

# S-CHIPS MOVING INTO THE FUTURE

**F**rom a small bourse in 1999 to the second-largest listed bourse in Asia, the rise of the Singapore Exchange (SGX) is remarkable. Today, it is a well-regarded Asian gateway comprising about 40% listed foreign companies. Half of this 40% consists of S-chips or companies incorporated in mainland China.

The mix of foreign and local listings adds diversity, and affirms Singapore's standing in the financial industry. However, in recent years, there has been an increasing number of S-chip companies falling foul of the Listing Rules. Their accounting irregularities and debt issues have resulted in share suspensions which not only affected various stakeholders, they have tarred the reputation and performance of other S-chip firms with the same brush.

In retrospect, what went wrong? What were the challenges faced by S-chip companies and/or the business environment? We invited stakeholders from different areas of expertise to give their views on the lessons learnt, and how the industry can deal with these problems. The wisdom of hindsight will hopefully provide the guiding principles of how to do things better going forward.

## OVERVIEW

### What went wrong?

**DR LEE:** To put things in perspective, it is useful to understand the frequency and scale of S-chip listings in Singapore. Based on the SGX monthly market statistics,

on average, there are about 152 China companies out of the 780 companies listed on SGX, or about 20%. In terms of market capitalisation, S-chips constitute around 5% of the market capitalisation of all listed firms in Singapore. Furthermore, the average market capitalisation of S-chips is about S\$300 million, which is significantly lower than the average market capitalisation of S\$1.1 billion of a typical SGX-listed firm.

The recent controversies relating to the S-chip firms can be broadly classified into two categories – alleged fraudulent financial accounting practices and general economic decline in the business performance, which subsequently resulted in the deterioration of financial health, and in extreme cases, leading to going concern issues. Naturally, news of the alleged fraudulent financial accounting practices, such as by Fibrechem Technologies, SINO Techfibre and China Hongxing, dominated the financial press. A large proportion of the alleged fraudulent financial accounting practices involved understated cash balances, fictitious accounts receivables, fraudulent revenue recognition and excessive payment to suppliers. It seems that the alleged fraud methods involved basic operational issues relating to the firm such as the sales cycle, cash management and product procurement process rather than complex and sophisticated schemes.

**MR TENG:** In 2008/2009, the world went into economic recession amid the most severe financial crisis in recent memory. Singapore saw its share of business failures in the financial downturn mainly due to poor business conditions, liquidity issues and excessive financial debts.

## PANELLISTS



**Mr David Gerald**  
President & CEO,  
Singapore Investors  
Association (Singapore)



**Dr Lee Kin Wai**  
Assistant Professor,  
Division of Accounting,  
Nanyang Business School,  
Nanyang Technological  
University & Member  
of ICPAS Corporate  
Governance Committee



**Mr Henry S K Tan**  
Managing Director,  
Nexia TS Public Accounting  
Corporation; Chairman,  
Nexia China, and Asia  
Pacific Chairman and  
International Board Member  
of Nexia International



**Mr Richard Teng**  
Head of Regulation,  
Singapore Exchange



**Mr Yeo Boon Chye**  
Head of Assurance,  
Foo Kon Tan Grant  
Thornton LLP





# In Depth

There were also cases where controlling shareholders pledged their shares for personal loans and failed to repay their debts, hence causing uncertainty with regard the ownership of the company. The media also highlighted a handful of irregularities among S-chip companies.

Since 2008, we have heightened vigilance and called on the industry to do further due diligence work. There were about 14 cases of listed companies with irregularities since the beginning of 2008. It is evident that these irregularities were not confined to S-chips or even to Singapore alone. In current times, we continue to read from the international media that listed companies worldwide have succumbed to financial difficulty and irregularities.

**MR YEO:** As a practitioner, I believe that sound and fundamental corporate governance may not have been adequately addressed by those who are in charge of corporate governance for S-chips. In particular, the operational policies and procedures may not have been effectively carried out.

## How have these irregularities impacted the industry?

**MR GERALD:** SGX has been continually improving the Listing Rules and pushing for better corporate governance standards among all listed companies. With respect to S-chips, SGX has also required these companies to amend the Articles of Association so as to make it easier to change the local representative in China. While this is an attempt to improve matters, I feel that it does not go far enough.

**DR LEE:** Shareholders suffered losses arising from the decline in value of their equity investments. If the fraud is severe and the company is delisted, there may be very little left for shareholders. Existing suppliers of debt capital typically demand

immediate repayment of the debt when the borrower defaults on its debt obligations. To the extent that the debt is secured or collateralised against tangible assets of the borrower, the existing suppliers of debt capital can probably recover part of their debt. However, if the borrower's collateralised assets are located in another country with different legal enforcement regimes, this is likely to pose substantial challenges to the lenders. In addition, plans to restructure the company after the announcement of the alleged fraud are likely to be derailed as potential suppliers of debt capital will shy away.

**MR TAN:** An "unhealthy" significant impact on the capital markets is that all S-chips are treated equally as black sheep, depressing their valuation and liquidity. This will exaggerate the existing problem and some otherwise good S-chips will also get into trouble. The market is merciless, once an opinion is formed, the price can only go one way – down. Restoring market confidence is a huge and costly exercise. Many of the better-run companies have started to explore other markets. More recently, Taiwan, Korea and Malaysia have come in as alternative markets for S-chips other than the usual listing in Hong Kong. Quite likely, there will be a hollowing out of S-chips in Singapore over the long term.

## AUDITING AN S-CHIP COMPANY

**In general, what are the challenges in auditing a company with business operations conducted and maintained in mainland China?**

**MR TAN:** Language and culture could be an issue. Also, the expectations of an auditee or an auditor are generally different in China. An example is that auditors are generally expected to extend a lot of help including some

form of accounting assistance as their Chinese counterparts may not be very familiar with the International Financial Reporting Standards (IFRS), and this may create an independence issue.

**MR YEO:** As practitioners are expected to carry out an audit with scepticism, auditing an S-chip company that has business operations in mainland China has become very challenging and demanding. In addition, to gain comfort that the financial numbers are reasonable and meaningful, a sanity check is expected to review non-financial data and the business environment vis-à-vis the industry.

**Traditionally, were there any significant differences in performing an audit for a Singapore-based**





**company and an S-chip or a China-based company?**

**MR TAN:** One of the key procedures in auditing an S-chip is to audit the people behind the company at the start of the audit. Once we are familiar with who the people are, their integrity and the values they represent, audit risk is reduced significantly. Audit procedures typically include more direct verifications or face-to-face verifications with third parties, and do not rely solely on written confirmations from third parties. Sample sizes and the audit coverage are also higher as compared to what is being done in Singapore-based company audits.

**MR YEO:** Certainly, the audit of an S-chip requires the practitioner to

be more attentive and to give due consideration when expressing an opinion on the financial statements. There may be questions over the extent of related-party transactions and their relationships; large cash and bank balances, or huge bank borrowings and the collaterals attached.

**Since the recent spate of accounting irregularities uncovered among S-chip companies, what changes, if any, have been introduced to the scope of audit performed for China-based companies?**

**MR TAN:** More stringent procedures and sample sizes are used. The scope of audit on significant components is more extensive now, for example, in the audit of cash existence, revenue

recognition, receivables existence and collectability. Procedures including visits to banks, customers and suppliers are common procedures in an S-chip audit. More detailed control testing despite non-reliance on the company's controls is generally carried out as well.

**MR YEO:** The recent spate of accounting irregularities uncovered in S-chips are found mainly in areas like related-party transactions including unapproved advances and loans made, insolvency due to bank creditors making demand





call, irregularities in customers and suppliers, and untrue bank balances. Distortions and irregularities found in related-party transactions are common problems found not only in S-chips but also among companies in other regulated jurisdictions. The heightening of audit expectations requires the practitioner not only to have the business knowledge of the S-chip but also to conduct a thorough review of the transactions entered into with extended scope. This may include a review of the business model to provide an assessment on whether the extent

of profit is meaningful based on the available resources of the S-chip and the industry in which it operates. A comparison of similar businesses within China is also a critical step which must not be overlooked.

### INVESTORS' CONFIDENCE IN S-CHIPS

**One of the challenges that S-chips are collectively facing is their share valuations. What are the measures or strategies that can help strengthen investor confidence in S-chips?**

**MR GERALD:** Singapore already has a good environment for upholding good governance. In the last ACGA<sup>1</sup> survey, Singapore was the highest rated in Asia.

Nevertheless, as mentioned above, regulators have taken further measures to try and improve the governance of S-chips.

**DR LEE:** The rapid and significant decline in stock prices when S-chip scandals were highlighted showed that investors were generally unaware of the impending bad news. When investor confidence is dented, the decline in stock price can persist over a long period. Thus, it takes substantial time and effort to restore investor confidence. The problem is especially severe if the alleged fraud involves top management such as the CEO. If senior management colludes to commit and conceal fraud, that is, if the tone from the top is wrong, it is very difficult to detect the fraud.

<sup>1</sup> The Asian Corporate Governance Association (ACGA) is an independent, non-profit membership organisation dedicated to working with investors, companies and regulators in the implementation of effective corporate governance practices throughout Asia.

## WE WILL CONTINUE TO WORK CLOSELY WITH OUR REGULATORY AND ENFORCEMENT AGENCIES IN EACH INVESTIGATION

Many S-chip firms with alleged fraudulent financial accounting practices subsequently undertake to improve their corporate governance structures. However, the critical question is whether investors perceive such changes in the corporate governance and internal controls to be sufficient to prevent future fraud. The substantial price discount imposed by investors on the alleged fraudulent firms indicates that investor confidence (once eroded by the fraud) may require a substantial period to be restored.

**MR TAN:** Profile and give more exposure to S-chips that have performed well and have good corporate governance. Such exposure will encourage them and their professional service providers. Separately, we could introduce more training for S-chip directors and CFOs on governance, controls and other SGX legal requirements. We could also consider having the SGX publish these companies' internal controls review report and extent of procedures, especially in the areas of cash, receivables and inventories balances. This will enhance transparency and reinforce that these companies are serious in addressing investor confidence. Confidence can only be restored by trust and transparency.

### REGULATORY, ENFORCEMENT REGIME IN SINGAPORE

**SGX has suggested several measures to improve corporate governance practices. In your view, have**

**these been effective in improving corporate governance of S-chips?**

**MR TENG:** SGX has tackled the issues head-on. We took unprecedented steps to manage emerging risks. We alerted boards, issue managers, and audit and legal professionals to be vigilant about risks. Directors, key management and auditors form a critical component of the ecosystem in safeguarding the integrity of the marketplace. We have publicly disciplined listed companies which breached the Listing Rules. Where there are allegations of irregularities, we will direct the boards to appoint Special Auditors to look into the matter. In the case of directors and CFOs, SGX will review whether they have discharged their duties and taken action where there have been lapses. We will continue to work closely with our regulatory and enforcement agencies in each investigation. As with the listing framework of leading markets, issue managers are responsible for conducting thorough due diligence to confirm that listing applicants are able to comply with the requisite requirements. We have sanctioned issue managers whose standards have fallen short. If other professionals, such as auditors and financial advisers, have not discharged their duties with due care, we will refer them to the relevant regulatory body for necessary action.

In September 2011, we announced amendments to the Listing Rules to strengthen corporate governance practices and foster greater corporate disclosure. These amendments are undertaken to keep abreast of the

challenges and developments in the industry and are part of SGX's ongoing efforts to enhance the quality of the marketplace. In view of the current market environment, boards and market professionals should continue to be vigilant. Efforts from all stakeholders are required for Singapore to uphold our high corporate governance standards.

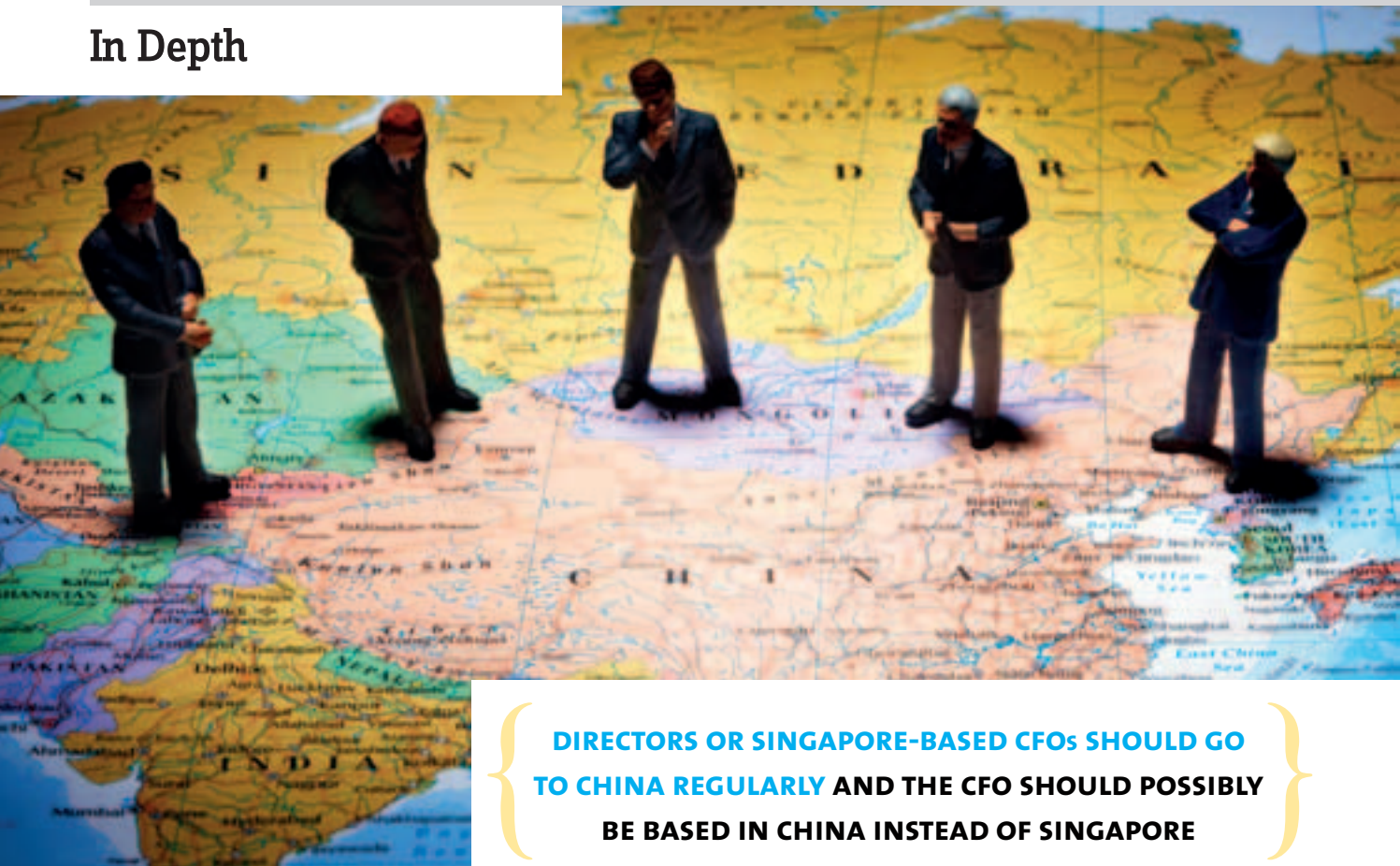
No amount of regulation can eliminate fraud or misconduct. Constant surveillance and strict enforcement are critical to minimise such occurrence. We will continue to work closely with our regulatory and enforcement agencies to pursue actions against wrongdoings. A recent example was the case of Daka Designs where SGX played an active role and cooperated with Hong Kong's regulatory agencies including its Independent Commission Against Corruption (ICAC) to pursue disciplinary actions against the wrong doers. The former senior executives of Daka Designs have been charged by the ICAC with conspiracy to defraud, and appropriate enforcement actions will be accorded.

The Exchange is conscious of the need to maintain high listing standards and good corporate governance. All market participants have their respective roles to play in our financial ecosystem. We will do our utmost to fulfil our responsibility. Other stakeholders – audit and legal professionals, issue managers, and directors – must also complement the efforts of the Exchange.

### MOVING FORWARD

**What would be your advice on the red flags or areas to watch out for that would indicate heightened risk in a company?**

**MR GERALD:** In my experience, if the Sino Environment case is anything to



**DIRECTORS OR SINGAPORE-BASED CFOs SHOULD GO  
TO CHINA REGULARLY AND THE CFO SHOULD POSSIBLY  
BE BASED IN CHINA INSTEAD OF SINGAPORE**

go by, investors and auditors must seek ways to authenticate the cash and assets of the company in China, especially if false banking records are a possibility.

**DR LEE:** Equity investors, suppliers of debt capital and analysts rely heavily on publicly available information such as audited financial statements to make business decisions. Based on my analysis of listed companies with alleged financial accounting fraud, typical warning signals or red flags include very high sales growth relative to growth in accounts receivable, large gap between net income and cash flow from operations, high fraction of intangible assets relative to total assets, increasing indebtedness (such as debt-to-equity ratios) and declining profitability. Besides time-series comparison,

these financial ratios should also be benchmarked against industry peers to get a better understanding of the company's financial performance.

**MR TENG:** Exchanges are conduits for risk-taking. It is a platform for companies to raise funds from the public, and for the public to take advantage of investment opportunities. Like other markets, our stock market operates under a predominantly *caveat emptor* regime. This means that investors should be fully apprised of risks when undertaking investments, and take responsibility for the outcomes. In order to make better investment decisions and to reap the rewards, investors need to understand both the inherent investment and business risks. Even with the best in disclosure and transparency, investors can make

informed decisions only if they have the knowledge and skills to do so.

**In your view, what are the key safeguards to ensure properly-governed S-chip companies, or companies with operations based in China?**

**MR GERALD:** There is a current review of the Corporate Governance Code in Singapore. All listed companies will have to comply with this new code. I believe that we will see more rights for shareholders being put in place. As the bar for corporate governance is raised, I have no doubt that the standards for all companies will also be raised. This is one way of improving the prospects of not just the S-chips but of all companies in Singapore.

**DR LEE:** At present, the S-chip firms are substantially smaller (in terms of average market capitalisation) than other firms. Existing finance studies



find that information opacity is more severe in smaller firms, that is, there is higher information asymmetry between external investors and corporate insiders in small firms. This problem is exacerbated by the lack of financial resources, which may impede the investment in good accounting systems and strong internal controls. Thus, it may be a good idea if we can attract the larger S-chips with more financial resources as these firms have more ability to invest in good accounting systems and strong internal controls.

**MR TAN:** Having experienced and qualified independent directors will ensure that the tone at and from the top is set right. They will work towards having a good set of professionals, key procedures and risk management. A strong and qualified internal audit team is also very important and this has to be reported clearly. Directors

or Singapore-based CFOs should go to China regularly and the CFO should possibly be based in China instead of Singapore. Names of S-chips that have scandals, together with their audit firm's name, can be disclosed publicly to ensure that care is taken by auditors when accepting clients.

**MR TENG:** For all listed companies, regardless of their country of origin, directors are best placed to safeguard assets of listed companies through establishing a robust and comprehensive framework of governance, accountability and control. Each board will need to review and assess the efficacy and adequacy of practical measures over the listed company's cash and other critical assets in view of changes in the operating environment, business activities undertaken as well as longer-term plans. Where necessary, professionals

should be engaged to determine whether enhancements to governance and controls are needed. Directors are reminded of the importance and their role in maintaining a strong control culture, and to conduct stringent checks to safeguard assets. SGX will continue to keep its rules and processes relevant to market needs, and engage stakeholders on regulatory compliance and corporate governance matters.

**MR YEO:** Continued training and establishment of a proper protocol of sound corporate governance is important to S-chips to understand what is meant by accountability and responsibility to the stakeholders when they are listed in jurisdictions outside their own country.

This article was contributed by ICPAS Technical division under the initiative of the ICPAS Corporate Governance Committee.

# PIT

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### PIT Software Pte Ltd

Address : Block 15, Toa Payoh Lorong 8, #04-01 Braddell Tech Singapore 319262

Telephone: **(65) 62537409**

Fax: **(65) 62523044**

Email [pitenquiry@softpro.com.sg](mailto:pitenquiry@softpro.com.sg)