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With the rush of mainland companies to list in Hong Kong comes a can of worms, writes *Jane Moir*

Dishing the dirt on China's corporate criminals

During its four-year history as a Hong Kong-listed company, First Dragoncom Agro-Strategy Holdings has by no means grabbed the headlines. For many years, its key product was cel food. Its shares have seen negligible action.

This month, it made a brief foray into notoriety, for all the wrong reasons. It became one of several mainland companies to draw the attention of regulators across the border.

In First Dragoncom's case, it involved a \$126 million hole in the company's accounts. Auditors had quizzed evidence surrounding deposits in that amount supposedly received by the company, and placed in a "trust co-operatives union".

Outside accountants brought in by the board to assess the existence and validity of the deposits found they "were and are, non-existent". The case was reported to police in Shanghai county by an executive director and legal representative of the company.

That same week, irregularities were found in the accounts of Growth Enterprise Market-listed Changchun Da Xing Pharmaceutical. Without giving details, the company said mainland police were investigating.

It was followed by an announcement from China Southern Airlines this week that a director of the company, Peng Anfa, has been arrested by the authorities in the mainland.

More news also emerged over the past few days of troubled Guangdong Kelon Electrical Holdings, whose chairman Gu Chujun is under

investigation for alleged economic crimes.

And the trial of former Bank of China (Hong Kong) chief executive Liu Jinbao culminated last Friday in a suspended death penalty for corruption. Liu was charged with embezzling, either by himself or with others, more than 14 million yuan between 1996 and 2003, while he worked in the lender's Shanghai branch and Hong Kong unit.

It has been a busy month for corporate misdemeanours involving mainland firms listed here, and the spectre is against a backdrop of a rising proportion of Chinese-based companies raising equity on Hong Kong's exchange - about 60 per cent of all offerings.

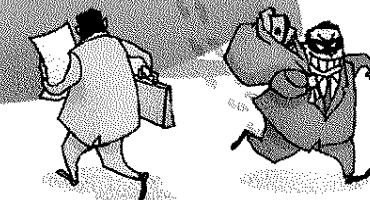
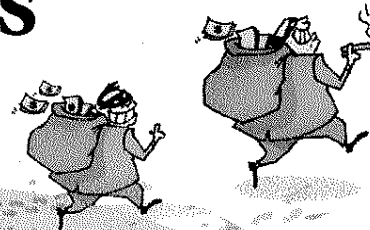
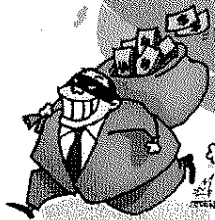
As the listings have increased over the past two to three years, so too has there been a steady flow of mainland-based irregularities coming to light.

"We are living in interesting times," says corporate governance activist David Webb.

He cites a higher than normal frequency of problems at the moment given prevailing economic factors in the mainland: a general crunch going on in the manufacturing industry and soaring oil prices.

Margins are being compressed and the more robust companies are barely weathering a bad year. "When you get a crunch in any sector, the more desperate companies start behaving in a more desperate fashion," he notes.

Alan Linning, an executive director of the Securities and Futures Commission, sees the phenomenon as a more



gradual one. "Over the past two to three years there's been an upsurge in the number of cases that have attracted our attention ... I do think certainly there is a correlation between these cases and the number of cases involving Chinese companies.

"It's been steady. There's always at one time a number on the go."

Unlike their local peers, mainland companies are increasingly posing a cross-border regulatory conundrum. In many cases, the authorities here are unable to glean basic information from their counterparts: for example, if a chairman is in fact being held in custody, or is under house arrest.

While shareholders for the best part sit back and watch the cases unravel across the border, the same is, however, unlikely to be said for the professionals in Hong Kong who either did business with or brought the troubled mainland company to market.

As the Euro-Asia Agricultural (Holdings) listing debacle showed, due diligence shortcomings can have hefty consequences. The Shenyang orchid grower collapsed in 2003 after revelations it had grossly inflated revenues published in its listing prospectus.

Investment bank ICEA Capital earlier this year agreed to pay a record \$30 million to the SFC, without admitting any liability, to settle a case alleging due diligence failure.

In the absence of directors to question over alleged wrongdoing, the danger to professionals is that the focus may shift to them. It seems little coincidence for example that a growing trend has emerged of audit disclaimers and resignations.

As Mr Linning points out, there have been an unprecedented number of auditors resigning from listed companies over the past 12 months. The number giving qualified opinions has surpassed 90 over the past year.

Similarly, there has been a mini boom in the due diligence business as companies and professionals increasingly conduct thorough background checks before taking on a new client or business partner.

"China is still pioneer country," says a senior accountant at one of the Big Four firms. "So consequently one might get caught out."

Coupled with this is a general tightening of rules and disclosure regulation globally.

In Hong Kong, a new investigation body is in the pipeline for accountants and auditors of listed companies. Pressure has also been coming from the stock exchange to raise the bar when it comes to auditor resignations.

Hong Kong Exchanges and Clearing and the Hong Kong Institute of Certified Public Accountants have proposed tighter disclosure for sudden switches of auditors. No longer will a

"lack of agreement over fees" suffice.

"It's going to be interesting," says the accountant.

For some companies, however, it is lucrative news. Accountants are not the only ones digging deeper into their clients' resumes. Lawyers, banks and prospective joint-venture partners are increasingly tapping the resources of private investigation and advisory firms such as I-OnAsia.

Founder Derek Elmer explains: "It used to be just among the large expat corporations [seeking background or 'engagement' checks] ... now we're seeing an increase in local firms."

Mr Elmer cites a marked increase in particular over the past six to 12 months, triggering a 50 per cent increase in business for the firm over the past year.

"It's getting more difficult to hide red flags," he says. "People want to know exactly who they are dealing with."