**FUQI INTERNATIONAL:**

**ALL YOU NEED TO KNOW ABOUT INVESTING IN CHINA**

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*“Learning without thought is naught; thought without learning is dangerous.”*

 *-* Confucius

Apparently, investors have learned very little from our past investment bubble fiascos. Today, China is frequently touted as the most important emerging market given its rapidly growing economy, prompting global investors to plough billions of dollars into Chinese company investments. But are we looking at another “dot-com tragedy” in the making? After all, investing in Chinese companies carries a multitude of risks including social and political instability, market illiquidity, exchange rate fluctuations, stock price volatility, and lack of regulatory oversight. And let’s not forget the governmental corruption we previously discussed in [Congress the Corrupt](http://blogs.smeal.psu.edu/grumpyoldaccountants/archives/474).

Yet, even [Warren Buffett](http://internationalinvest.about.com/od/globalmarkets101/a/The-Ultimate-Guide-To-Investing-In-China.htm) appears to have caught the China investing bug:

*"The 19th century belonged to England, the 20th century belonged to the U.S., and the 21st century belongs to China. Invest accordingly."*

What troubles these Grumpy Old Accountants, however, is the country’s blatant disregard for basic financial reporting transparency, and the willingness of investors and auditors to ignore this. So bad are Chinese financial reports that [Keith Fitz-Gerald](http://moneymorning.com/2009/05/06/china-investment-risks/) suggests that China “has actually brought financial misappropriation to an art form.” Yet this apparent lack of quality financial information by which investment performance is evaluated seems to concern few investors. Exactly how bad is it?

Well, according to [Matt Atkins](http://www.financierworldwide.com/article_printable.php?id=8480) at Financier Worldwide.Com, accounting fraud in US listed Chinese companies has grown recently with reporting problems at China Forestry Holdings, RINO International, Sino-Forest Corporation, and Longtop garnering significant attention. The situation is so dire, in fact, that the [US Justice Department](http://www.reuters.com/article/2011/09/30/us-china-usa-accounting-idUSTRE78S3QM20110930) has now initiated an investigation into accounting irregularities of Chinese firms that are publicly traded on US exchanges.

What has prompted all the sudden scrutiny? The use of a financial tool known as *reverse mergers*. According to [Joshua M. Brown](http://www.thereformedbroker.com/2011/07/24/anatomy-of-a-chinese-reverse-merger-scam/), as many as 300 Chinese companies entered the US stock market in recent years using this technique. In reverse merger transactions, an existing public reporting company with few or no operations, a “shell,” acquires a private operating company seeking to access funding in the US capital markets. The private company shareholders exchange their shares for a large majority of the “shell” public company, giving them a controlling interest. The board, management, assets, and operations of the post-merger surviving public company are primarily those of the former private operating company. These transactions are attractive as they are perceived to be a quicker and cheaper method of “going public” than an initial public offering (IPO).

One problem with Chinese reverse mergers (CRM) raised by the Public Company Accounting Oversight Board (PCAOB) is that the audits of these companies conducted by US auditors may not be in accordance with PCAOB standards. In [Research Note #2011-P1](http://pcaobus.org/Research/Documents/Chinese_Reverse_Merger_Research_Note.pdf), the PCAOB documented its concerns focusing primarily on cases where US audit firms relied on another firm, or assistants outside the firm, to do audits that did not comply with PCAOB standards. More recently, the PCAOB is increasing its CRM enforcement efforts in the US and also is pushing for permission to conduct [inspections in China](http://currents.westlawbusiness.com/Article.aspx?id=138ad2fb-4278-4ca9-ad57-e02055751f3d&cid=&src=&sp=).

The Securities Exchange Commission (SEC) followed up on the PCAOB’s warning with its own [Investor Bulletin](http://www.sec.gov/investor/alerts/reversemergers.pdf) on CRMs highlighting the lack of long-term viability for many of these companies, fraud, and bad audits. The SEC noted that it had recently suspended trading in a number of CRM’s including Heli Electronics Corp., China Changjiang Mining & New Energy Co, RINO International Corporation, Advanced Refractive Technologies, HiEnergy Technologies, Inc., and Digital Youth Network Corp. And what advice did the SEC have for investors?

* Research the company,
* Review the company’s SEC filings,
* Be aware of companies that do not file reports with the SEC, and
* Be skeptical.

Duh! These are not exactly the most insightful recommendations are they? [Richard Cant](http://www.integra-international.net/articles/home/show/457) at Integra International calls for “better” financial due diligence in his analysis of CRM fraud techniques. But is the issue really that “better financial due diligence” is needed, or simply that basic due diligence itself actually be performed period. Our limited review of one CRM, FUQI International, a Shenzhen-based jewelry company, suggests that investors may not be doing ANY financial analysis of Chinese companies!

First, we looked at FUQI’s risk disclosures in its 2008 Form 10-K. This is the last complete annual report actually filed by the Company. We found many of the risk disclosures cited by the SEC in its CRM Investor Bulletin, but one in particular stood out:

*PRC companies have historically not adopted a Western style of management and financial reporting concepts and practices, which includes strong corporate governance, internal controls and, computer, financial and other control systems...we may experience difficulty in establishing management, legal and financial controls,* ***collecting financial data and preparing financial statements, books of account and corporate records and instituting business practices that meet Western standards*** (bold emphasis added).

Excuse us for asking the obvious, but if a company cannot keep books and records, how do you assess operating performance? And if you can’t assess performance, how do you value it? And if a company can’t meet “Western standards,” why should it be allowed to participate in Western capital markets? And let’s not forget the auditors…if Chinese companies can’t keep a set of books, how can they be audited?

What exactly are we missing here? The very fact that these significant issues are being overlooked suggests that the markets are practicing impaired investing when it comes to Chinese companies. They are drunk with the promise of a large new, customer pool with changing consumer preferences and a growing retail market, that portends increased profit potential (if only it were truly measurable).

And what an accounting blog be without a few numbers? We decided to see how FUQI stacked up on the earnings manipulation issue using the [Beneish Model.](http://www.investopedia.com/terms/b/beneishmodel.asp#axzz1iyFZX5RK) Not surprisingly, the probability of earnings manipulation soared from 1.22 percent in 2006 shortly after the its reverse merger was consummated to 100 percent at the end of 2008.

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| --- | --- | --- | --- |
| **Weighted Predictor Ratios** | **2006** | **2007** | **2008** |
|  |  |  |  |
| **Days Receivables Index** | **0.387888** | **1.619159** | **1.068192** |
| **Gross Margin Index** | **0.579196** | **0.450239** | **0.492309** |
| **Asset Quality Index** | **0.569118** | **0.10638** | **7.530223** |
| **Sales Growth Index** | **1.135696** | **1.405043** | **2.252726** |
| **Depreciation Index** | **0.079155** | **0.124714** | **0.133419** |
| **Sell. & Admin. Exp. Index** | **-0.133945** | **-0.342213** | **-0.196769** |
| **Leverage Index** | **-0.290653** | **-0.104619** | **-0.469409** |
| **Total Accruals/Total Assets** | **0.264129** | **1.344162** | **0.860571** |
| **Constant** | **-4.84** | **-4.84** | **-4.84** |
| **Value of y** | **-2.249417** | **-0.237135** | **6.831261** |
|  |  |  |  |
| **Probability of Manipulaton** | **1.22%** | **40.63%** | **100.00%** |

So what’s the punch line? The SEC is right! Investors and auditors actually need to read the securities filings and related financial statements when making their financial decisions, and performing their audits. Clearly they are not.

*“We shall seldom get lost if we hold to main lines.”*

 *-* Confucius

*This essay reflects the opinion of the authors and not necessarily the opinions of The Pennsylvania State University, The American College, or Villanova University.*