Accounting failures in Chinese listed firms: Origins and typology

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Received: 10th February, 2005

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ABSTRACT

KEYWORDS: China, accounting failure, corporate governance, transitional economy

Since its reopening in the early 1990s, the stock market has gained considerable momentum in China. In less than 15 years, the Chinese stock exchange has grown into the eighth largest in the world, with market capitalisation of over US$500bn. This expansion, however, has been accompanied by frequent discoveries of accounting malpractice at Chinese listed firms. This paper begins by tracing the origins of these accounting failures through analysis of the Chinese stock market's institutional context, and goes on to classify 11 cases of accounting failures into various categories.

INTRODUCTION

The Chinese stock market was reopened in the early 1990s, with the establishment of the Shanghai and Shenzhen stock exchanges. Since then, stock market trading in China has gained considerable momentum: by the end of 2003, China's two stock markets had issued a total of 642.85 billion shares, about 35.27 per cent of which were negotiable shares. The market value of shares issued was US$511.54bn. This represents a dramatic increase from 1992, when the total issued capital and total market value amounted to only 6.89 billion shares and US$12.63bn. The number of listed companies (A and B shares) also increased enormously, from 53 in 1992 to 1,287 in 2003. In less than 15 years, China's stock market has grown into the eighth largest in the world. The rapid growth of the stock market has greatly contributed to China's reform of state-owned enterprises (SOEs), financing and investment, and the national financial system as a whole.

As stated by the Chinese government, the main purpose of the stock market is to help listed companies to raise funds and improve their corporate governance. Although the

International Journal of Disclosure and Governance, Vol. 2, No. 4, 2005, pp. 395–412
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1746–6539/05 $30.00

first goal has been achieved, the low quality of corporate governance in listed companies remains a serious concern, and one adverse consequence of this is the frequently discovered accounting scandals. The common factor in these accounting scandals is controlling shareholders seeking benefit for themselves at the expense of minority shareholders. Anecdotal evidence suggests that the low quality of corporate governance and inefficient legal protection are the root causes (from the China Securities Journal, *Zhongguo Zhenquan Bao,* one of the most popular and influential financial publications in China, 26th August, 2004).

The two main objectives of this study are to analyse the origins of these accounting failures and classify them according to the accounting manipulation techniques involved. The paper shows that there are three main causes of accounting failures in Chinese firms: the orientation of the Chinese capital market, weaknesses in corporate governance structure and a legal enforcement problem. It then studies 11 accounting scandal cases based on the reports filed by the China Securities Regulatory Commission (CSRC). In terms of the typology of the accounting practices involved, these scandals mainly fall into seven categories: manipulations concerning revenue recognition, trade credit, asset valuation, loans to related parties, capitalisation of expenses, scope of consolidation and disclosure.

The rest of the paper is organised as follows. The second section takes an in-depth look at the Chinese stock market's institutional context, in order to draw out the motives and causes behind these accounting scandals. The third section classifies and analyses a selection of cases, and the final section concludes the study.

ORIGIN OF ACCOUNTING FAILURES IN CHINESE LISTED FIRMS

This section presents the characteristics of the Chinese capital market in detail, in order to uncover the reasons why accounting manipulation occurs in Chinese listed firms. The analysis shows that, from the very beginning, the capital market in China has been designed to satisfy the transitional needs of state-owned firms. This orientation weakens the external monitoring mechanism role traditionally played by the market to protect against company fraud. From an internal control standpoint, the existence of listed subsidiaries and high ownership concentration levels also provide fertile ground for accounting manipulation. The lack of auditor independence and inadequate listing regulations are further factors facilitating accounting manipulation.

Market orientation

Developments in SOE financing and governance (state–bank–market)

In contrast to the stock exchanges in Western countries, the Chinese stock exchange was established to provide an external financing mechanism for SOEs to raise funds.

Under the planned economy system, China's enterprises were mainly financed by government fiscal allotments. Since the start of the economic reform, these have been replaced by bank financing so as to 'toughen up the budget constraints of state-owned enterprises'.[1] Sources of external financing were limited, however, and finding themselves left with no alternative, enterprises became overly dependent on bank financing and their debt/asset ratios rose dangerously high. For example, before 1995, China's enterprises had an average debt/asset ratio of more than 80 per cent. One of the main purposes of establishing the stock market was to expand external financing channels and improve the capital structure of China's enterprises.[2] Up to the end of 2003, total capital raised on the stock market amounted to US$122.06bn. But the stock market had another function besides financing:

improving the corporate governance of listed companies, an aim that has not been fulfilled as successfully. The market's weaknesses result in low-quality corporate governance in listed companies, a problem the authors will turn to later in this study.

From the outset, the Chinese capital market was not conceived as an open market where businesses seeking capital and investors would meet under clearly defined game rules. Mookerjee and Yu[3] conclude that there are significant inefficiencies in both the Shanghai and Shenzhen markets that can be traced to unique structural and institutional problems. They provide empirical evidence of semi-strong market efficiency by observing whether the stocks follow a random walk model. Darrat and Zhong[4] also conclude that the Chinese market is not efficient.

In such circumstances, the market can only play a relatively weak role as an efficient distributor of economic resources and guard against corporate fraud.

IPO quotas

This unique orientation in the Chinese capital market had another consequence: achieving listed status became the most popular way for SOEs to relieve their financial thirst. Permission for initial public offerings (IPOs) became a rare resource, and local governments and ministries fought each other to win it for the state-owned firms in their own jurisdictions. Limits to public offerings were set by the central planning committee and the quotas allocated by the provinces and administrative bureaus, and this left most companies undercapitalised at the time of their IPO. The need for capital spurred a demand for rights issues.[5]

The state imposed strict controls on the number and frequency of companies going public by setting an annual national quota for IPOs. Rights issues were strictly managed by the CSRC. The quota was allocated to provincial and municipal governments, and the ministries in charge of industries. In turn, local governments and ministries made allocations to firms selected from their jurisdictions; in general, firms with close ties to government had a great advantage over other companies in their bid for the right to go public.[6] Because of policy constraints, competition for the right to make an IPO was fierce. Since many firms were fighting over the limited quota, local governments tended to distribute their share between as many firms as possible, and as a result the quota assigned to each company was often too small to meet its capital needs.[7]

This high government intervention in firms' IPOs had some serious side effects. First, since local governments had to fight to obtain authorisation for their chosen firm, it is considered normal that the firm, once listed, should return the favour and comply with government orders. A listed firm is often treated as a cash cow by its local government for various purposes: organising social activities, bailing out other state-owned firms in the same jurisdiction, etc.[8] This provides listed firms with a very strong incentive for window dressing. Secondly, firms going public, as noted earlier, often have close ties to government, and as such are well protected by their local authorities — even in the event of accounting fraud.

Corporate governance structure

The second purpose of creating a capital market in China was equally important: to improve SOEs' corporate governance. Under the previous planned economic system, SOEs acted simply as manufacturing plants executing government orders. The state expected that going public would facilitate restructuring of SOEs, and that a well-functioning corporate governance system would be established. Although a huge volume of funds was raised through the stock market, corporate governance remained an unsolved problem. The following subsection

will discuss the corporate governance issues affecting the Chinese stock market.

Listed subsidiaries

Born out of a central command economy that now finds itself in a transition period, the Chinese stock market and Chinese listed companies reflect some of the serious weaknesses of their macro environment. The low-quality corporate governance in listed companies can be traced back to these weaknesses.

One of the main characteristics of Chinese listed companies' ownership structure is usually the existence of a parent company. It is common practice in developed stock markets for large groups to go entirely public, but in China, a listed company will often be a subsidiary of an unlisted business group.

State-owned business groups often hive off selected profitable business units and turn them into a subsidiary company in preparation for a public offering, in order to meet IPO requirements and achieve a higher IPO price.[9] The original enterprise, consisting of the remaining unprofitable units, then becomes the parent company of the newly listed company. Often, the same team controls the board and management of both the listed company and its parent company, and the listed company is under the absolute control of its parent, since only a small proportion of shares is floating in the market. The listed company is viewed by its parent as a platform for financing in the stock market and a cash cow for the whole group's internal capital market.[10] Since the parent company is not listed, there is little or no information available publicly for investors.

Chen *et al.*[11] find that rather than using the popular Western technique of accruals, most Chinese firms manage their earnings through real transactions, for instance by providing credit to a risky client or by related-party transactions such as a sale of fixed assets to a parent company that is an unlisted SOE.

Ownership concentration

Another characteristic of the ownership structure of Chinese listed firms is the different classes of shares, resulting in the very high level of ownership concentration.

Chinese listed companies are famous for their various classes of shares. All the following classes of shares are non-tradable:

- *State-owned shares:* shares obtained by a state institution in exchange for a capital contribution made by that institution to a corporation.
- *Domestic legal-person shares:* sponsor's[12] shares held by domestic legal persons.
- *Foreign legal-person shares:* sponsors' shares held by foreign legal persons.
- *Private placement of legal-person shares:* shares issued by private placement and subscribed by legal persons other than sponsors.
- *Employee shares:* shares held by company staff, issued by private placement of companies and yet not listed at the current time.

State-owned shares and legal-person shares will never become negotiable on the market. Publicly traded shares, that is, the only shares actually traded in mainland China, account for less than one-third of total shares in existence. The authors calculated the proportion of negotiable shares to total equity for all listed companies at the end of 2003. The mean and median are 39 per cent and 38 per cent, respectively. At the 80th percentile, the proportion is 48 per cent, indicating that for more than four-fifths of all companies the majority of shares are not tradable. This equity structure is incompatible with the principle of an 'open, fair, and just' stock market in which 'the same stock should bear the same rights, same interests, and same obligations', as China's 'corporate law' of 1994 stipulates. In their study evaluating the performance changes of 634 SOEs first floated on China's two stock exchanges in the period 1994–98, Sun and Tong[13] affirm

that state ownership has negative impacts on firm's performance.

To make matters worse, since state-owned shares and legal-person shares are non-tradable, they are not subject to stock market pressures or monitoring and are not responsive to the interests of the small shareholders who own the tradable shares.

Since most listed company equity consists of state-owned shares, ownership is concentrated in the hands of the agents representing those shares, who consequently dominate the boards and exert excessive influence over the operations of the business, reducing the board to a 'rubber stamp' role. This dual function as both controlling owners and managers leads to serious agency problems[14] and corporate governance quality is a question often ignored by Chinese listed companies.

Regulation and enforcement

IPO qualification requirements and ST/PT classification

To control the operation and growth of the market, the regulatory authority has issued a series of qualification requirements for a company to go public, make rights issues and avoid being delisted. But rather than ensuring the best-performing firms are selected for the capital market, these inappropriate rules actually create a huge incentive for accounting manipulation.

The restrictions on qualification for IPOs have been gradually tightened. The 1993 guideline only required two years' profits; this was raised to a three-year average return on equity (ROE) of 10 per cent in 1994; however, the 1994 guideline proved ineffective. The amount of capital raised through rights issues exceeded that from IPOs in 1995 and, in response, the new guideline issued in 1996 required an ROE of at least 10 per cent for each of the previous three years. This significantly reduced the number of firms that could apply to the CSRC for rights issues, and succeeded in curtailing the amount of capital raised through rights issues relative to A-share IPOs in 1996 and 1997.[15] The most important requirement for a rights issue by a listed company is that the company must have reported an ROE of at least 6 per cent for three consecutive years, and an average ROE of at least 10 per cent over those three years. This creates another incentive for earnings management, as illustrated by the following example. On 17th March, 1999, one and a half months before the deadline for releasing 1998 annual reports, the CSRC revised the rules for secondary and rights issues, replacing its previous requirement of an annual ROE of over 10 per cent for three consecutive years by a new requirement, as stated above (10 per cent minimum average ROE over three years, no annual ROE below 6 per cent). In this case, for the companies with high ROEs in 1996 and 1997 (more than 10 per cent), it was not necessary to maintain the ROE in 1998 above 10 per cent (if they could reach the required 10 per cent minimum average ROE over three years). The average reported ROE dropped abruptly to 7.4 per cent in 1998, from 9.5 per cent in 1997.

In an attempt to improve the quality of listed companies and encourage better corporate governance, the CSRC has also stipulated that listed companies registering bad performances will be punished. If a listed company reports a net loss for three consecutive years, the company will be labelled as 'ST', which stands for 'special treatment'. ST stocks are traded with a maximal 5 per cent daily price fluctuation before trading is halted, whereas a 10 per cent limit applies for normal stocks. If an ST firm fails to improve its performance over the next year, it will be labelled 'PT', which stands for 'particular transfer'. PT stocks are traded only on Fridays with a maximum 5 per cent upside limit to the last trading day's closing price, but no restriction on the downside. If the

company cannot generate profit in the next two to three years, it will be delisted.

For controlling shareholders and other insiders, delisting means losing access to a valuable source of external financing and opportunities for tunnelling. Companies on the threshold of ST or PT classification and delisting will spare no effort to avoid this, and so they will do their utmost to boost earnings.[16]

Unsurprisingly, China's regulatory efforts met with a rampant earnings management phenomenon.[17] This demand-based earnings management has been a subject of extensive study.[18] All these authors examine what has come to be known as the 10 per cent effect — the fact that firms manage their earnings so as to reach the 10 per cent ROE required by the regulators.

Auditor independence

Before the initiation of market-oriented economic reform in the late 1970s there was no need for the existence of external audits in China, since the whole economy was run by the government under a highly sophisticated planning and order system. The inflow of foreign investment triggered development of the auditing profession in China for the purpose of taxing these joint ventures.

The Chinese Institute of Certified Public Accountants (CICPA) was created in the early 1980s by the Ministry of Finance. The CICPA is involved in standard-setting and, among other things, oversees administration of the national examination for Certified Public Accountants (CPAs). Demand for external auditing increased greatly when the stock market reopened, and the government granted permission to a select set of accounting firms to audit public companies; however, as surveyed by Hao,[19] 75 per cent of audit companies are affiliated to local government.

Defond *et al.*[20] argue that this close government–auditor relationship is the root cause of the lack of auditing independence. Since the government holds majority ownership in listed companies while simultaneously exerting substantial control over the auditing firms, there is no demand for auditing independence. As explained above, most controlling shareholders of listed companies are government-related entities whose shares are not negotiable on the stock market; they are more interested in raising further capital from the market than maximising share prices. When it comes to meeting the 10 per cent ROE requirement, independent auditing is clearly not welcome.

Also, given the existence of an IPO quota, listed companies are valuable resources for local governments, which will go to great lengths to help these companies report positive accounting information and avoid being delisted. As they have control over the auditing companies, independent auditors are in short supply. Auditors' professional ethics in China have thus come under question.[21] Between 1993 and 2002, 26 auditing companies were sanctioned by the CSRC for malpractice in auditing. The most famous of these cases concerns the Zhongtianqin auditing firm, whose auditing licence was cancelled by the Ministry of Finance following its 'significant mistake' in auditing the Yinguangxia Co. Ltd (the case is discussed later in this paper).

TYPOLOGY OF ACCOUNTING MANIPULATION

The present sample consists of the companies sanctioned by the CSRC during 2000 and 2001 for providing misleading accounting information. The 11 listed companies included in this study (see the Appendix for the profile of each firm) were taken from a list of sanctioned companies found on the official CSRC website (www.csrc.gov.cn).

Before discussing these accounting fraud cases in detail, the fraud detection mechanism and the relevant punishments must be explained. There are mainly two mechanisms through which the highest regulatory

authority, the CSRC, detects accounting scandals of listed companies. The first one comprises some special investigation bureaus administered directly by the CSRC. These bureaus mainly consist of accounting and law experts. Their responsibility is to investigate the manipulation of accounting information and stock prices. The second mechanism comprises the regular joint meetings with the Shanghai and Shenzhen stock exchanges, in order to share the information from the stock exchanges.

There are two key sources of information to which the regulatory authorities pay special attention. The first one is the trading of the listed companies' stocks. This is associated with monitoring the stock account of brokerage firms to see whether there is an abnormal stock trading pattern. The second source of information is the audited financial statements. The regulatory authority will emphasise the information on related party transactions, sales recognition and abnormal profit growth. If there are abnormal changes of trading pattern or dubious financial information, the authority will launch an in-depth investigation.

If the manipulation of either accounting numbers or stock trading is confirmed, the regulatory authority will punish the concerned company and the persons in charge as well. The penalty usually takes the form of a public announcement or a fine paid by the persons in charge or by the company, or by both of them. If the economic loss is sufficiently large, the person in charge will face criminal action sued by the government, and a civil case brought by shareholders. For the criminal action, there are cases where the persons in charge were sentenced to imprisonment. To date, however, as regards the civil action, minority shareholders usually get nothing back.

Before 2002, the court did not accept minority shareholders' civil action against the controlling shareholders or the management team of listed companies because of 'the lack of expertise' (according to the explanation of the Supreme Court). In 2002, the Supreme Court stipulated that such civil actions should be accepted. Class action, however, is not available to minority shareholders, so they have to sue individually. Furthermore, the enforcement of legal protection of minority shareholders varies across regions. Some courts are reluctant in judging these cases. Usually the whole procedure will be prolonged and the minority shareholders actually get nothing back because the company has already run out of money.

The accounting issues involved in each company's case were analysed and classified into seven categories: (1) Revenue recognition: irregularities in definition and timing; (2) Abuse of trade credit and receivables; (3) Inflated asset valuation; (4) Loans to related parties; (5) Capitalisation of expenses; (6) Manipulation of the scope of consolidation; (7) Disclosure deficiencies.

Revenue recognition: Irregularities in definition and timing

An analysis of these accounting fraud cases shows that revenue recognition is an area with a high concentration of accounting frauds. These frauds are related either to the definition of revenue or the timing of revenue recognition.

Definition of revenue

According to the China Accounting Standard for Business Enterprises — Revenue, 'revenue is the gross inflow of economic benefits arising in the course of the ordinary activities of an enterprise from such events as the sale of goods, the rendering of services and the use by others of enterprise assets. Amounts collected on behalf of third parties or clients are excluded from revenue.'[22]

This definition indicates that revenue results from an arm's-length transaction, which must actually take place. Several companies studied in this paper, however, artificially improved revenues and profits by including

fictitious sales transactions. For example, Fujian Jiuzhou Group Co. Ltd, an import and export trading company listed on the Shenzhen stock exchange since 1996, increased its 1997 reporting profit by US$4.08m on the basis of fictitious contracts and real estate sales, accounting for 70.3 per cent of its reported net profit of that year.

Another notorious example of fictitious revenue inclusion is YinGuangXia Holdings Ltd (YinGuangXia), considered a star of the Chinese stock market during 1998–2001. Subsequent revelations that its high performance was based on bogus data rapidly brought the company to bankruptcy. In 1999, YinGuangXia recorded an artificial profit increase of 125 per cent of its reported net profit via Tianjin GuangXia (one of its subsidiaries), which fabricated sales, purchase contracts and invoices, and forged bank bills, customs declarations and income tax exemption documents that year. In 2000, YinGuangXia recorded another artificial profit increase of 12.5 per cent in the same way. Meanwhile, HaiYun Culture Company, another subsidiary of YinGuangXia, booked US$3.61m in advertising income from a film, 'Chinese Museums', to which it did not own the rights. This led to a fraudulent profit increase of US$3.22m for YinGuangXia in 2000, accounting for 6.4 per cent of the reported net profit.

In the case of Zhuhai Shining Metal Group Inc. (Zhuhai Shining), listed on the Shenzhen stock exchange in June 1996, the fraud concerned the treatment of negative goodwill. In 1998, Zhuhai Shining acquired a company in difficulty, Guangzhou Zhujiang Smelt Factory. Zhuhai Shining took over all its liabilities and assets for a price of US$0. The net assets of Zhujiang Smelt Factory should have been classified as 'negative goodwill', but Zhuhai Shining recorded Smelt Factory's net assets of US$1.52m as an addition to its retained earnings for 1998. This caused wrongful overstatement of the retained earnings in its annual financial statements from 1998 to 2000.

Zhuhai Shining's approach was contrary to the benchmark treatment defined by IAS 22, which in its revised version of 1998 eliminated immediate crediting of negative goodwill to reduce shareholders' equity as an acceptable approach. After the 1998 revision, IAS 22 concluded that negative goodwill often relates to expectations of future losses or expenses, for instance in connection with the acquirer's plans to eliminate redundancies in the combined operations, which are not appropriately accruable as of the date of the acquisition. Accordingly, it prescribes that negative goodwill of that nature should be deferred and recognised later in the P&L as the associated losses or expenses occur and are also recognised.

Timing of revenue recognition

According to Chinese accounting rules, 'revenue from the sale of goods should be recognized when all the following conditions have been satisfied:

— The enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods;
— The enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold;
— It is probable that the economic benefits associated with the transaction will flow to the enterprise; and
— The relevant amount of revenue and costs can be measured reliably.'[23]

These rules clearly prohibit accrual-based accounting in revenue recognition issues: revenue should be recognised when control over the goods is transferred, not when the contract is signed. Zhang Jia Jie Tourism Development Co. Ltd (ZhangJiaJie), a

company listed on the Shenzhen stock exchange since 1996, did the exact opposite.

In 1995 and 1996, this company signed several land-use rights transfer contracts[24] with Zhangjiajie Electric Power Bureau, Shenzhen QuanDa Trading Company and Shenzhen Dajia Industrial Co. Ltd. The total value of these contracts was US$9.6m, for 24.27 hectares of land. The contract specified that the deeds to the rights would not be issued until the buyers had completed payment, but the company recognised it as 1996 revenue before actually establishing the invoice, receiving the money and transferring the rights. This resulted in an unwarranted increase of 112.7 per cent of reported pre-tax profit in 1996.

In 1997, ZhangJiaJie signed rights transfer agreements covering a total of 10 hectares of land with Zhang Jia Jie Land Development Company, Shenzhen Kailaide Industrial Company and Hu Nan Investment Company, for a total value of US$5.17m. The contracts stipulated that the buyer would receive the rights deed only once payment was made, within six months of signature. If payment was not made by the deadline, the seller would retain the rights. But the company recognised the contract value as 1997 revenue, thus fraudulently boosting its reported profit, despite never having received any money nor transferred the rights.

Other companies have used related-party transactions to overstate their revenues. In these cases, there is no real transfer of the risks and rewards of ownership of the goods to the buyer.

In its consolidated financial statements for the first half-year of 2000, Guilin Jiqi Pharmaceutical Co. Ltd (Guilin Jiqi), first listed on the Shenzhen stock exchange in 1997, reported US$19.5m of revenue and US$8.8m of profits. It was revealed later that in January, March and April 2000, NanNing Jiqi RongGao Industrial Co. Ltd (Jiqi RongGao), a subsidiary company of Guilin Jiqi, had signed contracts with Shantou JinHuanHai Economic Development Company (Shantou JinHuanHai) and Guilin Lijiang Realty Development Co. Ltd (Lijiang Realty) successively, selling a 50-year lease to its 12,600 m^2 building materials market for US$12.14m. But a complicated arrangement lay behind this transaction. First, Guilin Jiqi Groups Co. Ltd (parent company of Guilin Jiqi), Guilin Jiqi Travel Agency and Guilin Jiqi Air Ticket Agency (both Guilin Jiqi Group subsidiaries) negotiated a bank loan of US$12.05m, guaranteed by Guilin Jiqi. These two subsidiaries then lent 80 per cent of this loan to Lijiang Realty, and Lijiang Realty used it to pay for the lease. Although the risks of ownership had clearly not yet been totally transferred, Jiqi RongGao included this contract value in its revenue, which contributed 209 per cent to its net profits.

Guilin Jiqi also signed a contract with Lijiang Realty in April 2000 for the sale of fixed assets worth US$2.12m. Once again, Guilin Jiqi recognised both the revenue on these sales and US$0.522m in profits in its 2000 half-yearly report, before actually receiving payment and transferring ownership. All these manipulations generated bogus profits in the annual report.

Commercial discounts and returns are other items that are not always recognised at the proper time. In 1998, Wuhan World Trade Co. Ltd (Wuhan World Trade), a subsidiary company of YinGuangXia, signed an agreement with its buyer cancelling the sale of the 23rd to 25th floors of the World Trade Building. But the company did not adjust the relevant sales data in its 1998 reports, which caused surplus sales revenue of US$6.82m, and an artificial US$3.24m boost to profits. This led to an undue 15.4 per cent profit increase for YinGuangXia after consolidation.

The problem of revenue recognition timing also applies for grants and assistance received from governments. Shangdong

Bohai Group Co. Ltd (BoHai), now renamed Yinzuo Bohai Group Co. Ltd, acquired Jinan Match Company at the end of 1993. At that time, Jinan Match Company owed a local bank a loan of US$1.79m (principal), plus interest amounting to US$365,000 prior to the acquisition.

A document from Jinan City Government prescribed: 'All the bank loans of the original Match Company are eligible for preferential treatment: two years' exemption from interest, and three years at half-rate interest. The banks concerned should apply for approval from their higher management.'[25] This statement remained vague, and Jinan City Government claimed that it would be responsible for coordination and implementation of the scheme. On 4th May, 1994, BoHai published the 'two-year exemption, three-year half-rate interest' policy in the attachment to its IPO bulletin, but omitted to state that its application was subject to approval by the banks' higher management, a 'detail' that remained unpublished until it was revealed by the CSRC. Although the 'two-year exemption, three-year half-rate interest' policy had not yet been approved, and the company was involved in a lawsuit with the bank over the issue, BoHai insisted that it should benefit from the local government's 'two-year exemption, three-year half-rate interest' policy from the outset. Accordingly, it did not record the loan interest as a financial cost for 1994 or 1995, and also omitted half of the interest payable on the loans for the years 1996 to 1998, falsifying the data in the annual financial reports for those three years. In 1999, BoHai restated its accounts, finally recognising the interest due in the years 1996, 1997 and 1998: a total of US$0.299m.

Sichuan Jinlu Group Co. Ltd (Jinlu), a chemical industry company listed on the Shenzhen Stock Exchange in 1993, violated the time period concept of accounting. In April 1998, in response to an application by Jinlu, the local Bureau of Finance intentionally agreed to grant Jinlu a US$2.17m subsidy for its products used in agriculture, and signed a formal agreement document. Jinlu counted it as revenue in its 1997 annual report. In fact, the authorities paid the subsidy in the form of 6.67 hectares of land instead of cash, in December 1998, but Jinlu did not fully disclose this.

Abuse of trade credit and receivables

In a normal market-based business environment, a supplier often allows his customer a certain amount of time to pay, in a practice that amounts to granting credit. The supplier recognises this transaction as a sale and a receivable. By taking advantage of their extensive network of related parties, some Chinese listed companies have abused this practice in order to satisfy their financing needs.

Sanjiu Medical & Pharmaceutical Co. Ltd (Sanjiu Medical & Pharmaceutical) is one of the biggest comprehensive pharmaceutical enterprises in China. In November 1999, it successfully executed an IPO on the Shenzhen stock exchange and attracted US$203.61m in capital. Between June 1999 and December 2000, a huge number of intercompany transactions took place between Sanjiu Medical & Pharmaceutical and Shenzhen Sanjiu Pharmaceutical Co. Ltd (Shenzhen Sanjiu Pharmaceutical), its parent company, with a total value of over US$2.04bn. At 31st December, 2000, the parent still owed Sanjiu Medical & Pharmaceutical US$83.73m, equivalent to 26.92 per cent of the latter's net assets (US$0.311bn). Sanjiu Medical & Pharmaceutical reported the net total transaction value in its 2000 annual report, but had never published any detailed information or analysis on the impact on operations (thus failing to comply with regulations) until the subterfuge was uncovered by the CSRC.

From July 1999, the parent Shenzhen Sanjiu Pharmaceutical issued a large number

of bank acceptance bills and commercial acceptance bills in favour of Sanjiu Medical & Pharmaceutical without any real underlying transaction. Sanjiu Medical & Pharmaceutical had these bills discounted by banks, thus obtaining cash while reducing the huge amount of receivables on its parent. From July 1999 to December 1999, Sanjiu Medical & Pharmaceutical used this technique to generate US$32.89m in cash. In 2000, it obtained a further US$274m, bringing the total up to US$306.87m. At the end of 2000, US$122m resulting from discounted commercial acceptance bills was included in Sanjiu Medical & Pharmaceutical's off-balance sheet liabilities. Over the same period, Sanjiu Medical & Pharmaceutical also issued US$71.57m in acceptance bills to its parent and other related companies in order to help them obtain cash from their banks.

In its 2000 annual report, Sanjiu Medical & Pharmaceutical merely reported — in its disclosures on contingent events — that by 31st December, 2000 the balance of discounted acceptance bills yet to mature was US$203.25m. But despite the regulations, more detailed information about the related-party transactions associated with these acceptances has never been disclosed. Sanjiu Medical & Pharmaceutical and its related companies clearly used this bill discounting technique as a financing method.

Inflated asset valuation

According to Article No. 22 of the China Accounting Standard for Business Enterprises, 'An asset is defined as an economic resource held or controlled by the firm . . . It should be evaluated by monetary unit.'[26] Because of the imperfection of the market and laxity over disclosure, however, some Chinese firms have been able to include dubious assets, especially intangible assets, in their balance sheets, and inflate their investments in other firms.

On 3rd November, 1999, the Board of Directors of Mudanjiang Petro-Chemical Group Co. Ltd announced that it 'approved the plan to acquire 98% ownership of Shanghai Shengfang Monitors Co., Ltd. The company was established in October 1999, with registered capital of US$6.02 million.' But it was revealed later by the CSRC that the company named in the announcement as Shanghai Shengfang Monitors Co. Ltd was actually Shanghai Shengfang Technologies Co. Ltd, a company that had only received its operation licence on 11th November, 1999. Its registered capital was 10 per cent as stated.

At around the same time, in December 1999, Xi'an Sunfield Company paid US$25.23m to acquire the control of Mudanjiang Petro-Chemical Group Co. Ltd. On 3rd December, 1999, Xi'an Sunfield published the acquisition announcement, stating that Xi'an Sunfield's total assets stood at US$72.3m, and net assets at US$54.22m at the end of October 1999. On investigation, it turned out that 53.33 per cent of the net assets were intangible assets. When an independent valuation report concerning these intangible assets was issued in March 2000, it revealed that about 70.8 per cent of the intangible assets had not been through the technical appraisal procedure until November 1999, so should not have been identified as assets at the time of the acquisition announcement. At the end of October 1999, Xi'an Sunfield's actual net assets thus stood at less than US$25.3m — only 47 per cent of the value declared. In this case, inflating asset values was motivated by the fact that, in China, a transaction of state-owned assets requires approval by the relevant supervisory authorities, and the higher the quality of the acquirer, the higher the probability that approval will be forthcoming.

Another example of overstated assets is the case of Zhuhai Shining Co. Ltd. In 1997, Zhuhai Shining planned to raise US$14.61m

through a rights issue, and eventually obtained US$13.88m from the market. Zhuhai Shining announced in its rights issue prospectus that the funds obtained through this capital increase would be invested into Tongchuan Shining Aluminium Co. Ltd (Tongchuan Shining). In its 1997 annual report, Zhuhai Shining stated that it had invested 59 per cent of the raised funds to build a standby power plant for Tongchuan Shining, and temporarily used the remaining 41 per cent as working capital. In the 1998, 1999 and 2000 annual reports, the company constantly reported that 75.5 per cent of the fund had been invested into the plant, and the remaining 24.5 per cent used temporarily as working capital. The findings of a CSRC investigation told a different story, however: only 17.37 per cent of the fund had been invested into Tongchuan Shining. The rest of the cash inflow had mainly been used by Zhuhai Shining to repay its debts and pay interest to two financial institutions in Shenzhen.

There are several more examples of this type of misleading statement. Fujian Jiuzhou Group Co. Ltd announced in its 1998 annual report that it had invested US$6.14m into certain long-term investment projects. It later emerged that the actual investment was only 33.6 per cent of the announced amount.

In April 1998, Zhenzhou Baiwen published its plan to undertake a rights issue and promised in the prospectus to invest US$15.18m into 30 new merchandise distribution centres. In July 1998, the company obtained US$18.67m from the market through its rights issue, but only used US$0.723m of this capital to merge with Zhenzhou Chemical Material Company as promised in the prospectus, all the rest of the money going to pay off bank loans. This meant only 0.4 per cent of the capital raised was used as promised. The company also failed to disclose this information in its 1998 annual report. Zhenzhou Baiwen thus fraudulently increased its assets by US$17.95m in its 1998 annual report.

Sichuan Electrical announced in its 1997 annual report that it had invested US$2.89m of capital, raised through a rights issue, in a revolutionary new technology project, and that the project had been inspected and accepted by the local authorities. But the actual investment totalled about 71 per cent, with the remaining 29 per cent used for other projects. The company was subsequently taken over by Chendu Borui, which in 2000 announced its planned rights issue without disclosing how the raised funds had actually been used.

In YinGuangXia's 1999 and 2000 annual reports, the company announced that the funds raised from a rights issue in 1999 (US$36.61m) had all been invested into certain projects as promised. Investigation revealed that the actual investment into the promised projects was 58.6 per cent. The rest of the capital had been used or borrowed by YinGuangXia's Board of Directors and its holding subsidiaries, including US$1.45m paid to the Board of Directors. In its 2000 annual report, the company stated that it had made a further investment to increase its stake in Wuhu GuangXia Eastern China Glass Product Holdings Ltd. The additional investment concerned a super-critical mass extraction product line, worth US$5.24m. A new company, Wuhu Guangxia Biological Technology Holdings Ltd, was established, by renaming and adapting an existing company, Wuhu GuangXia Eastern China Glass Product Holdings Ltd. The new company's registered capital totalled US$9.08m, including the US$4.02m contribution from YinGuangXia which accounted for 44.29 per cent ownership; Tianjin Guangxia invested US$3.18m or 35 per cent. Investigations revealed that Wuhu Guangxia Eastern China Glass Product Holdings Ltd did not become Wuhu Guangxia Biological Technology Holdings Ltd until 6th March, 2001. The registered capital was still US$3.84m,

and the ownership structure had never been changed. YinGuangXia had a 30 per cent ownership interest, and Tianjin GuangXia had no investment in it.

Loans to related parties

As mentioned in the above discussion of the characteristics of Chinese listed companies, a listed firm will often be treated as a cash cow by its unlisted parent company and other related firms. This explains why the level of long-term loans is often abnormally high in Chinese listed firms.

From 31st December, 1999, Sanjiu Medical & Pharmaceutical began to deposit capital with Shenzhen Financial Leasing Company Ltd — a related company belonging to the same group. By 31st December, 2000, Sanjiu Medical & Pharmaceutical had deposited a total of US$137.71m, with an annual interest rate of under 3 per cent. Meanwhile, according to its annual report in 2000, Sanjiu Medical & Pharmaceutical's long-term and short-term debts increased from US$14.21m at the beginning of 2000 to US$188.92m at the end of 2000, a net rise of US$174.70m. All the new debts were declared to be bank loans, with annual interest rates of between 3.504 per cent and 9.504 per cent (all higher than the rates on deposits made by Sanjiu Medical & Pharmaceutical with the Shenzhen Financial Leasing Company Ltd). Sanjiu Medical & Pharmaceutical only reported the amount of these related-party deposits in its 2000 annual report, but never disclosed detailed information about them and their impact on the company's business operations.

A similar case also came to light regarding Fujian Jiuzhou Group Co. Ltd (Jiuzhou). Up to June 1999, Jiuzhou lent US$45.78m of its own bank borrowings to its major shareholder Fujian Jiuzhou Trading Co. Ltd through related-party transactions, without fully respecting the required legal procedure for such transactions. Jiuzhou had never disclosed any information on these operations in its annual reports.

Capitalisation of expenses

When a company chooses aggressive accounting methods, one of the favourite techniques is to transform expenses into assets, taking them out of the income statement and into the balance sheet. To delay recognition of these expenses, the company must use the multi-period recognition-allocation mechanism, which means the artificially created assets must be long-term assets. The most famous examples in the USA are AOL (for capitalisation of its advertising expenses) and WorldCom (for capitalisation of network installation and maintenance costs).

If WorldCom is the American champion of expense capitalisation, the Chinese champion is without a doubt Zhenzhou Baiwen Group Co. Ltd (Zhenzhou Baiwen). This company had enjoyed bubble-type expansion on China's stock market. A retail and wholesale company, it passed CSRC's IPO qualification requirements by issuing false financial statements. Its reported revenues were US$95.78m in 1994 and US$167.23bn in 1995, and following its listing on the Shanghai Stock Exchange in April 1996, its reported annual revenues rose to US$419.52m. From 1994 to 1997, Zhenzhou Baiwen consistently reported high profits, but from 1998 its operating status changed dramatically. It reported losses of US$60.53m in 1998 and US$115.3m in 1999, and its net asset value was negative from 1999. Eventually, the company was taken over and restructured by a private company in 2003 after months of negotiation.

Zhenzhou Baiwen's reported net profits were US$3.03m in 1994 and US$3.3m in 1995. It was later revealed that Zhenzhou Baiwen had inflated its profits by US$2.3m, by capitalising expenses in 1994 and 1995 before its IPO (US$0.342m in 1994 and

US$1.96m in 1995). In the three years after it was listed on the Shanghai stock exchange, the company reported net profits of US$6.01m in 1996 and US$9.45m in 1997, followed by a loss of US$60.53m in 1998. These figures were false too. The amounts of fictitious profit generated by capitalisation of expenses took 23.8 per cent of net profit in 1996, 125 per cent in 1997 and was US$4.1m in 1998, giving an accumulated total of US$17.34m.

Following an investigation, it emerged that at 31st December, 1997 the annual loss made by five departments of Zhenzhou Baiwen's household electrical appliance subsidiary had been US$3.33m. No loss had been reported for these five departments, however; instead, the actual amount of the loss had been booked as assets.

In October 1998, when Zhenzhou Baiwen's household electrical appliance subsidiary handed in its income statement to the head office financial department, its reported current loss was US$30.77m, with accumulated losses from the beginning of the year reaching US$31.68m. This figure was rejected by the head office financial department. The subsidiary went back and revised the report, adjusting the year's accumulated profit to conceal a loss of US$27.15m.

Similar cases of fraud by expense capitalisation also can be found among other listed firms. For example, from 1996 to 1998 the sales expenses incurred by the non-independent sales subsidiary of Sichuan Electrical Apparatus Co. Ltd (Sichuan Electrical) totalled US$0.381m, 0.434m and 0.245m respectively. But the company did not include these sales expenses in determining the corresponding current profit, and this led to an undue increase of US$1.06m in the three-year accumulated pre-tax profit.

Another case concerned Sichuan Jinlu Group Co. Ltd. This company gave a fraudulent boost of 42.13 per cent to its 1997 reported annual profit by capitalising financial expenses as long-term asset costs.

Manipulation of the scope of consolidation

In another fraudulent technique to improve group performance, some companies hide losses in their subsidiaries, then do not consolidate these subsidiaries' accounts into their consolidated annual reports.

In the USA, Enron used the special purpose entity mechanism to hide losses in unconsolidated related firms. In the last quarter of 2000, AOL also deconsolidated its newly acquired subsidiary AOL Europe, with the help of the Goldman Sachs Group.

Zhenzhou Baiwen used the same method in its 1996 to 1998 annual reports. In total 23 Zhenzhou Baiwen subsidiaries, located in other cities outside Zhenzhou City, were not consolidated by the company: 15 subsidiaries in 1996, four subsidiaries in 1997 and four subsidiaries in 1998.

Disclosure deficiencies

Disclosure is another major issue in the Chinese capital market. Some listed companies tend not to comply with the principle of disclosure of material items, and keep important information back.

The material information concealed can concern the share issue price or ownership structure. In 1996, Fujian Jiuzhou stated in its IPO prospectus that it had 'issued 7 million legal-person shares and 77.36 million employee shares at the price of CNY1.8 per share. All legal-person shares and employee shares are subscribed in cash.' In 1993, however, the China Welfare Fund for the Handicapped subscribed one million legal-person shares for US$120,480. Jiuzhou did not disclose this fact faithfully in its prospectus, furthermore claiming in its IPO application document that its ownership structure consisted of 50 per cent state-owned shares 4.14 per cent legal-person shares, and 45.86 per cent employee shares in 1993. The real ownership structure was in fact totally different, comprising 50 per cent state-owned shares, 11.86 per cent legal-person shares,

34.72 per cent shares owned by non-profit organisations and 3.42 per cent employee shares.

Another example is YinGuangXia, whose Board of Directors made the decision on 17th March, 1997 to liquidate Shenzhen GuangXia Floppy Accessories Co. Ltd, Shenzhen GuangXia Mini Floppy Co. Ltd and Shenzhen GuangXia Video Equipment Co. Ltd. The company did not report this decision as required by disclosure regulations, and in the 1999 and 2000 annual reports and the half-yearly reports of 1999 and 2001 the company repeated its false disclosure.

The 50-year lease to its building materials business sold by Guilin Jiqi in January, March and April 2000 has already been mentioned in connection with revenue recognition issues, but the transaction involved disclosure irregularities too. Instead of reporting it immediately in compliance with the regulations, the company disclosed it in the half-yearly group report published later in 2000. Also in that report, Guilin Jiqi failed to disclose that it had provided a US$12.05m loan guarantee for its parent company, Jiqi RongGao and two subsidiaries. Jiqi RongGao had deposited US$6.02m raised through a rights issue with the NanNing Youai branch of the Bank of Communication, and used this deposit as the security to provide the guarantee for Guilin Jiqi. At 30th June, 2000, Jiqi RongGao's outstanding loan balance was US$9.59m. Guilin Jiqi did not disclose the rights issue in its interim report of 2000.

In a final example from 1999, Zhuhai Shining offered a US$14.29m guarantee to help a related company negotiate a loan from a Hong Kong bank. Zhuhai Shining did not disclose this material information in its 1999 annual report, and delayed the disclosure until publication of its 2000 annual report.

CONCLUSION

This paper set out to explore the origins and typology of accounting failures in Chinese listed firms. Although the Chinese capital market has achieved some remarkable progress in terms of size over the last 15 years, corporate governance remains a serious problem, and one of its consequences is the frequent occurrence of accounting fraud.

The paper has illustrated how these accounting fraud cases cover a wide range of accounting techniques: irregular revenue recognition, abuse of trade credit, inflated asset valuation, loans to related parties, capitalisation of expenses, manipulation of the scope of consolidation and disclosure deficiencies.

The authors believe that the causes of these accounting manipulations are mainly the high-state-intervention capital market, dubious system of corporate governance and weak levels of legal enforcement. In particular, the low proportion of tradable shares, the high ownership concentration and the extensive use of related-party transactions offer a fertile ground for accounting fraud.

All these factors suggest, as do Sun and Tong,[27] that state ownership in Chinese listed firms should be reduced from its current level. More shares should be sold off to independent external institutional investors, be they foreign or domestic. Effective enforcement of the legal framework to protect minority shareholders and fight against insider trading would be another useful weapon in the battle against accounting fraud.

APPENDIX: PROFILES OF COMPANIES INCLUDED IN THIS STUDY

Fujian Jiuzhou Group Co. Ltd (Jiuzhou)

This is an import and export trading company established in 1985, located in Xiamen, Fujian Province. It was listed on the Shenzhen stock exchange in November 1996. In October 2001 it received an official warning from the CSRC for issuing false

statements, and some of its managers were fined CNY100,000 to 300,000.

Guilin Jiqi Pharmaceutical Co. Ltd (Guilin Jiqi)

This company is located in Guilin, Guangxi Zhuang Tribe Autonomous Region. It was established in 1992 based on a state-owned factory founded in 1967 and gained listed status on the Shenzhen stock exchange in July 1997. In August 2002, it was fined CNY500,000 by the CSRC for false financial statements in 2000, and its managers were also sanctioned.

Mudanjiang Petro-Chemical Group Co. Ltd

This chemical company specialising in oil refining and coal was located in Mudanjiang, Heilongjiang Province. Originating from a state-owned company, it was established in 1993 and was first listed on the Shenzhen stock exchange in October 1996. In November 1999, the company was taken over by a private company, Xi'an Sunfield Science & Technology, and its name was changed to Heilongjiang Sunfield Science & Technology Co. Ltd. In August 2000, Heilongjiang Sunfield Science & Technology Co. Ltd and Xi'an Sunfield Science & Technology were both fined CNY500,000 by the CSRC for false statements, and some managers of the two companies were also sanctioned.

Sanjiu Medical & Pharmaceutical Co. Ltd (Sanjiu Medical & Pharmaceutical)

This company is located in Shenzhen, Guangdong Province and its '999' brand is famous in China's pharmaceutical industry. It was established in April 1999 and was listed on the Shenzhen stock exchange in March 2000. In July 2002, the company was disciplined by the CSRC for disclosure issues. The fine was CNY500,000. Certain managers were also fined between CNY30,000 and 100,000.

Shangdong Bohai Group Co. Ltd (Bohai)

This trading company was located in Jinan, Shandong Province. It was established in November 1984, and listed on the Shanghai stock exchange in April 1994. In November 2001, the false financial statements were revealed, and the company managers received a formal warning from the CSRC. In May 2003, Bohai was taken over and restructured by Shandong Commercial Group Co. Ltd and its name was changed to YinzuoBohai Group Co. Ltd.

Sichuan Electrical Apparatus Co. Ltd (Sichuan Electrical)

This company was located in Chengdu, Sichuan Province. It was established in 1988, and went public on the Shanghai stock exchange in November 1995. In February 2002, its chairman for the period 1996–98 was fined CNY30,000 by the CSRC for false statements, and some of the managers associated with the offence received a formal warning. In 1999, its 27.65 per cent state ownership was transferred to Chengdu B-Ray Investment Holding Group Co. Ltd and its name was changed to Chengdu B-Ray Media Co. Ltd. Once controlled by the B-Ray Investment holding group, the company changed its principal business to media activities.

Sichuan Jinlu Group Co. Ltd (Jinlu)

This company is located in Deyang, Sichuan Province. The company's main business is chemical materials and chemical production manufacturing. It was established in April 1992 based on a state-owned resin-producing factory. Jinlu was first listed on the Shenzhen stock exchange in May 1993 and, in 1998, a private firm acquired control of the company. In November 2001, it was fined CNY1m by the CSRC for its false

financial statements during 1997 and 1998, and some managers from that period were also fined between CNY100,000 and 300,000.

YinGuangXia Holdings Ltd (YinGuangXia)

This company is located in Yinchuan, Ningxia Hui Tribe Autonomous Region. It was established in November 1993, and defined itself as a high technology development company. When it was listed on the Shenzhen stock exchange in June 1994, its major business was the production of magnetic recording materials, but it quickly moved into biotechnology development in 2–3 years as it had announced it would. Between 1998 and 2001, YinGuangXia became a star company in China because of its rapid growth. But the bubble eventually burst in 2001, with accumulated fictitious profits of more than CNY771m. It was fined CNY600,000 by the CSRC, and some managers were convicted in court. The company also faced lawsuits from shareholders.

Zhang Jia Jie Tourism Development Co. Ltd (ZhangJiaJie)

This company is located in Zhangjiajie, Hunan Province. It was established in December 1992 and was listed on the Shenzhen stock exchange in August 1996. The company organised tours in Zhangjiajie, a famous beauty spot in China. In August 2001, it received an official warning from the CSRC following false financial statements during the period 1996 to 1998, and its chairman of the board was fined CNY80,000. Some other management executives were also fined. The company was restructured in 2002 by its large shareholders.

Zhenzhou Baiwen Group Co. Ltd (Zhenzhou Baiwen)

This company was located in Zhenzhou, Henan Province. It was established in September 1989 as a retail and wholesale company. In April 1996, it was listed on the Shanghai stock exchange. In July 2001, the company was fined CNY2m by the CSRC for making false statements, and its chairman of 1994–98 was fined CNY300,000. Other managers associated with the case were also fined between CNY100,000 and 200,000. The company was later taken over and restructured by Sanlian Commercial Group Co. Ltd, a private company from Shandong Province. Its name was changed to Sanlian Commercial Co. Ltd.

Zhuhai Shining Metal Group Inc. (Zhuhai Shining)

This company is located in Zhuhai, Guangdong Province. It was established in April 1992, and its business is non-ferrous metal smelting and rolling. The company's IPO was in May 1996, and it was listed on the Shenzhen stock exchange in June 1996. In April 2002, it was fined CNY500,000 by the CSRC for its false financial statements during the period 1996 to 2000. Some managers were also fined between CNY30,000 and 50,000.

Acknowledgments

The authors have benefited from helpful comments by John Friedland, the editor. The authors would like to acknowledge the material support of the CEIBS Case Center. Yuan Ding is a member of the GREGHEC, CNRS Unit, FRE-2810. The authors thank Ann Gallon for her much appreciated editorial help.

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