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Can the short selling mechanism curb corporate financial fraud——Taking Muddy Waters Short Selling Huishan Dairy as an Example

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Abstract:

Integrity stands as the most valuable cornerstone of the market. Promoting the culture of integrity, establishing a long-term mechanism for integrity construction, and practicing honest management are fundamental prerequisites for the sustainable operation of enterprises. Financial fraud disrupts the entire market rules and integrity system, severely damaging the legitimate rights and interests of the public. This article analyzes the motives behind financial fraud in listed companies and highlights that the essence of such fraud reflects the will of the actual controllers of these companies. The motives behind financial fraud in listed companies need to be explored from both external and internal perspectives. The short selling mechanism can effectively curb financial fraud. Taking Muddy Waters' short selling of Huishan Dairy as an example, this article introduces the process of Muddy Waters' research and evidence collection regarding financial fraud at Huishan Dairy. As a result of short selling, Huishan Dairy paid a heavy price: the listed company was forced to delist, with a market value of 30 billion yuan vanishing. It was eventually reorganized, facing uncertain prospects. The findings of this case indicate that the short selling mechanism can effectively suppress corporate financial fraud, serving as a beneficial supplement to regulatory systems and a purifier that accelerates the exit of low-quality companies while protecting the legitimate rights and interests of investors.

Keywords: short selling mechanism, financial fraud, investigation methods,Huishan Dairy

1. Introduction

In recent years, regulatory authorities have continuously intensified their crackdown on financial fraud in the capital market. Data indicates that from 2021 to 2023, the China Securities Regulatory Commission handled a total of 397 cases of illegal information disclosure, including 203 fraud cases. Since 2021, over 150 criminal cases involving financial fraud, fund embezzlement, and other entities such as listed companies and bond issuers have been transferred to public security organs.

On the other hand, the number of A-share listed companies has surpassed 5,300, and the methods of financial fraud have become more covert. Related parties or third parties often collaborate to orchestrate systematic fraud, making the difficulty of investigation and punishment continue to rise. Traditional financial fraud supervision methods alone struggle to achieve real-time and full coverage. This necessitates the utilization of additional means and channels to effectively supervise listed companies and impose severe penalties on those who violate regulations or engage in irregularities, along with their shareholders. In reality, short selling has emerged as a mature model and an effective means of suppressing financial fraud in listed companies, commonly employed in foreign markets. By examining the case of Muddy Waters short selling Huishan Dairy, this article explores the potential of the short selling mechanism in supervising and suppressing financial fraud. It concludes that short selling can fully harness social forces, keeping listed companies constantly under the sword of Damocles and effectively curbing financial fraud.

2. Literature review

Hoffinan et al. (2006) conducted an investigation and analysis of the American Institute of Certified Public Accountants, and identified a series of cautionary messages regarding financial fraud.

In Ge Zhixing's (2013) study, the relationship between demand and supply quality was used to analyze current accounting information issues. He found three problems between the supply and demand of accounting: firstly, the company's financial system urgently needs to be upgraded and transformed; Secondly, the professional technical level of the company's financial personnel needs to be further strengthened; Thirdly, government departments and external supervisory agencies should strengthen their supervision and governance of companies.

In Hu Wenhan's (2015) study, it was pointed out that our certified public accountant auditors have the responsibility to investigate and deal with financial fraud in listed companies during the process of reviewing company financial statements. We also studied the ways and processes of financial fraud in listed companies.

Wang Li's (2017) research suggests that increasing the punishment for audit default and financial fraud by listed companies can effectively prevent corporate financial fraud.

Liu Yunliang (2016) believes that the improvement of a company's equity structure is the most effective way to curb financial fraud in listed companies. Listed companies need to improve their corporate governance structure by optimizing their internal equity structure, enhancing the ethical and professional qualities of their financial personnel, and preventing the root causes of financial fraud.

Ping Xinqiao (2017) believes that it is necessary to curb false reporting in financial statements from the following points, reform the salary structure of management personnel, reduce the temptation of financial fraud, and improve the audit and supervision mechanism of accounting firms.

Wu Liansheng (2017) summarized that the governance plan for the authenticity of accounting information includes strengthening responsibility arrangements, effectively implementing accounting supervision, and improving the quality of government and certified public accountant audits.

Li Hanyue (2015) pointed out that improving the company's internal control system is an important way to curb the occurrence of financial fraud. The two most important factors are controlling the environment and controlling activities. Therefore, when improving the internal control system, on the one hand, it is necessary to enhance the normalized management of company employees, promote a good corporate culture, and create a harmonious and rigorous internal control environment; On the other hand, it is necessary to improve the business authorization approval system, conscientiously implement the incompatible separation of duties system, and strengthen the protection measures for the assets and accounting information of the enterprise.

Liang Xiufen (2016) found that the key to suppressing financial fraud in listed companies lies in establishing an effective corporate governance system.

Zhang Yi and Ma Guang (2015) first proposed a new concept to curb financial fraud in Chinese listed companies.

Chen Guanting (2017) conducted a differentiated study on the pressure and opportunities in fraud factors, which showed that he suggested reducing the pressure on listed companies, strengthening supervision, and increasing the punishment for managers' professional ethics.

Yu Li (2017) proposed that the effectiveness of internal governance directly affects the healthy development of enterprises. Therefore, Yuan Yu believes that in order for

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listed companies to curb financial fraud, it is necessary to improve the internal environment of the company, so as to fundamentally reduce the probability of financial fraud.

Du Xingqiang (2014) believes that the country needs to introduce legal regulations to supervise the financial information of listed companies.

Jiao Yuehua and Qiu Qiyan (2016) suggest that companies should take into account their internal control mechanisms, equity structure, and compensation mechanisms for top management personnel, in order to solve the problem of listed companies monopolizing the securities market and fundamentally prevent financial fraud. The false reporting of financial information is closely related to internal management personnel and requires top-level organizational staff.

Xiao Shiqing (2015) believes that it is necessary to change the salary structure of management personnel, reduce the temptation of financial fraud, and improve the audit and supervision mechanism of accounting firms.

Li Wei'an's (2016) study found that the key to curbing financial fraud in listed companies lies in establishing an effective corporate governance system.

Zhu Kongyang (2015) first proposed a new concept to curb financial fraud in Chinese listed companies through field investigations and research.

3. Advantages of Short Selling Mechanism over Traditional Financial Fraud Supervision System

3.1 Short selling institutions have a high degree of independence

The profits of short selling institutions come from the recognition of financial fraud by the investigated companies, and their stock prices quickly fall to achieve large profits. Therefore, short selling institutions naturally have a relative relationship with major shareholders and management, and have the motivation to tear apart the corporate veil. Compared with audit institutions, they have a high degree of independence.

3.2 More Adequate Investigation Time

There are numerous listed companies in our country, and due to factors such as manpower and costs, regulatory authorities are unable to conduct comprehensive investigations and it is difficult for them to investigate a company for a long time. The purpose of short selling institutions is to find sufficient evidence to prove the existence of fraud and ensure the success rate of short selling. They can track the changes of a company for a long time, visit and research upstream and downstream enterprises, etc. They have low sensitivity to time and only seek clear investigations and comprehensive information, because once short selling fails, they will suffer large losses.

3.3 More flexible investigation methods

Although short selling institutions do not have administrative power like regulatory authorities, they do not have the authority to require companies to cooperate with investigations, provide relevant account sets, materials, etc. However, the means they can take are more flexible. Through traditional methods such as reviewing listed company announcements, official websites, media reports, etc., they can carefully read and discover suspicious points. For a company that has engaged in fraud, if they want to deceive the world and create a seamless lie, the cost of fraud will be very high. Moreover, it is also quite difficult to achieve consistency over a long period of time. There may be some loopholes that may seem fine at first glance, but with the expansion of information search scope, they will discover connections in different information in the future, resulting in numerous loopholes. After identifying the doubts, methods such as field research and interviews can be used to further explore and find empirical evidence.

4. Case Study of Huishan Dairy

4.1 Introduction to Huishan Dairy

Huishan Dairy is an established dairy product enterprise, founded in 1951 and headquartered in Shenyang. It has established ranches, dairy factories, and other facilities in various parts of Northeast China to achieve full industry chain integration. In 2013, it successfully listed on the Hong Kong Stock Exchange and became a white horse stock in the market due to its superior profitability compared to its peers. In 2017, it was continuously shorted by Muddy Waters and its market value plummeted.

4.2 The whole story of the Huishan Dairy incident

In December 2016, Muddy Waters released its first short selling report, pointing out fraud in alfalfa self-sufficiency rate and gross profit margin, resulting in a slight decline in stock price.

In March 2017, a short selling report was released again, and at the same time, a bank audit found that the documents were falsified. During this period, some financial institutions still provided additional support.

On March 16-17, 2017, major shareholders Yang Kai and

Ge Kun significantly reduced their holdings and cashed out 400 million yuan.

On March 23, 2017, the Liaoning Provincial Government held a creditors' bank meeting, which is expected to involve an amount far exceeding 10 billion yuan.

On November 16, 2017, Huishan Dairy announced that its comprehensive net liabilities as of March 31, 2017 may reach RMB 10.5 billion. In view of this, the company has entered a temporary liquidation and will consider all available options as much as possible to preserve the group's assets.

The Hong Kong Stock Exchange placed the company in the second and third stages of the delisting process on September 27, 2018 and May 3, 2019, respectively. The Hong Kong Stock Exchange stated that Huishan Dairy did not submit any resumption proposals before the third phase of the delisting process expired on November 15, 2019. Therefore, the Hong Kong Stock Exchange has decided to cancel the listing status of the company's shares on the Hong Kong Stock Exchange.

4.3 The investigation process of Muddy Waters on income and profit

In addition to its traditional advantage of conducting field research and collecting evidence, Muddy Waters also utilized a large amount of data analysis and identified logical loopholes in Huishan Dairy to support its investigation results.

4.3.1 Muddy Waters entry point: significantly higher gross profit margin than peers

Huishan Dairy has revealed that its gross profit margin exceeds 55%, far surpassing its peers such as Yili, Mengniu, and Guangming. Its explanation is that it is self-sufficient in alfalfa, does not need to purchase alfalfa from third-party suppliers, and can save long-distance transportation costs, resulting in high gross profit margins and lucrative profits. Therefore, the first investigation of Muddy Waters points to the authenticity of alfalfa self-sufficiency.

(1) Field research: Visited 35 ranches and 5 production facility bases, and the results showed that the alfalfa used to feed cows on a ranch was imported from the United States and the alfalfa packaging was labeled as a product of a certain brand in the United States; In addition, through drone photography, there are no signs of construction at the two production bases.

(2) Visited suppliers: Communicated with alfalfa suppliers and importers, some suppliers stated that Huishan is their customer, and one American supplier stated that their supplier accounts for half of Huishan Dairy's batch production.

(3) Undercover visits to grassroots employees: Undercover visits to grassroots employees of 9 ranches, indicating that Huishan purchases alfalfa from overseas and third-party sources.

(4) Industry common sense: Many pastures in Huishan are located in Liaoning, and Northeast China is not a suitable place for alfalfa growth.

In addition, Huishan claimed to intentionally lower the average milk production per lactating cow when the terminal raw milk price fell, reducing the energy intake of each lactating cow and lowering feed costs, thereby increasing profit margins. Experts hired by Muddy Waters believe that this approach is contrary to past practices and may lead to a decrease in profit margins.

4.3.2 Logic of Revenue Growth

In order to make fraudulent behavior more sustainable, Huishan Dairy constantly changes its revenue growth logic, claiming at the beginning of its listing that its milk single production is high; The annual report of fiscal year 2016 declared that "'Internet plus' has led us to create a miracle of selling liquid milk in the depressed dairy market."; In the first half of the 2017 fiscal year, it claimed that the average selling price of its raw milk was higher than all competitors in the market, resulting in an increase in its sales revenue due to the increase in average selling price. The following investigation methods were used to verify the authenticity of this turbid water:

(1) Data analysis: Comparing Huishan Dairy with the average milk production of dairy cows, the average milk production of dairy cows in China in 2012 was 5.8 tons, while Huishan's annual report for 2014 showed 9 tons.

(2) Field investigation: The hardware facilities of the dairy farm are poor, the farm is barren, disorderly, and the roof is dilapidated. The construction of dairy sheds and related facilities, as well as the growth environment and living conditions of cows, can affect milk production.

4.3.3 Reference and Inspiration

(1) The starting point of the questioning and argumentation of Muddy Waters is also the surface anomaly point. In addition to the gross profit margin being contrary to industry rules, there are also some operations that go against common sense and business logic. It is not a deeply buried logical difference, but these surface anomaly signals can often trigger a whole body to uncover the true purpose behind the enterprise.

(2) The research on turbid water is actually a traditional combination of material analysis, field research, and interviews, without many innovative methods. However, the most primitive and effective approach is often long-term tracking, due diligence, and obtaining real data.

(3) It is easy for a company to fabricate a lie when it

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comes to analyzing accounting subjects, just as it likes to cross check each other to verify their rationality. However, it is very difficult to achieve seamless integration between this lie and other information.

5. The effectiveness of short selling mechanism in suppressing financial fraud

Short selling mechanism, as a market-oriented supervision, is a supplement to the regulatory system, a purifier to accelerate the clearance of inferior companies, and a driving force to urge companies to improve their governance capabilities. Once short sold, the company's market value will significantly decline, and even close down directly. Compared with administrative penalties, the actual losses caused by short selling are greater, and the deterrent effect on enterprises is sufficient. Therefore, it can urge enterprises to establish a sound internal control system and suppress fraud.

Short selling institutions have flexibility and concealment in their selection of targets. Listed companies cannot predict in advance whether they will be selected, and are in a passive position, constantly under threat, which has a certain inhibitory effect on the motivation for corporate fraud.

Short selling has reduced information asymmetry in the market. In China, with the comprehensive implementation of the registration system and the promotion of the collective litigation system, relevant short selling mechanisms are gradually being introduced. The introduction of short selling mechanisms makes it more convenient for investors to vote with their feet, suppress stock prices, and once financial fraud is found to cause losses to investors, they can be compensated through collective litigation in the future, greatly increasing the cost of gambling on corporate fraud.

Although the short selling mechanism has a certain inhibitory effect on financial fraud, based on historical experience, short selling is also a double-edged sword. Short selling when stock prices fall can trigger further stampede effects, leading to unreasonable oversold of stock prices and even market crashes. Therefore, the use of short selling mechanisms must fully consider China's national conditions and market conditions, flexibly use short selling as a tool, and leverage the advantages and roles of short selling within a controlled and regulated institutional system to ensure the healthy and prosperous development of China's securities market.

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