Smooth criminal

Longtop Financial's (LFT.NYSE) downfall suggests fraud is far more widespread than most imagined

At first glance, the imbroglio that recently enveloped Longtop Financial Technologies bears a superficial resemblance to other instances of Chinese reverse-merger fraud: halted trading, short-seller pressure and the resignation of the company's auditor, Deloitte Touche Tohmatsu (DTT). But here the resemblance ends.

This financial software company is no small-cap nonentity. Longtop had a market cap of more than US$1 billion on the New York Stock Exchange (NYSE) when trading in its shares was suspended on May 18.

Short war

The company had issued shares to some of China's most prominent financiers, including Maverick Capital and Tiger Global, and its customer list included most of China's major banks and insurers. Seemingly confident in Longtop's potential for explosive growth, leading investment banks Goldman Sachs and Deutsche Bank took the company public in 2007.

Yet the company's share price was pummeled in the last few months as short-sellers, led by Citron Research, published claims that Longtop's results are fabricated. Among other accusations, the reports alleged that Longtop has used off-balance sheet transactions to prop up its hefty profit margins, and that its chairman's massive gifts of personal stock holdings to employees and friends were used to pay off hidden liabilities or generate undisclosed benefits.

Short positions were equivalent to roughly half of Longtop's public float – a huge ratio – when trading in the company's shares was suspended in late May, after Longtop announced that it would not report financial results on time.

Shorters' suspicions were seemingly validated on May 23, when Longtop released an announcement that its chief financial officer, Derek Palaschuk, and its auditor, DTT, had resigned.

Explaining its resignation, DTT stated that it had identified inaccuracies in Longtop's cash at bank and loan balances, and possibly in its recorded revenue. DTT also said that Longtop management had interfered in the audit process and unlawfully detained audit files. The case is now under investigation by the US Securities and Exchange Commission (SEC).

As this issue of China Economic Review went to press in May, the full scope of Longtop's transgressions was far from clear. But one thing seems certain: The company's stock price is unlikely to recover anytime soon.

ABOUT PORTFOLIO

The China Economic Review Company Reports team researches Chinese companies listed on US exchanges. Excerpts from these reports are published in the Portfolio section. In-depth reports are available for sale online. China Economic Review has no financial interest in and seeks no business relationship with any of these firms.

End of an era

Longtop's story looks likely to be a turning point in the ongoing saga of Chinese fraud. For one, the scandal has surely left investors skittish about the extent to which fraud permeates even into the rarified air of large-cap companies.

Some larger Chinese firms undoubtedly engage in the dodgy accounting practices of their smaller counterparts. Furthermore, recent scandals prove that Big Four auditors are not always able or willing to follow the muddy tracks.

In short, large-cap companies are no longer sacred – even those that trade on the hallowed New York Stock Exchange (NYSE), the US market with the strictest listing requirements. This realization among investors will surely translate into less liquidity for US-listed Chinese companies, and much bigger opportunities for savvy researchers and short-sellers. These parties could generate huge returns from shorting the shares of China's better-established companies.

It's likely that many more empires will crumble in coming months as researchers begin to scrutinize Chinese company performance and financials. Peter Humphrey, the CEO of forensic due diligence consultancy, ChinaWhys, estimates that fraud is far-ranging, even among China's largest companies.

"I would not be surprised if one-third of Chinese companies listed in the US have underlying fraud," said Humphrey.

Stock snapshot

Stock snapshot	May 20, 2011
Stock Price	US$18.93
52-week Range	US$16.70-42.86
Outstanding Shares	57.07 m
Avg. Daily Volume ('000)	1656
Dividend Yield	-
Market Cap	US$1.08 b
Enterprise Value	US$667.76 m
Current Ratio	4.13
P/E Ratio	-

Source: NYSE, company reports

Two-faced

The Longtop scandal is also notable as a sign of the growing sophistication of Chinese executives. Whereas some smaller-cap swindlers responded to short-seller reports with murder threats, Longtop launched a sophisticated public relations campaign.

The company triggered a temporary recovery in its share price by expanding its share repurchasing program by an additional US$50 million and minimizing the role of a contested third-party company in its human resources operations. Management also held a conference call to defend the company where it appeared to manage many of the fraud allegations adeptly.

In the past, critics have often claimed that Chinese executives lacked sophistication in tapping capital markets overseas. The case of Longtop provides evidence to the contrary: The company looks likely to have been far more sophisticated in defrauding investors than anyone realized.