Journal of Forensic & Investigative Accounting
Vol. 5, Issue 2, July - December, 2013

CHINESE REVERSE MERGERS: ACCOUNTING FRAUD AND STOCK PRICE COLLAPSE

Brittany Lang
John R. McGowan*

INTRODUCTION

From the collapse of Enron to the scandalous events that took place at WorldCom, America and the rest of the globe have been no strangers to the existence of fraudulent financial reporting (FFR). Inflated revenues, fraudulent record keeping, and forged signatures are just the beginnings of the twisted world of accounting fraud. With the implementation of the Sarbanes Oxley Act in 2002, the United States has tried to subdue the rampant nature of fraudsters. However, the same efforts are not being made in the global economy. This is especially the case in China. In fact, FFR seems to be the foundation on which many reverse merger businesses are formed in China (Goldberger, *et. al.,* Ahmed, 2011).

Forget the principles of business ethics; in China, it is slowly becoming evident that top executives involved in reverse mergers are solely concerned with making a profit and could care less about how they achieve this goal (Ahmed, 2011). A reverse merger is a process in which a private company overtakes a public shell company and controls it (Altucher, 2006). This method allows companies to avoid the costs and scrutiny inherent to an initial public offering, and allows them to more easily become listed in U.S. markets (Altucher, 2006). From there, the newly listed company portrays itself as being much more successful than it actually is by exaggerating revenues, setting up phony customers, and pursuing other fraudulent activities to keep investors in the dark.

---

*The authors are, respectively, Candidate for Bachelor of Science in Business Administration Degree 2012, and Professor of Accounting at Saint Louis University.

Financial fraud has also occurred to a large extent in certain U.S. companies. The following is a partial list of major U.S. financial and accounting fraud since 1999: Waste Management (1999), Computer Associates (2000), Enron (2001), Adelphia, Freddie Mac, Global Crossing, Merrill Lynch, Tyco International and Worldcom (2002), HealthSouth Corporation (2003), AIG (2004), and Lehman Brothers (2010). These cases led to some major U.S. reforms such as Sarbanes-Oxley.

The remainder of this article is divided into four sections. The first section describes the risks inherent with reverse mergers. The problems with regulating Chinese reverse merger companies are also discussed. The second section reviews several Chinese reverse merger companies that have been accused of fraud within the past few years. A discussion of the practices that lead to heightened investor scrutiny is also included. The third section considers the role of research companies, particularly Muddy Waters LLC, in revealing the fraud within many of the Chinese companies. The fourth section discusses the volatility of Chinese reverse merger companies' stocks. Finally, the fifth section of this article provides due diligence steps investors should follow to avoid falling prey to fraudulent Chinese companies.

REVERSE MERGERS

There is nothing intrinsically shady about a reverse merger. However, when viewed in light of a company that pursues unethical financial reporting, the process looks perversely crooked. In a reverse merger, an established private company merges with a shell company that has zero or only nominal operations and assets. The shell company does have registered securities that comply with the Exchange Act of 1934.[1] Paul Gillis, a professor at Peking University, said it quite nicely, "The reverse merger in itself is not a big problem, but the type of company that would use

[1] In contrast to the Securities Act, the Exchange Act primarily regulates transactions of securities in the secondary market – that is, sales that take place after a company initially offers a security.

a reverse merger is" (Gillis, 2011). By pursing a reverse merger, Chinese companies avoid the high cost and overview that the IPO process normally carries (Gillis 2011, Trindle 2011). As a result, the reverse merger process has quickly become the manner chosen by foreign, specifically Chinese, companies to list their shares in the US.

Currently, there are over 300 Chinese Companies listed in North America (Xie, *et. al.*, Gammeltoft, 2012). The Public Company Accounting Oversight Board of Research and Analysis determined that nearly 150 Chinese companies have accessed U.S. stock markets through reverse mergers versus the mere 56 that did through an initial public offering (PCAOB 2011). In 2011, U.S. listed Chinese reverse merger company shares have experienced a nearly 50% decline (Cornerstone Research). It is obvious that the reverse merger is the avenue of choice for these companies to "get rich quick" in U.S. markets. The question many U.S. investors are asking is how so many Chinese reverse mergers took place without the accounting fraud getting noticed? The answer to that question is twofold. Limited regulation and secrecy laws that arise between the United States and China both play a key role in facilitating the fraudulent accounting practices in many CRM firms.

Regulation and Secrecy Laws

One main reason why so many Chinese reverse merger companies have gained access to U.S. markets is that regulation of such companies is extremely limited. United States regulators are not permitted access by Chinese authorities to oversee the companies (Gillis, 2011). Furthermore, because these reverse merger companies are listed in the U.S. and not on Chinese stock exchanges, they also lack regulation from China (Gillis, 2011).

Presently, U.S. and Chinese regulators are in disagreement about how Chinese companies who have are listed on U.S. stock exchanges should have their financial statements audited

(Lubman, 2012). Under Chinese law, American auditing companies are not allowed to open offices in China which forces them to rely on their Chinese affiliates (Lubman, 2012). Deloitte Touche was caught in a predicament when the U.S. Securities and Exchange Commission (who has been investigating Chinese corporate fraud) demanded that they produce audits by their Shanghai affiliate (Lubman, 2012). Deloitte turned down the request because of the possibility it could suffer from trying to get around Chinese secrecy laws (Lubman, 2012). These limitations remain a huge problem for the Public Accounting Oversight Board, which is undergoing the process of reaching an agreement to regulate Chinese firms with the aide of the China Securities Regulatory Commission (Harkness, 2012). There is little room to improve regulation of reverse merger firms under the current restrictions. However, that has not stopped the SEC from increasing restraints upon companies seeking reverse merger listings.

SEC Scrutiny

Amid the recent uncovering of fraud within Chinese reverse merger companies, the U.S. Securities and Exchange Commission has instituted a stricter set of listing rules (Lubman, 2012). Under recently updated SEC standards, companies who seek to go public via reverse mergers and list on the NASDAQ OMX, NYSE Euronext, or NYSE AMEX, must meet stricter standards (Trindle, 2011). For example, one such standard forces companies to file a complete fiscal year of audited financial statements before being eligible for listing (Lubman, 2012). Another rule requires companies in the initial period of listing to hold a minimum share price for up to 30 to 60 days (Trindle, 2011). Due to lax rules in the past, the SEC has been forced to stop the trading of nearly a dozen companies. Accordingly, the increased regulations should provide a safeguard for investors who were blindsided by these companies in the past (Trindle, 2011).

CHINESE REVERSE MERGER COMPANIES

The lack of adequate regulations in China has helped fraud spread rapidly throughout Chinese reverse merger companies. In most cases, the ethical delinquencies seem to begin with top management and trickle down through the companies. This section documents several Chinese companies that have been accused of spreading a variety of fraudulent accounting practices within their organizations over the past decade.

Longtop Financial Technologies

Longtop Financial Technology was a software company that listed its shares on the New York Stock Exchange in 2007 (Lubman, 2012). It did not go public via reverse merger, but offered an initial public offering for $17.50 a share (Lubman, 2012). The SEC has since delisted Longtop. At one time, Longtop was one of the most prominent Chinese companies listed in the U.S. with a $2.4 billion market capitalization (Fulcrum Inquiry, 2011; Lubman *et al*., 2012). One reason for their prominence was the backing of Deloitte as their auditor for nearly seven years. However, this all came to a screeching halt in March 2011 when Deloitte raised suspicion about Longtop's cash balances (Norris, 2011). Longtop grew increasingly anxious at the inquiry and began a stream of shady dealings with Deloitte. For example, Longtop allegedly stated that Deloitte was indeed not their auditor and instead was stealing steal some of the auditor's documents from the company (Norris, 2011). Deloitte resigned as Longtop's auditor after they received threats and interventions from company officials. Deloitte also discovered that Longtop did not hold the cash balance they claimed (Norris, 2011). Moreover, like many reverse merger companies, Longtop was very much "a real company, but its revenue and profits were a small fraction of the amounts reported" (Norris, 2011). By May 17, the SEC halted the trading of their stock, and on May 23 Longtop's Chief Financial Officers resigned (iStockAnalyst, 2011).

Sino-Forest

Sino-Forest is a forestry company located in Hong Kong, China that became listed in Canada on the Toronto Venture Exchange nearly 16 years ago via reverse merger (Cant 2011). In March of last year, it was experiencing a share price of C$25.30. However things went south after Muddy Waters analyst, Carson Block alleged they overstated assets (When It Matters, 2011). In the Muddy Waters Report it alleged that Sino exaggerated their timber assets by a massive $900 million (Block, 2011). The company also created a phony third party who was set up to make it appear that the recorded sales numbers they recorded were authentic (Block, 2011). After researching the company, Muddy Waters also found that four of the timber agents Sino claimed to have purchased $2.9 billion of timber from were fraudulent (Block, 2011). Moreover, the report claimed that Sino-Forest was a "multi-billion dollar Ponzi scheme" which raked in $3.5 billion from capital markets and yet never paid anything via free cash flow or even a dividend (Block, 2011). By June 2011, the market had witnessed enough and Sino-Forest's share price plummeted to C$1.99 (When It Matters, 2011). Sino-Forest tried to soft-pedal Mr. Block's statements claiming his statements were hardly possible as the information was not retrievable (Xie, *et. al.*, Gammeltoft, 2012). Despite such efforts by the company, they could not stop the downward spiral. By August 2011 the Ontario Securities Commission terminated the trading of Sino Forest (Cant, 2011). Several days later, Allen Chan, Sino-Forest's Chief Executive Officer, resigned (Cant, 2011).

China Media Express Holdings

China Media Express Holding (CCME) is an advertising company that plays television ads in buses throughout the Republic of China. In 2009, they began trading on the Nasdaq via a reverse merger when they took over the shell company TM Entertainment & Media. By February

2011, the media was flourishing with negative reports regarding CCME. Muddy Waters did a report on the company that implicated them on a number of fraudulent actions (Coenen, 2011). The report criticized the company for a variety of fraudulent activities. Management supposedly engaged in a pump-and-dump which involves a company trying “to boost the price of a stock” by making dishonest or embellished statements, and then selling their positions once the stock price rises (Coenen, 2011; Investopedia, 2012). Another allegation of fraud by Muddy Waters was that CCME inflated revenue by over $78 million claiming to have $95.5 million when in reality it was closer to $17 million (Coenen, 2011; Block, 2011). Muddy Waters also accused them of lying to investors by claiming to advertise on 27,200 buses, when in reality they were only carried on 12,565 buses (Coenen, 2011).

Another lie that CCME was caught telling concerned their distributors; they claimed to have agreements with Apple. Muddy Waters discovered that was false (Block, 2011). When Muddy Waters questioned media buyers in China about CCME they indicated they had never even heard of the company (Block, 2011). In spite of all this, Zheng Cheng, CEO of CCME, claimed that the Muddy Waters report was merely “another attack by short-sellers” (Holmes, 2012). Mr. Cheng even went so far as to claim that the company was “strong and doing well.” Over time it became evident that was not the case (Holmes, 2012). About one month after the Muddy Waters report and several other negative media reviews of the company, its auditor, Deloitte Touche Tohmatsu (a Deloitte affiliate), resigned (Gammeltoft and Lawrence, 2011). On that same day, March 11, China MediaExpress shares were halted after a 48% decline caused by the Muddy Waters report. Figure 2 displays the price decline and subsequent collapse of CCME after reports of fraud hit the market. By the time May rolled around, the company had been delisted from the NASDAQ (Coenen, 2011).

Duoyuan Global Water Inc. and Duoyuan Printing

Duoyuan Global Water Inc, (DGW), a water treatment equipment supplier, began trading in June 2009 on the NYSE with its IPO at $16.00 per share (Duoyuan 2009). A little over six months later, on January 28, 2010, the company commenced a secondary public offering at $29.50 dollars a share. On April 4, 2011 Muddy Waters released a report covering the financial reports and the value of DGW's shares (Block, 2011). In the report, they valued DGW at less then a dollar when they were trading at $5.49 on April 1, 2011. Muddy Waters accused DGW of inflating revenue, which was revealed by DGW's PriceWater. The company claimed to have revenue of over $154 million. In actuality, their revenue was closer to $800,000 (Block, 2011). This however, was just the beginning of the fraud charges for DGW. Muddy Waters also discovered that they had forged their 2009 audit report. Moreover, Muddy Waters reviewed the 2009 audit report, prepared by Langfang Zhongtianjian Certified Public Accountants Co. Ltd., and found that DGW had falsified their revenue from the initial $0.3 million into an exaggerated $85.7 million. DGW also overstated the number of their employees. Wenhua Guo, the company's chairman, stated that there were 580 employees that worked at DGW. When Muddy Waters visited the factory they found a mere 240 workers (Block, 2011).

Muddy Waters also conducted surveillance of the factory five different times between January and April 2011. They ceased to see any shipping or receiving take place from the factory. This seemed very odd for a company that claimed sales of $1 billion RMB ($158.7 million USD) in products. DGW was also accused of making undisclosed related party transactions, whereby money was transferred to their chairman (Block, 2011).

Mr. Guo also owns a digital printing business in Beijing called Huiyuan that "had improper payables owed" to it from DGW according the Langfang 2009 audit report. Evidence has shown that Mr. Guo tried to disguise this fact by recording payables to Huiyuan "using different Chinese characters (but having the same pronunciation) for Huiyuan's name" (Block, 2011). After Muddy Waters researched the differing Chinese names, they found that the only one in existence was Huiyuan; therefore, they concluded that all of the payables were indeed indicating the same entity owned by Mr. Guo (Block, 2011). Also within the Muddy Waters report, they mention DGW's sister company Duoyuan Printing which happens to be run by the same chairman as DGW (Holmes, 2012). The fraud found within this company was extensive and lead to the suspension of the trading of Duoyuan's securities on January 25, 2012 (NYSE).

DGW's sister company, Duoyuan Printing (DYPNP.PK), produces printing equipment. It initially became listed on the NYSE via reverse merger in 2006 (Eden, 2011). In November 2010, the SEC issued a subpoena against the company (Eden, 2011). Duoyuan has not filed financial statements with the SEC since May 2010 (Eden, 2011). The company had several accusations against them regarding fraudulent accounting practices. Duoyuan Printing had allegedly "engaged in fraud in the sale of securities, filed materially false documents with the SEC, failed to maintain adequate books and records, and failed to maintain an adequate system of internal accounting controls" (Eden, 2011). Their executive officers had also been accused of falsely certifying their financial records and lying to their external auditor (Eden, 2011). Duoyuan received much scrutiny the company due to the SEC investigation that caused their stock to fall nearly 20% (Eden, 2011). On April 4, 2011, after undergoing investigation by the SEC since October 2010, Duoyaun Printing Company was delisted from the NYSE (Holmes, 2012).

Orient Paper

Orient Paper (ONP) is a paper production company located in China. In 2008, it became listed on the American Stock Exchange via reverse merger. It was not long, however, until this company also began facing fraud allegations. In 2010, Muddy Waters released a report on Orient Paper that accused them of having "overstated its 2008 revenue by 27 times" (Block, 2010). ONP's 2008 10-K showed total net assets to be worth more than half of what its 2008 audited balance sheet displayed. The report also stated that ONP misappropriated nearly $30 million since October 2009. For example, between October 2009 and May 2010, ONP raised $31.5 million in supposed efforts to finance the purchasing of equipment; however, Muddy Waters concluded that ONP barely paid $5 million for these assets. The rest of the $31.5 million was unaccounted for (Block, 2010).

Muddy Waters also accused ONP of falsifying their list of customers in 2008 (Block, 2010). Orient Paper claimed to sell $2.7 and $2.2 million of paper to Baoding Dadi Colour Printing Co. Ltd. and China Lucky Offset Group Integrated Services Co. Ltd. (Block, 2010). Both companies revealed information to Muddy Waters that made the supposed purchases highly unlikely (Block, 2010). Dadi Printing stated that its annual revenues were less than $1.5 million, and Lucky Services indicated that it never had revenue over $1.3 million (Block, 2010). Therefore, it seems that ONP had greatly exaggerated the purchasing volume from its alleged top ten customers (Block, 2010).

ONP had also been accused of overvaluing their assets by 10 times (Block, 2010). Muddy Waters toured their facilities, but were only shown two production lines, which were in deplorable condition (Block, 2010). After showing video and photos of the equipment to an expert European paper manufacturing equipment producer, they concluded that the equipment was worth only "a few hundred thousand dollars" (Block, 2010). Thus, ONP seemed to have overstated the value of their assets by nearly 10 times (Block, 2010). The overstatement did not stop there as Muddy Waters also found that the company had overstated the value of their inventory as well (Block, 2010). ONP claimed to have $605,719 of finished goods inventory. However, Muddy Waters researchers found no evidence of the goods at the facilities upon their visit (Block, 2010). The researchers also questioned the value that ONP placed on their recycled paper board- over $2.3 million (Block, 2010). Muddy Waters pointed out that ONP stored the recycled paper outdoors. This would cause it to decompose as it was soaked with moisture from the cold temperatures (Block, 2010). Thus, Muddy Waters concluded the value of the paper could not possibly be anywhere near the $15 million ONP claimed (Block, 2010).

RINO International Corporation

RINO International Corporation (RINO.PK) is a wastewater and gas desulphurization equipment manufacturer. RINO became listed on the NASDAQ via reverse merger. In November 2010, Muddy Waters released a report valuing RINO's shares at $2.45 when they were selling at $15.52 (Block, 2010). The report lambasted the company for participating in a variety of fraudulent activities. For example, RINO contrived numerous customer relationships in an effort to increase revenue (Block, 2010). Muddy Waters investigated by speaking with nine of RINO's customers, five of whom denied buying any gas systems from them (Block, 2010). Since nearly 65% of RINO's revenue came from gas systems, these fabricated customers created great revenue inflation (Block, 2010). Muddy Waters also noticed that RINO filed separate financial statements to the SEC listing revenues of $192.6 million whereas their SAIC financial statements showed revenue of only $11 million (Block, 2010).

Muddy Waters researchers found other problems with RINO's financial statements. For example, RINO reported that they had no income tax expense for either 2008 or 2009 (Block, 2010). RINO's management had also been accused of using $3.5 million to buy a luxury home (Block, 2010). To make management's action even more suspicious, they made the purchase on the day they closed their $100 million financing (Block, 2010). After the numerous fraud allegations rapidly spread, shares of RINO, which were trading at $15.66 before the Muddy Waters report, had a rapid decline in value hitting $3.60 by the beginning of 2011 (Durden, 2012). By April 11, 2011, the SEC made an announcement that they were suspending the trading of RINO stock (SEC, 2011). The announcement stated that the company did not disclose that certain financial information regarding their securities (SEC, 2011). The allegations dealt with the size of their operations, the number of employees, the number of customers contracted, and two corporate accounting books (SEC, 2011).

China Green Agriculture

China Green Agriculture (CGA) is a manufacturer of humic acid fertilizer in China and is listed on the New York Stock Exchange. In January 2011, J Capital Research released a report that accused this organic fertilizer producer of fraud stating that its real value was less than even one third of its stock price (Rivas, 2011). The report stated that CGA inflated its revenue to such a degree that instead of having a stock price at $9.05 (at the time the article was written in January 2011) it should have been closer to $2.85 (Rivas, 2011). As shown in Figure 3, shares fell nearly 10% that same day and continued to decline to its current price of $4.45 (Rivas, 2011).

MUDDY WATERS RESEARCH COMPANY

For most Chinese Reverse Merger cases, the main fraud whistleblower has initially been an attentive research company, in particular Muddy Waters Research Company. Muddy Waters LLC is a research company that has focused on finding fraud within Chinese companies. Carson Block, who created Muddy Waters in 2010, is a short seller and research analyst who currently runs the company. Muddy Waters first gained global attention in June 2011, when they alleged that Sino-Forest Corporation, a commercial forest plantation operator in China, misrepresented the amount of land they held for their timber plantation (Xie, *et. al.*, Gammeltoft, 2012). This company has been extremely accurate in performing detailed research of these companies' financial and operational activities. After analyzing company information, Muddy Waters typically releases a report on the financial and operational status of the company. Creditors use this information to evaluate the credibility and riskiness of the company under review.

Muddy Waters Gets it Wrong

It should be noted that all reports submitted by Muddy Waters did not hit the fraud nail right on the head. Consider the case of the Chinese company Orient Paper Inc. In June of 2010, Muddy Waters bombarded the company with allegations of fraud and advised a strong sell on the stock with a target price of less than $1. As a result, Orient Paper shares fell nearly 60% to $3.31 from it's high in January 2010 of $13.58 (Wachtel, 2011). After suffering the effects of Muddy Waters negative report, Orient Paper hired Loeb & Loeb LLP, Deloitte & Touche Financial Advisory Services, and TransAsia Layers to further investigate the allegations. However, no factual evidence was found to back up Muddy Waters accusations. Liu Zhenyong, Chairman and Chief Executive Officer of Baoding, Hebei-based Orient Paper, advised other companies to conduct similar third-party independent investigations (Wachtel, 2011).

Problems With Muddy Waters Research

The problems with Muddy Waters is that Mr. Block's more recent research findings have a spotty track record and in certain cases, were wrong (Xie, and Gammeltoft, 2012). For example, in one of Muddy Water's most recent announcements they declared that Spreadtrum Communications Inc. (SPRD), a chip making company, had questionable revenues (Xie, *et. al.*, Gammeltoft, 2012). However, Spreadturm recently traded at $15.02 from $12.49 on June 28 (Xie, *et. al.*, Gammeltoft, 2012).

Recently, Sino-Forest also slammed Muddy Waters with a $4 billion defamation lawsuit (O'Toole, 2012). Muddy Waters accused Sino-Forest of being "a multi-billion dollar Ponzi scheme… accompanied by substantial theft" in a June 2011 report. This report triggered more than a two-thirds decline in their stock value (O'Toole, 2012). However, Muddy Water's owner Carson Block claims that lawsuit held no ground especially when Sino-Forest filed for bankruptcy on the same day in which they filed the lawsuit (O'Toole, 2012).

Much of the information that comes via Muddy Waters reports is hard for investors to ignore. However, because Carson Block holds short positions in many of the companies he reports on it has lead some to question the reliability of his reports (Xie and Gammeltoft, 2012). If Mr. Block's allegations against these Chinese companies are true, then his suggestions should be heeded at all costs and investors should avoid the risks involved with Chinese reverse merger companies. However, if the information relayed within Mr. Blocks reports are unfounded, than investors must undergo the process of determining the validity of his statements. The risks involved with these investments makes ignoring such reports nearly impossible. In fact, investors frequently read these reports and then bail out of their investments.

To Muddy Waters Credit

Pearson (2010) gives advice to investors regarding short sellers. He explained how there are millions of postings on stock investor boards by people trying to lower share prices in order to buy companies stock (Pearson, 2010). However, Muddy Waters differs greatly from these unfounded sources in that their reports take months to prepare and are extensively circulated (Pearson, 2010). He went on to explain that Muddy Waters is a credible source that investors should take into consideration when contemplating selling out (Pearson, 2010). To their credit, their reports have contributed much to aid investing world. Whether or not they always get it "right," they have at least helped pull the covers off and reveal the harsh realities of the pervasiveness of fraud in Chinese reverse merger companies.

STOCK PRICE VOLATILITY

Chinese reverse merger companies experience large share price volatility as many investors view them in a negative light. As more fraudulent activities come to light, investors become more skeptical (Hu and Shanshan, 2011). Upon reviewing many reverse merger companies financial statements there is often much obscurity that affects investor trust. For example, Universal Travel Group (UTA) bought an OTCBB shell in 2006. In 2007, it merged with four other Chinese travel agencies, and in 2009 made the move to NYSE (Hu, *et. al.*, Shanshan, 2011). However, when a Bronte Capital investment manager initiated some concerns about UTA's financial statements, it caused their stock price to plummet even though the company denied his accusations (Hu, *et. al.*, Shanshan, 2011). Much of investor mistrust is due to the plethora of Chinese accounting scandals that have come to light in recent years, which is another reason for the tanking share prices. Investors simply have many Chinese fraud concerns (Trader, 2011). Another common cause of share price volatility is due to the latest rules the SEC instituted regarding reverse mergers (Leong, 2011). The rulings have made it more difficult for reverse merger companies to be listed without first filing required documentation as well as financial statements that have been appropriately audited for a full fiscal year (Lubman, 2012). Once the SEC gets involved, it should raise red flags for investors. One final cause of share price volatility is due to negative mainstream press coverage (Trader, 2012). The onslaught of Muddy Waters reports, SEC announcements, etc. has proven to be a fatal blow to Chinese reverse merger stocks. These resources are the main cause why reverse merger companies stocks fluctuate so greatly. Figure 1 shows the impact of the release of Muddy Waters announcement on trading volume. When they released their report on June 28, 2010 regarding Orient Paper, Inc., the initial effect was a spike in trading volume and a drop in price. This company, like many other Chinese Reverse Merger companies, has experienced the same investor reaction to negative news coverage.

INVESTOR DUE DILIGENCE

While research companies are often sources of critically valuable information, investors cannot rely solely on their reports. It is important that every investor take all the necessary steps to make the most accurate moves in the market. However, not all investors can perform the thorough due diligence which professional investors do. Therefore, to be fully protected against the risks associated with investing in foreign companies stocks, it is of utmost importance that the average investor learn to accomplish a certain degree of preventive due diligence (Ricard, 2012).

In an article published by *Seeking Alpha*, Ricard (2012) explains the difficulties investors encounter when performing due diligence on foreign based companies. “Access to capital markets abroad, where investors will have more trouble keeping in touch with the business’s product, provides a lot of incentive for perpetrators to do whatever it takes to 'pass inspection' and pocket your money" (Ricard, 2012). Since many are limited to a certain levels of due diligence, the best bet is to avoid investments in Chinese reverse merger companies. Paul Gillis of Peking University warns that investors how the numbers in many Chinese based companies provide an extremely unreliable basis for making investment decisions (Gillis, 2011).

Ricard (2012) lists three steps investors must take before investing in a foreign company. These steps are: reality check, qualitative analysis, and quantitative analysis. First, initiating a reality check involves being fully exposed to the company's products, business model, as well as those of its competition. Regarding Chinese companies, it is virtually impossible for investors to be familiar with company and sector developments. As a result Ricard advises American investors to steer clear of this hazardous ground (Ricard, 2012). Secondly, qualitative analysis is similar in nature to a reality check. This step requires the investor to analyze the research and actual updates found on a particular company. Press releases and management assessments by the company alone do not provide a sufficient basis for investment decisions. Outsider information, reports, and opinions are crucial for avoiding the risks inherent from investing in Chinese companies. Lastly, quantitative analysis can only be achieved through the comprehensive study and analysis of the numbers that make up the company's financials (Ricard, 2012). Earnings, dividend, and comparative yield are just a few of the quantitative numbers that should be given close attention. Moreover, all significant quantitative analysis should be easily traceable to the bottom line, i.e. yield. Without intensive research and analysis, Chinese reverse merger companies often prove to be extremely risky and hazardous investments. It is very difficult for the average investor to do the appropriate level of due diligence, therefore the safest bet may be to stay clear of these companies.

CONCLUSION

Research suggests that fraudulent and unethical accounting and business practices are widespread and pervasive in a majority the approximately 150 Chinese reverse merger companies in the U.S. Furthermore, a Bloomberg index of the 12-month stock performance of nearly 80 of those companies looks like a ski slope with a peak above 200 in Nov. 2010 and the low well under 100 by year end. In addition, at least 11 of the firms had to halt trading or have been delisted from major U.S. stock exchanges amid investigations by regulators (McCoy and Chu, 2011). As shown from the companies analyzed in this article, the odds are definitely against any profitable investments with Chinese reverse merger companies. As is often the case with U.S. companies, the most common instance of accounting fraud among Chinese Reverse Merger companies was inflated revenue. Other pervasive examples of accounting fraud involved overstated assets, non-existent employees and customers. With financial numbers as twisted as the management creating them, Chinese reverse merger companies have proven to be nothing more than risky investments. Thanks to research companies such as Muddy Waters, the fraud alarm has been sounded on Chinese reverse merger companies across the investment world. Perhaps, through perpetual due diligence and the plethora of evidence that has surfaced regarding reverse mergers, potential investors can avoid becoming the next victim of Chinese accounting fraud in U.S. markets.

FIGURE I

Orient Paper (ONP)
Trading Volume Spikes After MW Announcement

Source: Finance.yahoo.com

FIGURE 2

Source: Finance.yahoo.com

FIGURE 3

Source: Finance.yahoo.com

REFERENCES

Altucher, James (2006). Mergers That Go Forward in Reverse. *Financial Times*. 1+. *Access World News*.

Ahmed, Azam (2011). Chinese Reverse Merger Companies Draw Lawsuits. *DealBook*. Web. <http://dealbook.nytimes.com/2011/07/26/chinese-reverse-merger-companies-draw-lawsuits/>.

Block, Carson (2011). *China Media Express Holdings*. Rep. Muddy Waters Research.Web. <http://www.muddywatersresearch.com/>.

Block, Carson (2010). *RINO International Corp*. Rep. Muddy Waters Research.Web. <http://www.muddywatersresearch.com/>.

Block, Carson (2010). *Orient Paper Inc*. Rep. Muddy Waters Research. Web. <http://www.muddywatersresearch.com/>.

Block, Carson (2011). *Initiating Coverage on DGW – Strong Sell: Report on Duoyuan Global Water Inc*. Rep. Muddy Waters Research. Web. <http://www.muddywatersresearch.com/>.

Block, Carson (2011). *Sino-Forest Corporation*. Rep. Muddy Waters Research. Web. <http://www.muddywatersresearch.com/>.

Cant, Richard (2011). Financial Fraud of Chinese Companies Calls for Better Financial Due Diligence. *Integra International*. Web.

Coenen, Tracy (2011). China MediaExpress: Massive Fraud or Victim of Short Sellers. *The Fraud Files Blog*. Web.

Duoyuan Global Water Inc. (2009) "News Release," June 24.

Durden, Tyler (2011). RINO's Stock Price Plunges Into Muddy Waters As Research Report Claims Stock Is Scam. *ZeroHedge*. Web. <http://www.zerohedge.com/article/rinos-stock-price-plunges-muddy-waters-research-report-claims-stock-scam>.

Fulcrum Inquiry (2011). Huge Fraud in Chinese Stocks. June. Web. www.fulcrum.com/Chinese-Investments.htm.

Eden, Scott (2011). SEC in Fraud Probe of China RTO Duoyuan Printing. *TheStreet.com*. Web. <http://www.thestreet.com/story/11051462/1/sec-in-fraud-probe-of-china-rto-duoyuan-printing.html>.

Erickson, Merle (2004). "How much are nonexistent earnings worth?" University of Chicago Graduate School of Business.

Gammeltoft, Nikolaj, and Dune Lawrence (2011). China MediaExpress CFO Quits, Auditor

Calls for Inquiry of Bus Advertiser. *Bloomberg*. Web. <http://www.bloomberg.com/news/2011-03-14/china-mediaexpress-cfo-resigns-auditor-calls-for-investigation.html>.

Gillis, Paul (2012). Q&A: In China, Do the Numbers Say It All. *G+*. Web.

Goldberger, M. Norman, and Laura Krabill (2011). Fraud Prevalent in Reverse Merger Companies with Operations in China. *Corperate Board Member*. Web. <https://www.boardmember.com/Fraud-Prevalent-in-Reverse-Merger-Companies-with-Operations-in-China.aspx>.

Harkness, Timothy P. (2012). Legal. *Chinese Companies under Fire: The Recent Boom in U.S. Securities Cases against Chinese Public Companies*. Thomson Reuters News & Insight, Web.

Here's a Time Muddy Waters May Have Got It Wrong. *Financial Post*. Bloomberg News, (2011). Web. <http://business.financialpost.com/2011/06/21/heres-a-time-muddy-waters-may-have-got-it-wrong/>.

Holmes, Robert (2012). China MediaExpress Shares Halted. *The Street.* Web. <http://www.thestreet.com/print/story/11040973.html>.

Holmes, Robert (2011). Duoyuan Global CFO Park to Resign. *TheStreet.com*. Web.

Huge Fraud In Chinese Stocks. *Fulcrum Inquiry*. (2011). Web. <http://www.fulcrum.com/Chinese-Investments.htm>.

Hu, Shen, and Wang Shanshan (2011). Tricks of the Reverse Merger Trade. *Caixin Online*. Web. <http://english.caixin.com/2011-06-10/100268291_all.html>.

Investigations and Litigation Related to Chinese Reverse Merger Companies. (2011). *Cornerstone*. Cornerstone Research.Web.

IstockAnalyst (2011). The Rosen Law Firm Files Class Action Lawsuit Charging Longtop Financial, Inc. With Securities Fraud - LFT. May.

Leong, George (2011). Market Risk Dries up IPO & Reverse Merger Pipelines. *Wall Street Pit*. Web. <http://wallstreetpit.com/85380-market-risk-dries-up-ipo-reverse-merger-pipelines>.

Lubman, Stanley (2012). Unpacking the Law Around the Chinese Reverse Takeover Mess. *WSJ.com*. <http://blogs.wsj.com/chinarealtime/2012/01/24/unpacking-the-law-around-the-chinese-reverse-takeover-mess/>.

McCoy, Kevin and Kathy Chu (2011). Merger of U.S. Chinese Firms is a Cautionary Tale. *USA Today.* Dec. 26.

McMahon, Dinny (2011). China Researcher Carson Block Captures Investors' Interest. *WSJ.com*. Web.

Norris, Floyd (2011). The Audacity of Chinese Frauds. *The New York Times*. Web.<http://www.nytimes.com/2011/05/27/business/27norris.html?pagewanted=all>.

NYSE Regulation, Inc. (2012). NYSE to Suspend Trading in Duoyuan Global Water Inc. Moves To Remove from the List. *Euronext*.

O'Toole, James (2012). Sino-Forest Sues Muddy Waters for Defamation. *CNNMoney*. Cable News Network, April.

PCAOB (2011). Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Regio*n:* Rep. no. 2011-P1.

Pearson, Rick (2010). Rino International: 6 Lessons for Investors. *The Street*.

Investopedia (2012) Pump And Dump. <http://www.investopedia.com/terms/p/pumpanddump.asp>.

U.S. Securities and Exchange Commission (2011). Securities and Exchange Commission Suspends Trading in the Securities of Rino International Corporation. <http://www.sec.gov/litigation/suspensions/2011/34-64291.pdf>.

Ricard (2012). Reviewing Due Diligence Procedures: Learning From Muddy Waters - Seeking Alpha. *Stock Market News & Financial Analysis*. Seeking Alpha, January Web.

Rivas, Teresa (2011). J Capital: China Green Agriculture Could Wilt. *Barron's*. January. Web. <http://blogs.barrons.com/stockstowatchtoday/2011/01/05/j-capital-china-green-agriculture-could-wilt/>.

Trader, Dutch (2011). Still In Love With U.S.-Listed China Stocks? - Seeking Alpha. *Stock Market News & Financial Analysis*. Seeking Alpha, October. Web. <http://seekingalpha.com/article/302192-still-in-love-with-u-s-listed-china-stocks>.

Trindle, Jamila (2011). SEC Tightens Rules for 'Reverse Merger' Listings. *The Wall Street Journal*.

Wachtel, Katya (2011). Here's the Time that Muddy Waters May Have Gotten a Chinese Fraud Totally Wrong. www.businessinsider.com.

When It Matters. *Business Source Premier*. EBSCO, (2011). Web.

<http://web.ebscohost.com.ezp.slu.edu/ehost/detail?vid=4&hid=17&sid=1b876ffba9054ff78964c930cbf51718%40sessionmgr10&bdata=JnNpdGU9ZWhvc3QtbGl2ZQ%3d%3d#db=buh&AN=64875311>.

Xie, Ye, and Nikolaj Gammeltoft (2012). Muddy Waters Loses Support in Market on Latest Calls. *Bloomberg*. February. Web. <http://www.bloomberg.com/news/2012-02-27/muddy-waters-losing-support-in-market-as-latest-calls-prove-inconclusive.html?cmpid=yhoo>.