



# THE ASIAN TIGER'S CAMOUFLAGE

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Once fraud is revealed, investor losses can be sudden and dramatic. When considering Asian investments, look beyond the audited financials.

A prominent British lord justice once remarked that the role of an auditor is that of a watchdog — not a bloodhound. Despite the reality of this observation, investors still often rely primarily on audited financial accounts to confirm the soundness of Asian companies they plan to invest in. Unfortunately, this approach can lead to sudden and dramatic losses.

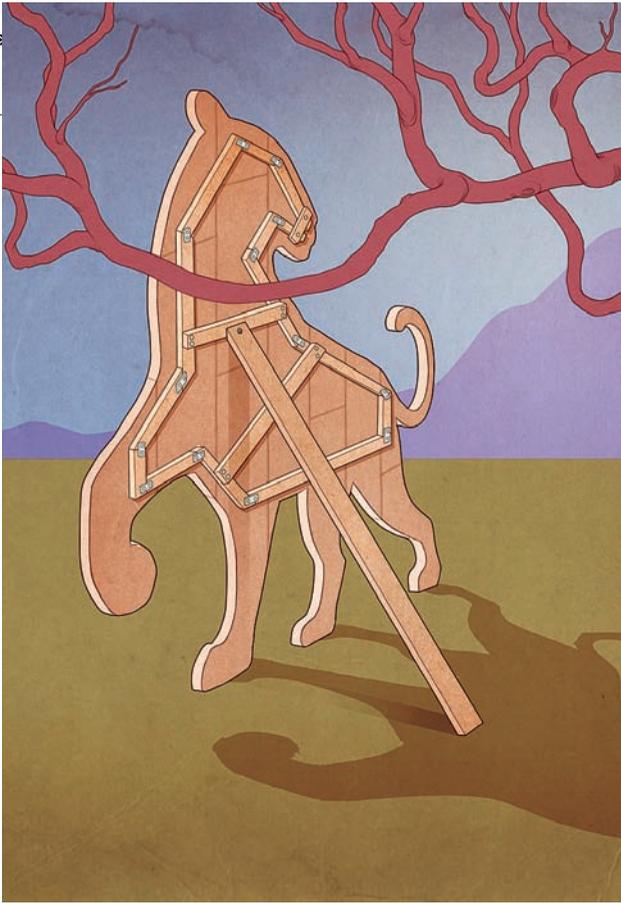
A few recent headlines underscore the danger:

- The Carlyle Group lost \$105 million after the Hong Kong Securities and Futures Commission suspended trading in China Forestry Holdings and brought criminal charges against its CEO.
- Shares of China Natural Gas plunged 59% after the company “restated earnings.”

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- Paulson & Co., one of the world's largest hedge funds, lost more than \$550 million after financial fraud was revealed at Sino-Forest.

Investors aren't always cognizant of the role of audit firms. These firms primarily serve to verify documentation behind financial statements, not probe for evidence of fraud. Many investors also make the perilous assumption that an Asian company listed on the Hong Kong, New York or other established exchange meets the same standards of disclosure as Western companies listed there. Moreover, investors don't usually have the resources needed to investigate a maze of jurisdictions and languages to verify a company's claims.

But the next big corporate failure has already happened. It just hasn't surfaced. When considering Asian opportunities — particularly in emerging markets such as mainland China, India, Indonesia, the Philippines and Thailand — investors need to conduct deeper and broader due diligence, beyond just reviewing audited financial statements. They need to scrutinize corporate governance and business structures, and examine in depth what lies behind the assets on the books.

#### WHAT TO LOOK FOR

Investors should dig deeply into these issues to vet opportunities and protect their interests.

#### CORPORATE GOVERNANCE

Look carefully at corporate governance structures. An Asian company may not have the clean segregation of duties between board, CEO and management that is common in the West. Family relationships and personal networks play an enormous role in Asia. In many ways, these relationships hold the society together. Reciprocal obligations with extended family, or even someone who hails from the same village or town, can be a counterweight to the more objective business decisions expected in the West. Many publicly traded companies, for example, began as family-run enterprises. Family and friends may sit on boards or even audit committees. It is also not uncommon for the head of a family to be both



CEO and chairman. Weak governance structures can allow for company investments to be based on family ties and needs vs. all shareholder interests.

#### COMPLEX BUSINESS STRUCTURES

Unnecessarily complex business structures may be designed to conceal inappropriate activities. For example, Peace Mark (Holdings) Limited, a Hong Kong–based watch manufacturer, distributor and retailer, collapsed in the wake of financial irregularities. When FTI Consulting investigated, we discovered that the \$900 million company had more than 300 corporate entities. The annual report disclosed 60. The complex group structure was being used to conceal various transactions and financial arrangements.

#### ASSETS AND HOLDINGS

It is crucial to verify the assets and holdings a company claims it has. Among the issues that led to suspension of trading for China Forestry: The company did not have the logging permits it claimed it did and the company also materially misstated its cash balances. China-Biotics, a provider of probiotics used as dietary supplements and food additives, reported that some 25% of its revenues came from 100-plus stores it owned and operated. Most did not exist.

Inventories and receivables are the asset types most often misstated by troubled companies trying to deceive stakeholders. There are countless

stories of companies in China financing the same purchase multiple times and making sales to parties that don't exist. Several companies may even pool inventories at audit time.

Reporting large levels of cash while increasing debt levels can be a warning sign. The company may be trying to conceal operating or other losses — or the cash may not have existed to begin with. Moulin Global Eyecare, a Hong

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Kong–listed company with operations primarily in China, shifted cash into a subsidiary from outside the group just before the financial year-end and then back out again immediately afterward. The purpose was to artificially inflate its consolidated cash balances.

Companies that regularly raise capital should also be scrutinized. Management may be trying to fund its way out of inherent operational weaknesses. More than one acquisition every two or three years is a red flag as well. The company may be trying to mask underlying financial problems by increasing the size of the business.

It is not atypical for Asian companies in financial trouble to misrepresent their assets and transactions. Western investors can be caught by surprise if they do not look hard for troubles before they commit. ■

The views expressed in this article are those of the authors and not necessarily those of FTI Consulting, Inc., or its other professionals.