**Economy**

**Disappearing cash**

# Is this the Enron moment for China's accounting profession?

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Among all the things that sit on a company's balance sheet, "cash" should be the most straightforward item for auditors to deal with. A written confirmation from the bank is often all that's needed to verify the cash position the company says it has.

That's why investors were shocked to learn that a prominent Shanghai-listed firm had misstated its cash holding to the tune of Rmb29.9 billion ($4.4 billion). What could be even more shocking, however, is that lightning struck twice this month, as another firm announced a drastically worse cash position too. The two similar scandals have rattled confidence in China's financial markets and cast a pall over the Chinese accounting profession.

The first bombshell exploded in late April at Kangmei Pharmaceutical, previously one of the biggest listed drugmakers. When responding to enquiries by the Shanghai Stock Exchange, the traditional Chinese medicine (TCM) producer said in a circular that multiple "accounting errors" had led to a $4.4 billion overstatement of its cash position in its 2017 financial statements.

Most analysts have found the explanation unbelievable and unforgivable.

"Over the years A-share investors thought they had seen it all. Sometimes a chairman or CEO goes missing without notice. Even scallops could 'fly' away without wings [referring to an infamous scandal five years ago when Zhangzidao Fishery told shareholders its entire harvest of its scallops was wiped out; see WiC260]. Now blink your eyes and Rmb30 billion is gone. The immense size of Kangmei's accounting error is unprecedented," Sina Finance noted.

Citing several audit professionals, Caixin Weekly said veteran accountants were concerned that there may be further problems in Kangmei's financial statements "beyond the accounting errors", given the shock revelations. Some suspect the TCM maker may have intentionally inflated its cash holding and inventories in order to "cosmetically" boost profit.

More astute shareholders had already exited the company before the latest revelation (the company had gone through a slew of bribery and financial scandals last year). According to a court document published last June, the company was accused of offering bribes to drug safety regulators in Guangdong province where it is based. In December Kangmei was put under investigation by the China Securities Regulatory Commission (CSRC) on allegations that it had violated disclosure rules (it was this probe that triggered its confession of a $4.4 billion "accounting error"). In February, it was on the verge of defaulting on $300 million of bonds before an intervention by the Guangdong local government.

Kangmei was once styled as one of the "white horses" of the A-share market, a term akin to a "blue chip" in developed markets and bestowed on local listed companies with a sound track record for growth. Indeed, the TCM firm was carrying a market value of as much as Rmb130 billion almost a year ago. Its value has since declined to Rmb28 billion – meaning more than Rmb100 billion has been wiped out, with the latest accounting scandal triggering a nearly 50% dive in its share price in a week.

But Kangmei is not the only "white horse" that has triggered a "black swan event".

On Monday, Chinese police said that Zhong Yu, the former chairman and “actual controller” of the Shenzhen-listed Kangde Xin Composite Material Group was facing “criminal coercive measures”, which usually implies detention or arrest.

Kangde Xin has also been the subject of a CSRC investigation since October on allegations that it had violated information disclosure rules. Zhong only stepped down as the laminating film manufacturer’s chairman in February, after his company defaulted on bond repayments, including a Rmb55 million interest payment in the same month.

The defaults looked highly suspicious to most onlookers, given Kangde Xin had claimed in its annual reports in recent years that it had maintained billions of yuan in cash.

The company said it had Rmb12.2 billion of cash on deposit at the end of 2018, according to its latest annual report (which was published on April 30). However, it later emerged that its auditor had actually given a ‘qualified opinion’ on the financial statement as it could not confirm the authenticity of that cash position.

That led the Shenzhen Stock Exchange to send a number of urgent enquiries to Kangde Xin to seek clarification on its finances. In its responding statement, the company confessed that its auditors refused to sign off on its accounts because they were told by Bank of Beijing, its bank, that Kangde Xin actually had no money in its deposit account. Instead, Kangde Xin claims the missing cash is held in an account of an affiliate company which is 80%-owned by Zhong, the former chairman.

CBN said the revelation has sparked speculation that billions of yuan belonging to the shareholders of Kangde Xin may have been embezzled. The escalating scandal has seen nearly Rmb80 billion of market value decimated from Kangde Xin in barely a year. Its market capitalisation had dropped to about Rmb13 billion as of this week.

The outrageous activities of Kangmei and Kangde Xin have also got the attention of international media outlets, especially as the former is a newish member of MSCI’s global indices.

“Investors have to be more careful about Chinese firms’ reporting,” Andrew Lam, a director at BDO, an international accounting firm, told Bloomberg this week. “They will have to do real homework, examining closely companies’ financial reporting for any potential irregularities.”

In fairness, the dirt has been uncovered thanks partly to regulatory probes. According to Jiemian, a news portal, the market watchdog is keen to protect the reputation of the Chinese financial markets and to show it means business has said it has expanded its investigation to cover Kangmei’s auditing firm too.

It remains to be seen if the latest crackdown will be as forceful as that of the SEC, its American counterpart, when it sought to clean up after the 2001 Enron scandal.

The Texan energy firm’s gigantic fraud and bankruptcy led to the break up of Arthur Andersen, its auditor.