which claimed that reported financial report filings to the SAIC showed a much smaller business that was indicated in filings to the SEC. Also, the company's largest customer was an undisclosed related party and many of the company's top customers were owned by Gulf Resources board of directors—also undisclosed in financial reports (Stan, 2012). Having such customers for this manufacturing business may have given the impression that this company was benefitting from the ghost city construction projects that contributed to the double-digit Chinese GDP growth rates during the 2005-2010 period.

In April, 2011, a Glaucus Research Group report highlighted many shortcomings for Gulf Resources. Key findings focused upon competitive analyses. Gulf Resources claimed an Earnings Before Income Taxes (EBIT) margin of 43.5% versus three major competitors' average EBIT margin of 14.4% and an EBITDA margin of 50.6% versus competitors' average EBITDA margin of 18.9%. A key conclusion in this report was: "It is highly unusual and in our opinion nearly impossible, for a commodity manufacturer to consistently produce the types of margins typically only achieved by the likes of Microsoft, Apple and other businesses with unique products, unless the commodity sector is benefiting from abnormal supply-demand imbalances… According to industry data, there are approximately 75 licensed bromine producers in Weifang City, Shandong Province, which produce approximately 85% of all the bromine produced in China" (Kerrisdale, 2011). Subsequently, Gulf Resources had $442 million in market cap destruction. One commentator concluded: "Gulf Resources is now a prominent member of the China reverse merger bad boy club, which includes quite a few companies that have been accused of accounting irregularities" (Stan, 2012).

In March, 2011, an Absaroka Capital Management report listed many serious concerns about the validity of the Shen Zhou Mining & Resources company. The company had encouraged

the common misconception that it was a rare earth business to take advantage of investor interests in rare earth minerals even though it had no exposure to such business. Management had significantly exaggerated the size of its critical fluorite mine. Guidance for the upcoming year could not be reconciled with prior results and implied commodity prices were irrationally high, based upon revenue guidance. A recent company investment appeared to be a fraudulent scheme to transfer equity to related parties with a put option that was highly dilutive to public shareholders. There were misleading investor relations while insiders were selling stock prior to an equity offering which had no rational explanation, based on business needs, and significantly increased the risk of corporate malfeasance (Absaroka, 2011). Subsequently, $500 million in market cap was destroyed.

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. It indirectly benefited from the ghost city projects that significantly contributed to the investor-attractive double-digit Chinese GDP growth rates during the 2005-2010 period when many of these RTO companies listed in the U.S. (Grove and Clouse, 2014).

In August, 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. 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" (Nachman, 2010). In a second report on September 14, 2010, 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 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 (Left, 2010). On June 24, 2011, NASDAQ delisted China-Biotics' stock and a shareholder lawsuit was filed one month later. The company had destroyed $380 million in market cap.

10. QUESTIONABLE BUSINESS STRATEGIES WITH OPAQUE DISCLOSURES

For examples of opaque and misleading disclosures, the financial statements numbers reported to the SAIC have been compared to the financial statement numbers reported to the SEC numbers for various Chinese RTO companies. One example related to China Integrated Energy, one of the Chinese RTO companies, which may have supplied energy to ghost city projects. When it was delisted, it had destroyed $490 million in market cap. A short seller compared its SAIC 2011 numbers to its SEC 2011 numbers and found the SAIC numbers to be much smaller. The company responded by stating that its SAIC numbers misrepresented its financial performance, business prospects, and financial condition to investors (Lucy, 2011). A manager in this company said an independent and unregulated agent had persuaded the company to get listed on a U.S. market for easy accessibility of capital but did not inform the company of any risks. The agent described NASDAQ as the "land of honey and milk." Ironically, this same agent was later persuaded by a short seller to whistle blow on the company's problems (Fan and Xue, 2013).

Other examples of Chinese RTO companies reporting different numbers to the SAIC versus the SEC included China MediaExpress revenues of $17 million to the SAIC versus $96 million to the SEC, Harbin Electric's loss to the SAIC versus $77 million net income to the SEC, and Deer Consumer Products' loss of $1.2 million to the SAIC versus $17.5 million net income to the SEC. Deer also reported a land purchase of $11.3 million in Chinese property records versus $23.2 million to the SEC. In 2011, Chinese officials confirmed that both Harbin Electric and Deer Consumer Products committed multi-million dollar land fraud. A short seller said that this discrepancy was a typical method for Chinese executives to siphon off (steal) company cash (Left, 2011).

An outrageous example was from another Chinese RTO fraudulent company, China-Biotics. It's SAIC versus SEC reporting differences were also compared to the average differences between eight delisted Chinese RTOs and eight ongoing dual-listed Chinese companies (Chen et.al, 2015) as follows:

Table 2. SAIC versus SEC reporting differences

	SAIC	SEC	China Biotics	Average
Cash	$ 100,000	$64,300,000	643	24.3
Accounts Receivable	1,000,000	13,200,000	13	6.8
Revenues	500,000	42,300,000	85	17.4
Net Income	(1,200,000)	17,500,000	19	13.2

Such large discrepancies between SAIC and SEC financial reports have become warning signs or red flags for potential fraud by Chinese companies. Citing the China- Biotics numbers, a short seller 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?" (Left, 2010). For example, Zeng Chengjie, a Chinese businessman, nicknamed "China's Madoff," 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 repaid $280 million (60%) at the time of his execution, as compared to Bernie Madoff's lifetime jail sentence for his $50 billion Ponzi scheme (Lu, 2013).

Another example of opaque disclosure concerned the related party transactions of Keyuan Petrochemicals Inc. The SEC charged in a lawsuit filed against the company that numerous related party transactions between the company and its CEO, controlling shareholders, senior management, and family members were not properly identified or disclosed, causing the financial statements to be misstated, specifically cash, receivables, construction-in-progress, interest income, other income, and general and administrative expenses. An extreme example was the use of an off balance sheet cash account to pay cash bonuses to senior management, travel expenses and apartment rental to the CEO, and both cash and non-cash gifts to Chinese government officials (SEC, 2013). Subsequently, $265 million in market cap was destroyed.

11. SENIOR MANAGEMENT IS UNCOMFORTABLE WITH CRITICISM

In June, 2011, a short seller, Carson Block of Muddy Waters Research, released a negative research report on Sino-Forest, an owner of tree plantations and manufacturer of engineered-wood products. The company claimed to derive most of its revenue from the sales of wood fiber needed to produce industrial, commercial, and residential wood products. Thus, the company was an obvious beneficiary of the ghost city projects. Block claimed that the company had been inflating its assets and earnings and that the company's shares were essentially worthless as the company was a "multibillion-dollar Ponzi scheme" (Wikipedia, 2015). The company rejected these allegations and announced that it would sue Muddy Waters. Its shares were suspended in August, 2011 and in March, 2012, the company filed for bankruptcy (now in liquidation status) which was a $5 billion market cap destruction. Block's other negative research reports also initiated stock price decreases in the following Chinese RTO companies: China MediaExpress, Orient Paper, RINO International, and Duoyuan Global Water. Block said that his success has made him and his wife a target of threats. Thus, he has moved his main office from Hong Kong to an undisclosed location on the U.S. West Coast, removed his phone number for the Muddy Waters website, and has listed a false address on the website (Bases et. al, 2011).

In February, 2011, China MediaExpress released a letter, reaffirming its financial statements and operating practices in response to attacks by various short sellers. In May, 2011, Deer Consumer Products 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 (Dando, 2011). In September, 2010, China-Biotics released a press release commenting on its stock. The company didn't defend their alleged false stores claim explicitly but instead stated that there were "market rumors" and blamed the shorts for stock price declines, similar to Enron's strategy. The short seller, Andrew Left, 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!" (Left, 2010).

12. INSIDER STOCK SALES

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. It was a development stage company until 2005. The company indirectly benefited from the ghost city projects that significantly contributed to the investor-attractive double-digit Chinese GDP growth rates during the 2005-2010 period when many of these RTO companies listed in the U.S. (Grove and Clouse, 2014).

In October, 2010, the Harbin Electric CEO and a private equity firm made a $750 million buyout offer to take the company private. In June, 2011, the short seller, Citron Research, posted a report on Harbin Electric, claiming the buyout loan was a fraud and had the documents to prove it. He 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. Citron stated that the Harbin Chairman/CEO had a history of fraudulent loan guarantee documents and 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. 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 (Left, 2011). However, Harbin Electric only destroyed $118 million in market cap, due to its successful buyout offer.

In June, 2011, an *Asian Times* reporter also questioned this buyout offer, saying 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" (Lee, 2011). In September, 2011, another short seller read the customer footnote in Harbin Electric's 2010 annual report which claimed 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. He then investigated and discovered that this customer barely did any manufacturing of electric car-seat adjusters while Harbin Electric's major product line was electric motors. 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 2008. Thus, the electric motor sales to this customer that Harbin asserted "represented a big disconnection" (Boyd, 2011).

Concerning Longtop's insider stock sales, it was a short seller'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). This short seller hoped that these observations could end any debate as to whether the company has been deceiving its investors and said it was 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" (Left, 2011).

13. SENIOR MANAGEMENT TURNOVER

On July 20, 2011, four members of Douyuan Global Water's Board of Directors resigned amidst allegations of fraudulent internal company controls which later in October, 2013 led to a $5.2 million settlement of a class action lawsuit. Carson Block, of Muddy Waters Research, had initiated coverage of the company on April 4, 2011 as a strong sell, alleging that the company's revenues reported in China were $800,000 annually versus the $154 million reported in the U.S. Block also caught the company forging its China audit report and cited improper undisclosed related party transactions that shifted money to its chairman (Block, 2011). Douyuan Global Water, another Chinese RTO company, specialized in manufacturing water and waste water treatment equipment for municipal, industrial and agricultural water systems. Thus, the company was another obvious beneficiary of the Chinese ghost city projects in the last decade and subsequently destroyed $960 million in market cap.

On March 13, 2011, a short-seller released a video claiming to be a tour of the China MediaExpress offices. The video featured sleeping employees and empty offices. The next day both the company's CFO and its auditor, Deloitte, resigned (Bases et. al, 2011). On March 16, 2011, the CEO of Shen Zhou Mining & Resources resigned after many analysts had whispered that is was likely a fraud (Rubin, 2011). Its stock had traded as high as $10 in January, 2011 on the hype about its rare earth minerals production and sales which may have been aided by China's ghost city projects and double-digit GDP growth of the last decade. Its stock now trades in 2015 at $0.04 with no recent trading activity which was a $500 million market cap destruction.

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, 2008-2010 and had issued clean audit opinions for all three years but refused to certify the 2011 numbers (Bezek, 2011).

14. INDEPENDENCE PROBLEMS WITH THE COMPANY'S EXTERNAL AUDITORS

In March, 2013, an investor filed a class action lawsuit against Deer's auditor, Goldman Kurland and Mohidin LLP, 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. This auditor was claimed to be a favorite auditor for Chinese RTO companies per Alfred Little, a short seller (2011). In December, 2011, Harbin Electric'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. In April, 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, 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" (Norris, 2011).

15. INDEPENDENCE PROBLEMS WITH THE COMPANY'S INVESTMENT BANKERS

In May, 2011, 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. However, two weeks later, Longtop removed Deloitte as its auditor when Deloitte sent bank confirmations to the bank's home office instead of to the branch bank managers as in the past (Norris, 2011).

16. CONCLUSIONS AND EPILOGUE

In conclusion, when Boards of Directors, auditors, forensic accountants, financial analysts, government regulators, and other risk managers are investigating possible fraudulent financial reporting, we advocate the use of the five "structural" factors of corporate governance and the five "behavioral" factors of corporate governance for risk assessment .By June, 2013, the SEC had filed more than 65 fraud cases and deregistered the securities of more than 50 Chinese RTO companies (Lynch, 2013). For a current example of users not following our recommended strategy to investigate these "structural" and "behavioral" factors of corporate governance, red flags existed for a recent June 2014 IPO for Tianhe Chemicals Group in Hong Kong. Its CEO was also its Executive Director since 2007 and also the Director of both of the two subsidiaries which conducted all of the company's business. He had completed only three years of education in commercial enterprise management from a university. Four of the eight directors were company officers, another director worked for another Tianhe company and a sixth director worked for Tianhe's IPO lead bank, Morgan Stanley. Thus, there was not a majority of independent directors as required by U.S. stock exchanges. Three of the eight directors were over 60 years old. An insider trading report listed one substantial individual shareholder who sold almost 90 million shares just four months after the IPO (Dun & Bradstreet, 2015).

Tianhe's IPO on the Hong Kong stock exchange had lost $1.9 billion in market cap in just over six months by early 2015. Morgan Stanley was the lead investment bank in that IPO along with Merrill Lynch and UBS AG with Deloitte as the auditor. Morgan Stanley twice conducted due diligence investigations into Tianhe Chemicals—once before its own private equity fund made an investment in Tianhe and again before the Tianhe IPO. Morgan Stanley spent over $2 million in these two due diligence investigations (Kinetz et.al, 2014). After an initial Tianhe fraud warning by a short seller, the Associated Press (AP) did an extensive investigation into Tianhe and found discrepancies in Tianhe's profitability and relationships with customers as well as the company's origins.

Short sellers and the Associated Press (AP) found that Tianhe revenues cited in government sources were $106 million in 2012 versus the $684 million in the financial statements reported to investors. Also, the AP found that one of Tianhe's principal customers had been reported to purchase about $100 million of chemicals each year which was about 15% of Tianhe's total annual revenues. However, governmental data for this customer showed its annual revenues being less than $6 million in 2012 and a negative net worth of $900,000. This customer's registered Chinese office was an unoccupied room containing broken furniture and old mattresses in a rundown apartment building (Kinetz et.al, 2014).

For another example of users not following our recommended procedures, the 2007 Longtop Financial Technologies IPO destroyed $2.4 billion in market cap by the time of its demise in late 2011. The lead investment bank was Goldman Sachs along with Deutsche Bank and Deloitte as the auditor. Morgan Stanley did a secondary public stock offering in 2009. Yet, only the short sellers were able to detect fraud problems with Longtop (Left, 2011).

As a result of these Chinese financial reporting frauds with their corporate governance failures, these companies were delisted by U.S. stock exchanges, their auditors resigned, investors filed class action lawsuits, and the SEC pursued investigations. For example, Longtop and China MediaExpress recently had large shareholder class action lawsuit settlements of $882 million and $535 million, respectively, in 2014. These lawsuits were not even contested by the defendants who went home to China. The same "Big 4" Chinese affiliated auditing firm, Deloitte Touche Tohmatsu, was held not liable in the first case but was held liable in the second case, guaranteeing future legal appeals (Stanford Law School, 2014).

Finally, a combined "structural/behavioral" factor is emerging in corporate governance, especially in the European Union: representation of women on boards. On March 6, 2015, the German parliament passed a law that requires 100 of Germany's biggest and best known companies to give 30% of their supervisory board seats to women, starting in 2016. In 2014, only 18.6% of supervisory board members or directors were women at these 100 German companies. A further 3,500 German companies have a September 30, 2015 deadline to submit plans to increase their share of women on boards. This vote means that Europe is really endorsing a quota line for women on boards. Norway was the first in 2008, joined by Spain, France, and Iceland, which all have minimum board quotas of 40% for women. Italy has a quota of 33% with Belgium and Netherlands at 30%. Both Britain and the U.S. just have voluntary efforts with 23% and 17% women on boards, respectively (Smale and Miller, 2015).

An August 2015 epilogue had global stock markets in free-fall and extreme volatility and it certainly seems that Jim Chanos, the billionaire short seller, who has been warning about China's real estate bubble since 2009, has been vindicated. China is an important reason for such global stock market volatility. China's economy is faltering, its stock market is collapsing, and the inefficient efforts by government officials to prop up its stock market have led to a loss of confidence in China and its leaders which have spooked global stock markets (Nocera, 2015). Per a McKinsey & Company China report (2015): "China's debt rose from $7 trillion in 2007 to $28 trillion by mid-2014. At 282% of GDP, its debt share, while manageable, is larger than either the U.S. or Germany. Several factors are worrisome: half of the loans are linked directly or indirectly to China's real estate market, unregulated shadow banking accounts for nearly half of new lending, and the debt of many local governments is likely unsustainable." Per Ken Rogoff, a Harvard economics professor, who has long warned of a potential financial crisis in China: "Financial

meltdown leads to a social meltdown, which leads to a political meltdown. That's the real fear" (Sorkin, 2015). Finally, Jim Chanos recently declared about China: "Whatever you think, it's worse" (Sorkin, 2015).

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APPENDIX

Ten Timeless Corporate Governance Weaknesses Facilitating Fraud by Companies Related to Chinese Ghost Cities

1. All-Powerful CEO and Insider Board Influence

The Chief Executive Officer (CEO) is also the Chairperson of the Board of Directors (COB). Also, insiders (senior company managers) on the Board effectively have either significant influence or majority voting control.

- **Corporate Examples:** The CEO, often the company founder, was also the COB at **Parmalat, Enron, Global Crossing, Tyco, Lehman Brothers**, and **WorldCom**. The brother of **Satyam's** CEO was the COB with several Satyam Directors coming from the CEO's circle of friends from his Harvard University days. Thus, Satyam insiders had significant influence on the Board of Directors. The **Qwest** COB, who was the company founder and largest single shareholder, hand-picked the CEO. Parmalat's CEO, CFO, and the company lawyer continued to run the corporation together after it went public and controlled the Board of Directors. Both Enron and **Citigroup** paid their Board Directors such high compensation that at one time both were in the top ten U.S. Board compensation packages. Enron also contributed significantly to its Directors' favorite charities. Accordingly, these companies had significant influence on their Board of Directors.
- **Strategic Guideline: Effective Board Structure**

A small, legally accountable, well-diversified board should be comprised of a maximum of seven members, including an independent Chairperson, independent members, and the CEO. The board should conduct its activities through only two committees: an integrated audit and risk management committee and an integrated board management committee.

- **Warren Buffett Comments & New York Stock Exchange (NYSE) Corporate Governance Listing Requirements:** Concerning this Strategic guideline for an effective board structure, Buffett observed: "true independence—meaning the willingness to challenge a forceful CEO when something is wrong or foolish—is an enormously valuable trait in a director. It is also rare." He looks for people whose interests are in line with shareholders in a very big way. All eleven of his directors each own more than $4 million of Berkshire stock. They are paid nominal director fees. No directors and officers liability insurance is carried, not wanting them to be insulated from any corporate disaster that might occur. Basically, Buffett wants the directors' behavior to be driven by the effect of their decisions on their net worth, not by their compensation. He calls this approach "owner-capitalism" and says he knows of no better way to create true independence for board directors. The NYSE requires that its listed companies have a majority of independent directors and has defined independence as directors having no material relationships with the company over the past year after adoption of corporate governance listing standards.

2. Weak System of Management Control

The system of internal control (checks and balances, separation of duties, etc.) is so weak that senior management can override it anytime it wants.

- **Corporate Examples: Satyam's** CEO has admitted that $1.5 billion cash on its balance sheet was non-existent and that its revenues and operating margins were less than one-tenth of what was reported. Satyam admitted that it did not have a financial expert on its audit committee. **Parmalat's** CEO has admitted shifting over EUR 500 million cash from the company to other businesses. However, an investigative report prepared by an independent auditor for prosecutors in Milan put that Parmalat number closer to EUR 1 billion cash. Although Parmalat had reported profits each year, this report

said that Parmalat only had one profitable year between 1990 and 2002. Major international investment and commercial banks, like **Lehman Brothers, Bank of America, JPMorganChase,** and **Citigroup**, had inadequate risk assessment procedures, especially for their mortgage-backed security investments (toxic assets). Board audit committees failed to perform this key risk assessment function, helping to cause the bankruptcy of Lehman Brothers and the necessity for government bailout money for Bear Stearns, Citigroup and 18 other major U.S. and international banks. Also, there were weak management controls at **Enron, Global Crossing, Tyco, Qwest**, and **WorldCom,** according to the Securities and Exchange (SEC) investigations of fraudulent financial reporting at these companies.

- **Keep It Controlled Guideline: Board's Auditing Function**

To improve the quality of internal control, effective cooperation is needed between the external auditor, the board, the audit committee (to which it reports) and the internal auditor (which should also report to the audit committee). The effectiveness of the internal control system and compliance should be a central focus of the audit committee.

- **Buffett & NYSE:** Concerning this Keep it controlled guideline for a board's auditing function, Buffett observed that many intelligent and decent directors failed miserably due to a "boardroom atmosphere." He elaborated: "It's almost impossible, for example, in a boardroom populated by well-mannered people, to raise the question of whether the CEO should be replaced. It's equally awkward to question a proposed acquisition that has been endorsed by the CEO, particularly when his advisors are present and support his decision." To avoid these "social" difficulties, Buffett has endorsed the NYSE requirement that outside directors regularly meet without the CEO. Also, the NYSE requires that every listed company have an audit committee of at least three members composed entirely of independent directors who must be financially literate. Every listed company must have an internal audit function.

3. Focus on Short Term Performance Goals

The overriding performance goal is to "make the numbers," for each quarter and each year, especially for executive compensation. Performance emphasis is given to both revenue, or "top-line" growth, and earnings, or "bottom-line" growth. Aggressive or fraudulent accounting and business practices facilitate the achievement of such goals.

- **Corporate Examples: Qwest's** CEO was criticized by his own board for having a short-term focus on making the numbers, particularly double-digit revenue growth. For example, to help make its revenue goals in one year, Qwest recorded thirteen months of advertising revenues from its telephone directories, instead of the normal twelve months. Qwest also did quarter and year-end swaps of its fiber optic networks with other companies, such as **Global Crossing** and **Enron**, in order for all these companies to make their double-digit revenue growth targets. Both **Satyam's** CEO and Board constantly focused upon double digit revenue growth every year. A German firm rejected a proposed merger with Enron, citing Enron's huge off-balance-sheet debt in its Special Purpose Entities (SPEs) and use of aggressive accounting practices to create gains from its SPE transactions. Similarly, another German firm rejected a proposed merger with Qwest, citing its huge on-balance sheet debt and aggressive accounting practices. **Tyco** and **WorldCom** were "greedy corporations" as they were purely interested in short-term financial gain (Gladwell, 2009, p.366) Also, WorldCom's CFO never kept a single share of WorldCom stock in his personal investment account since he exercised and sold his stock options as soon as they vested. Many international banks, like **Lehman Brothers, Goldman Sachs,** and **Citigroup**, hid their toxic asset investments off their balance sheets in Structured Investment Vehicles (SIVs) and refused to recognize market value declines or impairments of such assets in their income statements. Board compensation committees at these companies encouraged short-term performance goals related to bonuses, stock options and stock grants.

- **Integrated Guideline: Executive Remuneration**

The total compensation package can be divided into fixed (e.g. 40%) and variable (e.g. 60%) components. The variable component can be made up of several performance measures: 1) long-term financial performance over three years, 2) comparative value indices (e.g. 50% Economic Value Added, 20% customer loyalty, 20% employee satisfaction, and 10% public image), and 3) functional performance assessments (20% board committee performance, 30% individual board member performance, and 50% corporate performance).

- **Buffett & NYSE:** Concerning this Integrated guideline for executive compensation, Buffett stated: "In judging whether Corporate America is serious about reforming itself, CEO pay remains the acid test. To date, the results aren't encouraging." He noted that when CEOs meet with boards' compensation committees, too often one side (the CEO) has cared much more than the other side about the pay package. The difference often has seemed unimportant to the compensation committee, particularly when stock option grants had no effect on earnings under prior U.S. accounting rules. He observed that such negotiations often had a "play-money" quality and said that directors should not serve on compensation committees unless they are capable of negotiating on behalf of the shareholders. Buffett noted that "CEOs have often amassed riches while their shareholders have experienced financial disasters. Directors should stop such piracy. It would be a travesty if the bloated pay of recent years became a baseline for future compensation." The NYSE requires that all listed companies have a compensation committee comprised solely of independent directors. This committee must have a written charter which includes objectives for CEO compensation and performance evaluation. Also, Buffett has argued that a red flag should exist if a company always does meet its quarterly and annual goals, like Enron did, since such performance ignores the reality of competitive environments and business cycles.

4. Weak or Non-Existent Code of Ethics

Company employees are encouraged to push their behavior and financial reporting to or beyond ethical and professional limits. The company's code of ethics (if one exists) is not taken seriously.

- **Corporate Examples: Parmalat** unraveled quickly after it had trouble making a routine bond interest payment, prompting tougher scrutiny of its books by Italian regulators and its own auditors. A follow-up audit found that Parmalat's EUR 4 billion cash in a Bank of America account did not exist. The auditors had sent the confirmation request to the bank through Parmalat's internal mail system where it was intercepted. Then the written confirmation from the bank back to Parmalat's auditors was forged as were other supporting documents. The EUR 4 billion cash had just been fabricated to help cover up the CEO looting his company. Similarly, **Satyam's** $1.5 billion in cash disappeared, allegedly into the CEO's various family businesses. Also, the World Bank banned Satyam for at least eight years from its list of information technology providers, citing alleged bribing of its bank staff and data theft. A Fortune financial magazine reporter, Bethany McLean (2001), was the first national reporter to question **Enron's** value in the financial press. She noted that the use of the mark-to-market accounting method for pricing Enron's securities in illiquid markets with no fair value benchmarks was a red flag for fraudulent financial reporting. She said, "Enron often relied upon internal models which created serious potential for abuse." According to former Enron managers, salespeople used wildly optimistic assumptions about the forward price of commodities and other factors to value their contracts so profits would be inflated and their bonuses would be bigger. One power- industry consultant said, "That's valuation by rumor. There's no way for those results to be taken seriously." In a home video at a retirement party for an Enron manager, Enron's CEO, Jeffrey Skilling, boasted that he could "add a kazillion dollars to the bottom line anytime" by using this mark-to-market method. **Tyco's** CEO, CFO, and general council secretly took out $170 million in no/low interest loans from the company that had not been approved by Tyco's Board compensation committee. These loans had been hidden from Board members, shareholders and employees. Then, the CFO "forgot" to include $12 million of loans forgiven by Tyco as income in his personal income tax return. The three telecom companies, **Global Crossing, Qwest**, and **WorldCom**, all created cultures of fear to help override any codes of ethics and achieve earnings management goals. Weak codes of ethics facilitated the hiding of toxic asset investments in the SIV off-balance-sheet accounts by various banks, like **Lehman Brothers, Goldman Sachs,** and **Citigroup**.
- **Keep It Controlled Guideline: Board's Auditing Function**

There are three main audit tasks of the board: 1) financial reporting—observation and realization of the financial targets, 2) operations—observation and assessment of operational targets, and 3) compliance—surveillance of compliance with laws, regulations, and guidelines, such as a code of ethics.

- **Buffett & NYSE:** Concerning this Integrated guideline for board competence, Buffett commented: "In addition to being independent, directors should have business savvy, a shareholder orientation, and a genuine interest in the company. In my 40 years of board experience, the great majority of these directors lacked at least one of these three qualities. As a result, their contribution to shareholder well-being was minimal at best and too often negative. They simply did not know enough about business and/or care enough about shareholders to question foolish acquisitions or egregious compensation." The NYSE requires that its listed companies have a code of ethics and promptly disclosure any waivers of the code. Also, CEOs must certify annually that they are not aware of any company violations of NYSE corporate governance listing standards. CEOs must promptly notify the NYSE in writing if they become aware of any material non-compliance from these standards.

5. Questionable Business Strategies with Opaque Disclosures

Questionable and opaque business and disclosure strategies may exist for the company's business model and related financial reporting. Buffet (2004) has given this advice: "If you don't understand what a company does, don't invest in it. If management refuses to fill in holes and keeps investors in the dark, run!"

- **Corporate Examples:** Questionable business strategies existed along with opaque (unclear) disclosure strategies at **Enron**. The Fortune reporter McLean said: "How exactly does Enron make its money? Details are hard to come by because Enron keeps many of the specifics confidential for what it terms competitive reasons. The numbers that Enron does present are often extremely complicated. Seemingly basic questions, like the effects of lower natural gas prices and less volatility in energy markets on Enron's profits, are still unanswered." Another example of intentionally opaque, complex financial reporting and disclosure came from Enron's related party transactions with SPEs. As the short seller Jim Chanos said, "We read the disclosure over and over and over again and we just didn't understand it—and we read footnotes for a living." An A.G.Edwards energy analyst, Michael Heim, said, "I've never seen such complicated disclosures. It was hard to follow the movement of money." Also, Enron's CEO and CFO both repeatedly told financial analysts that Enron would never be liable for bank loans with its SPEs. However, there were credit triggers in the bank loan covenants that did make Enron liable for such loans. The two major credit triggers were Enron's common stock price falling below a certain level and Enron's credit rating falling to junk bond status. When pushed to reveal more, Enron management was uncooperative and pleaded confidentiality concerns. **Parmalat** used a similar SPE strategy to help earn its nickname as "Europe's Enron." It created an elaborate network of related party transactions, using opaque disclosures of its subsidiaries in tax havens such as the Cayman Islands and Luxembourg to hide the declining state of its finances. One subsidiary was called Buconero, which means black hole in Italian. **Satyam** used a similar opaque disclosure strategy to help earn its nickname as "Asia's Enron." After Satyam went public in 1991, it was supposed to stop using its

cash reserves to invest in family owned companies. However, such problem practices surfaced again in 1998 and in 2008, just before its confession of fraudulent financial reporting. None of these cash reserve investments were adequately disclosed in Satyam's financial statements. Neither **Qwest** nor **Global Crossing** disclosed that their revenues from fiber optic swaps and equipment sales were non-recurring in nature. The strategy of both the CEOs at Qwest and **WorldCom** was never to disclose anything that would cause their stock prices to go down. **Tyco** did not fully disclose its transactions with its complex network of subsidiary and affiliated companies. Many banks, like **Lehman Brothers, Goldman Sachs,** and **Citigroup,** did not (and still do not) fully disclose the market values of their toxic assets which were often hidden in their off-balance-sheet SIVs.

- **Keep It Controlled Guideline: Communication Function**

The following two functions are most relevant: 1) the content function: to promote transparency of information at the board level through the exchange of information that is comprehensive, true, understandable, and relevant to board members, top managers, employees, shareholders, customers, and the public and that relates to financial, market, and other performance measures, and 2) the relationship function: to create a real culture of trust and learning through a constant improvement of the relationships between board members, top managers, shareholders, and other stakeholders, to deal with conflict constructively and to avoid unnecessary confrontations.

- **Buffett & NYSE:** Similar to the Enron short seller Chanos' comments, in his 2003 CEO letter to shareholders, Buffet observed the Enron SPE disclosures were just not understandable. The NYSE can issue a public reprimand letter for violation of any of its corporate governance standards in addition to the existing penalty of delisting. It can also list a flag next to the stock ticker of a company whose corporate governance policies are deficient.

6. Senior Management is Uncomfortable with Criticism

When questioned by outsiders, like financial analysts during conference calls, senior management is defensive and abusive to these outsiders. Senior management, especially the CEO and CFO and even board members, may wind up lying to outsiders.

- **Corporate Examples: Enron's** CEO, Jeffrey Skilling, was uncomfortable with criticism in a conference call with financial analysts as he called one analyst an "asshole" when questioned about Enron's performance. The prosecutors at the successful fraud trial of Skilling played a tape of that conversation to the jurors. Jim Chanos, who was the first hedge fund manager to question Enron's performance, called Skilling's conference call a disaster and the final piece of the puzzle. He began to short Enron's stock shortly thereafter while it was still trading at around $70 per share. Similarly, the CEOs of **WorldCom, Lehman Brothers**, and **Citigroup** had problems with their conference calls, especially being challenged on the issue of excessive executive bonuses, primarily at the big Wall Street banks after being given U.S. government bailout money. **Qwest's** CEO criticized the Morgan Stanley financial analysts who questioned his company's performance and downgraded Qwest's stock from a buy to a neutral status. He said that they were "not the sharpest knives in the drawer" and called their report "hogwash." He pledged never to talk to them again and terminated any future investment banking business with Morgan Stanley. **Parmalat's** CEO was uncomfortable with criticism from his Italian bankers and new auditors. Italian law requires audit firms to be rotated every five years. To mitigate this law, he moved 51% of Parmalat's operations and its questionable business practices to the Cayman Islands where the former lead audit firm had been rotated. He began using American banks and fabricated EUR 4 billion cash that was supposed to be in a Bank of America account in the Cayman Islands.

- **Strategic Guideline: Constructive and Open Minded Team Culture**

To overcome the traditional, mechanistic, confrontational, and secretive board environments, an effective board culture must be created with five factors: an outward, learning orientation; a holistic perspective; a consensus orientation; a constructively open, trusting environment; and a mix of global effectiveness and local adaptability.

- **Buffett:** Concerning this Strategic guideline for an effective board culture, Buffett observed that when the CEO cares deeply and the directors don't, a necessary and powerful countervailing force in corporate governance is missing. He said: "Getting rid of mediocre CEOs and eliminating overreaching by the able ones requires action by owners—big owners. Twenty, or even fewer, of the largest institutional investors, acting together, could effectively reform corporate governance at a given company, simply by withholding their votes for directors who were tolerating odious behavior."

7. Insider Stock Sales

Senior managers, especially the CEO and the CFO and even board members, are selling their own company's common stock at current prices, rather than holding these shares for the long term. At the same time, they are publicly saying that their company's stock is undervalued and has a great future.

- **Corporate Examples:** Significant insider trading occurred at **Enron** in the last half of 2000 and the first half of 2001 before its stock crashed in the last half of 2001. The former CEO, Ken Lay, and the CEO during that time period, Jeffrey Skilling, as well as the general council, the CFO, and other chief executives all sold large blocks of stock. In 2000, Lay made $66.3 million and Skilling made $60.7 million from exercising stock options and selling the shares, roughly double the amounts of the year before. A shareholder lawsuit alleged that 29 Enron executives made $1.1 billion in profits on insider sales. Since the selling at Enron was prolific and it persisted even as the stock price fell throughout 2001, one financial analyst at Thomson Financial, Paul Elliot, called such insider sales a "screaming red flag," and questioned: "If Lay and Skilling believed that the stock was undervalued and headed for $120, as they repeatedly told investors, then why were they cashing in so heavily?" Lay and Skilling

were convicted by the United States Department of Justice for numerous counts of conspiracy and securities fraud. **Tyco's** CEO, Dennis Kozlowski, and the CFO secretly sold over $400 million of shares without announcing it just before Tyco blew up. Similar insider trading occurred at **Qwest** where eight Qwest senior executives made $2.2 billion in profits while still "touting" the stock price prospects at Qwest. Qwest's CEO has also been convicted on nineteen counts of securities fraud. Similarly, both **WorldCom's** CEO and CFO have been convicted of securities fraud for insider trading. All these individuals, except the deceased Key Lay, are now serving, or have served, long jail sentences. **Global Crossing's** CEO returned over $50 million of insider stock sales to his shareholders.

- **Integrated Guideline: Targeted Remuneration**

An effective company performance system includes four dimensions: 1) customer, 2) shareholder, 3) people, and 4) public company image. Then targeted remuneration can proceed on the three dimensions previously discussed: 1) long-term financial performance, 2) comparative value indices, and 3) functional performance assessments, not just granting huge stock options to senior executives.

- **Balanced Scorecard & NYSE:** Concerning this integrated guideline for effective performance systems, researchers similar to Hilb (2008) have advocated that the balanced scorecard approach be used to evaluate both the company and the board's performance since boards are rarely evaluated. One of the four strategic perspectives of the balanced scorecard would be slightly modified. The customer perspective for the company would be expanded to a stakeholder perspective for the board. The other three balanced scorecard categories would remain the same: financial, internal processes, and learning/growth. The NYSE requires annual performance evaluations of the board and its committees.

8. Senior Management Turnover

The CEO, senior managers, especially the CFO, and even outside Board members quit their "dream jobs" to "spend more time with their families."

- **Corporate Examples: Enron's** CEO, Jeffrey Skilling, resigned only six months after being promoted to his "dream job", and called it a "purely personal" decision, elaborating that he wanted to devote more time to his family. One investment-fund manager, John Hammerschmidt, said: "That was the worst excuse I've ever heard. As soon as I heard that, I dumped my shares." Others, including Sherron Watkins, the Enron whistleblower, have speculated that Skilling knew that Enron's falling stock price would cause Enron's loan guarantees of its SPE partnerships to be exposed and then lead to Enron's bankruptcy. Similarly, **Qwest's** CFO resigned over one year in advance of its accounting problems surfacing and **Parmalat's** CFO quit nine months before it went into bankruptcy after a bond issue was surprisingly pulled out. **Satyam's** CEO abruptly resigned after admitting fraudulent financial statements, saying "It was like riding a tiger, not knowing how to get off without being eaten." Two months after **Tyco** restated its earnings from $2.20 to a loss of $0.96, due to unusual costs, the CEO resigned for "personal reasons" which turned out to be a tax evasion indictment. Four months later, both the CFO and the general counsel left as Tyco's false financial reporting was being uncovered.

- **Integrated Guideline: Targeted Executive Selection**

Potential senior managers and board members need to have the following four competences: 1) personality (integrity, independence and breadth of perspective), 2) professional (risk management experience, management and/or board track record, and international experience if necessary), 3) leadership (strategic thinking, planning skills, and controlling skills), and 4) social (constructive openness, listening skills, and team role of coach).

- **NYSE:** The NYSE requires that each listed company have a nominating/corporate governance committee comprised solely of independent directors. This committee must have a written charter which includes the criteria and responsibilities to identify individuals qualified to become board members.

9. Independence Problems with the Company's External Auditors

The company may pay the audit firm additional consulting or other types of fees that may be significant in relation to the audit fees. Using the same audit partner as the lead or engagement partner is often a condition for retaining the audit firm.

- **Corporate Examples:** Italian securities laws require that a company change its external auditors every five years. However, **Parmalat** defeated that requirement in two ways: (1) it initially had its lead audit partner change auditing firms, and (2) it subsequently switched 51% of its business to the Cayman Islands where the former lead audit firm had been rotated. Thus, the same audit partner had signed various parts of Parmalat's audits for twenty years. There were also independence problems with **Enron's** auditor, Arthur Andersen (AA) which led to AA's demise. Its consulting fees with Enron were $27 million, larger than its audit fees of $25 million for total fees of $52 million or $1 million per week! Many former AA auditors worked for Enron and Enron outsourced its entire internal auditing work to AA. AA was also the auditor of **Qwest, Global Crossing** and **WorldCom** and earned large consulting fees from those firms as well. Also, PriceWaterhouseCoopers had been the auditor of both **Tyco** and **Satyam** for many years as these companies had not rotated external auditors. Three U.S. companies have had the same auditors for over 100 years!

- **Keep It Controlled Guideline: Board's Auditing Function**

The external auditor is the only external institution that can give an objective view of the financial condition of a company and effective cooperation is needed with the board and its audit committee. In order to ensure the independence of the external auditors, both the auditors and the auditing firm should be changed periodically.

- **Sarbanes Oxley Act**: This U.S. Act was passed in 2002 after large U.S. financial statement

frauds, such as Enron and WorldCom, were not detected by external auditors who are now prohibited from doing consulting work with an audit client.

10. Independence Problems with the Company's Investment Bankers

Favorable "buy" recommendations from an investment banker's financial analysts may be a requirement for a company to do any new business with an investment banking firm. Investment bankers' research, which is provided free, may not represent an independent analysis of the company's investment potential.

- **Corporate Examples:** The sell-side financial analysts, who worked for the investment bank firms that earned significant fees from **Enron, Parmalat, Global Crossing, Tyco, Qwest, and WorldCom,** had the same independence problems as the external auditors. Typically, investment banking fees are much higher that equity research fees. For example, 17 of the 18 sell-side analysts following Enron still had buy recommendations the day after the CEO Jeff Skilling resigned, ignoring that red flag. One investment banking firm fired a financial analyst for changing his investment rating to a "sell" recommendation on Enron and was rewarded with $50 million of new investment banking fees by Enron. Another big firm told its financial analysts to maintain a "buy" recommendation for Enron no matter what. One of Parmalat's investment bankers upgraded its investment recommendation from hold to buy, saying the current price was a bargain since Parmalat's restructuring was attractive at that price. That bank was subsequently sued by investors.
- **Situational Guideline: Internal Business Context**

The majority of board members should be totally independent directors who have no vested interests. The board should not comprise 1) more than two members of senior management (ideally only the CEO should represent management and should have none of the following vested interests), 2) persons who have an active business relationship with the firm (such as suppliers, customers, vendors, consultants and auditors), and 3) representatives of the main source of debt and/or equity financing.

New York Attorney General Lawsuit: In December 2002, the twelve largest U.S. investment banking firms agreed to pay $1 billion in fines to end SEC and other investigations into whether they issued misleading stock recommendations and handed out hot new shares to obtain favor with corporate clients. These firms also agreed to pay an additional $500 million over five years to buy stock research from independent analysts and distribute it to investors to help restore integrity and confidence to the marketplace.