

Study on Shorting Mechanism to Promote the Construction of Internal Control System of Listed Companies

—Based on Muddy Waters' shorting of Huishan Dairy Perspective

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ABSTRACT

In order to explore the promotion effect of shorting mechanism on the internal control of listed companies, this paper takes Muddy Waters' shorting of Huishan Dairy as an entry point to explore the internal control deficiencies faced by Huishan Dairy in the event. The analysis shows that the enterprise has problems such as fragile control environment, imperfect risk assessment system, poor implementation of control activities and lack of internal supervision. In response to these problems, this paper puts forward a series of optimization strategies and recommendations, aiming to provide valuable reference and reference for enterprises in the same industry to strengthen the construction of internal control, and help enterprises to build a more solid management cornerstone.

KEYWORDS

Internal control; Short-selling mechanism; Risk assessment

1. INTRODUCTION

In recent years, with the rapid development of China's capital market, the number of listed companies has been growing year by year and market transactions have become increasingly active. However, along with the new market environment and economic situation come problems such as financial fraud of listed companies and manipulation of companies by major shareholders. Against this background, short-selling mechanism, as a means of market discipline, has gradually been emphasized. This paper takes Muddy Waters' shorting of Huishan Dairy as an example, analyzes the deficiencies of Huishan Dairy's internal control and puts forward corresponding optimization suggestions to provide reference for listed companies in the industry to improve the construction of internal control system.

2. INTRODUCTION OF HUISHAN DAIRY'S CORPORATE BACKGROUND AND EVENTS

2.1. Huishan Dairy Company Background

Established in 1951, China Huishan Dairy Holdings Limited (hereinafter referred to as "Huishan Dairy") is a company engaged in the production and sale of dairy products, which has gradually developed from an ordinary cattle farm to become the leading dairy products company in China. During this period, Huishan Dairy has always adhered to the corporate philosophy of "building China's most trustworthy dairy brand", and has created a whole industry chain model of "from farm to table". Its whole industry chain development model involves nearly 80 enterprises, from 2010 to

2012 Huishan Dairy net profit continued to grow, the growth rate of up to 110%, it is by virtue of the enterprise's successful business philosophy and high-speed performance growth, on September 27, 2013, Huishan Dairy in the Hong Kong Stock Exchange main board successfully listed, IPO raised a total of 1.3 billion U.S. dollars, the company on the first day of the market capitalization of 5 billion U.S. dollars, once became Hong Kong's first-ever dairy brand, and the company has become the largest dairy company in the history of Hong Kong, and the largest dairy company in China. The company's market capitalization reached US\$5 billion on the first day of the IPO, making it one of the top three initial public offerings in the consumer goods industry in Hong Kong's history.

2.2. Introduction to the Pfizer Dairy Incident

However, when Huishan Dairy was developing rapidly, in 2016, Muddy Waters, a well-known U.S. shorting organization, released several shorting reports on Huishan Dairy, arguing that Huishan Dairy had financial falsifications, and on December 16th, Muddy Waters released its first shorting report, directly pointing out that Huishan Dairy was a "fraudulent company" and citing a series of evidence of falsely increasing Muddy Waters released its first short-selling report on December 16, calling Huishan Dairy a "fraudulent company" and citing a series of evidence of inflated profits, capital accumulation inconsistent with reality, and asset transfers. Huishan Dairy responded by saying that Muddy Waters' allegations were unfounded, unrealistic, malicious and false. However, the report still caused Huishan Dairy's stock to be suspended in an emergency, and before the suspension, it was reported at 2.75 yuan, down 2.135 percent. On December 18, Muddy Waters released its second short-selling report, stating that the tax returns returned by the tax department showed that Huishan Dairy's sales figures were grossly inconsistent with the actual situation. In response to this accusation, Huishan Dairy quickly made a second clarification, releasing two announcements at the same time. The first clarification announcement pointed out that the company's aggregate gross sales revenue did not differ from that of the State Administration of Taxation and that it was compiled in accordance with International Financial Reporting Standards (IFRS); the second one was a stock increase announcement, in which it added value to 210,067,000 shares at an average price of HK\$2.79, thus once again demonstrating to the outside world its confidence in the operation of the company.

Although the two short-selling reports did not immediately crush Huishan Dairy, they had an irreversible negative impact on its corporate image, with several creditors investigating the company's financial situation and determining that the funds were indeed uncollectible. on March 23, 2017, Huishan Dairy voluntarily admitted in a joint meeting that the company's financial chain was broken, thus triggering the second precipitous drop in its share price. Towards midday, Huishan Dairy's share price rapidly fell by at least 85% to close at only HK\$0.42, and its market value instantly evaporated by about HK\$32.2 billion. During the period, Huishan Dairy tried to complete self-help by introducing reorganization parties and asset divestment, but in the end, they all came to nothing. Finally on December 23, 2019, the listing status of Huishan Dairy was canceled. In summary, Muddy Waters' short-selling behavior this time was very successful, accusing Huishan Dairy of having many false information in its financial statements over the years, and despite Huishan Dairy's attempts to recoup its losses, it still didn't change the end of the company's eventual delisting.

3. CURRENT STATUS AND PROBLEMS OF INTERNAL CONTROL OF HUIZHAN DAIRY

3.1. Control Environment

3.1.1. Shareholding structure

Huishan Dairy has a relatively concentrated shareholding. According to Huishan Dairy's financial reports for 2014-2016 (Table 1), the largest controlling shareholder of the enterprise is Champ

Harvest Limited (Champ Harvest), and two board members of Huishan Dairy-Yang Kai and Ge Kun-hold 100% of Champ Harvest's equity and control 72% of Huishan Dairy's equity, thus They are also the de facto controllers of Huishan Dairy and enjoy a high degree of say in the company's decision-making.

The board of directors of Huishan Dairy consists of four members: audit, remuneration, nomination, and food quality and safety consulting, and there is no independent supervisory board or other supervisory body in the organizational structure; only an internal audit department is set up under the finance department, which serves as an internal audit supervisor of the enterprise, but this setup has greatly weakened the independence of the internal audit. In addition, Yang Kai, the largest shareholder of the enterprise, is the chairman of the board of directors and the chief executive officer at the same time, and there is no corresponding supervisory department to restrain him. To sum up, the unscientific setup of the organization has laid a hidden danger for the enterprise's financial fraud.

Table 1. Shareholdings of major shareholders of Huishan Dairy, 2014-2016

Stockholder	Number of shares held (in 10,000 shares)	Shareholding (%)
Koon Fung Co.	980919.23	72
Ping An Bank of China corporation	379200	28

Source of data: Huishan Dairy Annual Reports 2014-2016

3.2. Risk Assessment

3.2.1. Lack of risk early warning mechanisms

In 2017, Huishan Dairy's balance sheet showed 16 billion yuan of debt, 70% of which were short-term liabilities to be repaid within one year, coupled with unfinished ranch construction projects resulting in a tight capital chain. In the face of the shortage of funds, the company adopted the issuance of high-interest short-term financial products to raise funds, however, instead of solving the problem at all, these initiatives further aggravated the financial burden due to the inverted financial product yield (i.e., the interest rate paid to investors is much higher than the company's own financial returns). In addition, the company also frequently adopted the financial leasing strategy of sale-and-leaseback, which continuously pushed up financial leverage and exposed the enterprise to extremely high risks of debt repayment on maturity, while this series of abnormal conditions failed to attract the attention of the management and the finance team, which emphasized the lack of risk warning mechanism.

3.2.2. Gaps in risk controls

At the risk control level, although Huishan Dairy has established a risk assessment mechanism based on departmental divisions and has formulated a relevant system requiring the regular investigation and reporting of risks, in practice, due to the isolation of departments and the lack of information flow, it is difficult to effectively integrate the results of risk assessment, which has resulted in the obstruction of the implementation of risk control measures. More critically, the enterprise failed to formulate detailed preventive strategies for potential risks, and there were obvious loopholes in the risk control mechanism, making it impossible to effectively respond to market changes and uncertainties in internal management, which ultimately exacerbated the company's financial difficulties.

3.3. Control Activities

3.3.1. Inadequate control of debt size

The financial report of Huishan Dairy shows that the current liabilities of the company increased year by year from 2013 to 2016, and after 2015, the current liabilities of the company exceeded the current assets and showed a trend of gradual growth (Table 2). Although current liabilities can solve the company's capital needs at the fastest speed and provide financial support for the company's operation, in the long run, there is a huge operational risk. Until the first half of 2016, the total current assets of Huishan Dairy were only 13.992 billion yuan, while the total current liabilities had reached 15.863 billion yuan, creating a negative gap of nearly 1.9 billion yuan. The current ratio, as an important indicator of the short-term solvency of enterprises, has fallen below 1 since 2015, reflecting the obvious deterioration of capital liquidity. Meanwhile, the sharp rise in the gearing ratio, which jumped from 37.73% to 62.07%, further warned of the decline in the enterprise's solvency and increased the risk of capital chain breakage that might be triggered by the failure of short-term debts to be repaid on schedule.

Table 2. Current assets and liabilities of Huishan Dairy, 2013-2016

Date of statement	2014-03-30	2015-03-31	2016-03-31	2016-09-30
Current assets (billions of dollars)	72.93	78.21	101.04	139.92
Mobile service wars (billions of dollars)	29.19	53.2	110.17	158.63
current ratio	2.49	1.47	0.92	0.88

Note: September 2016 data are for the first half of 2016

3.3.2. Failure of financial reporting controls

Muddy Waters' short report pointed out that Huishan Dairy's controlling shareholder used related party transactions to illegally take up a large amount of the company's funds, misappropriating as much as RMB 150 million or more. In the first half of 2014, Huishan Dairy purchased seeds from its indirectly-controlled entity, and the amount of this related transaction exceeded the 0.1% limit of the size test ratio, but failed to publicly disclose this key information in the first instance, until a correction was announced in the subsequent interim report. However, it failed to disclose this key information publicly at the first time and did not make a corrective announcement until the subsequent interim report. This series of events not only highlights the significant failure of Huishan Dairy's control over financial reporting, but also reveals significant deficiencies in its internal control system regarding the authenticity and timeliness of information disclosure.

3.3.3. Inadequate procurement processes

Muddy Waters' short-selling report pointed out that Huishan Dairy had misrepresented the cost of alfalfa, a raw material, in order to boost gross margins, exposing loopholes in its business process control. A large amount of data shows that although Huishan Dairy has repeatedly emphasized the self-sufficiency of its industrial chain, it has located its main alfalfa grass breeding base in Changtu County, which is susceptible to flooding from the Liaohe River, resulting in Huishan Dairy's long-term dependence on the alfalfa grass supply from a number of domestic and foreign companies, including bulk imports through the Chinese agent of the U.S.-based Anderson Corporation, as well as purchases from domestic suppliers in places such as Heilongjiang. Meanwhile, the company's financial reports also show the number of cattle surged by 78 percent between 2013 and 2016, while the area planted with alfalfa grass only increased by 17 percent, a far mismatch. In addition, Huishan Dairy also lowered the production cost of alfalfa grass through accounting means as a way to boost its profits, an act that not only exposed serious deficiencies in its business controls, but also

highlighted serious failures in internal control management, further exacerbating the company's operational risks.

4. SUGGESTIONS FOR OPTIMIZING INTERNAL CONTROLS IN HUIZHAN DAIRY

4.1. Optimization of Shareholding Structure

In order to get out of its predicament, Huishan Dairy needs to adjust its shareholding structure and optimize the governance environment in its subsequent operations to prevent absolute control by its major shareholders, and to ensure that decision-making promotes the sustainable development of the enterprise and protects the interests of small and medium-sized shareholders. It is necessary to recognize the disadvantages of a high degree of equity concentration, find a balance between shareholders' ownership and the enterprise's operations, and avoid the impact of "one share dominance" on the fairness of decision-making. The board of directors should separate operational execution and equity control and clarify the division of responsibilities between the board of directors and the CEO, with the board of directors focusing on major decisions and the CEO responsible for day-to-day operations. At the same time, the role of independent directors should be strengthened, and independent directors with a sense of responsibility and professional competence should be appointed, with reasonable incentives established to ensure their independence. Adjust the distribution of executive directors, reduce the power of major shareholders in the audit committee, and promote internal checks and balances in the board of directors. Emphasize the role of the Supervisory Board, establish a selection mechanism to ensure that members' abilities match their positions, and strengthen its supervisory function to ensure the healthy development of the enterprise.

4.2. Enhanced Risk Management

In order to effectively manage business risks, Huishan Dairy needs to build a comprehensive risk assessment system and set up a specialized risk management department responsible for goal planning, risk identification and response strategy formulation. Firstly, target setting should be based on the actual situation of the company, incorporate the concept of sustainable development, and combine the industry benchmarks with its own conditions to establish challenging and practicable strategic targets. Secondly, strengthen the risk identification mechanism through financial analysis and business review, with the former utilizing financial statements and DuPont analysis to gain insights into financial hazards, and the latter focusing on business risks such as production safety and inventory management, to ensure that risks are detected, reported, and responded to as early as possible. Finally, the company conducts risk likelihood and level assessment, compiles internal and external risks in detail, adopts a combination of quantitative and qualitative analysis, clarifies the probability of occurrence and potential impact of risks, compiles a risk list, and prioritizes the treatment of key risks, so as to provide a solid guarantee for the sound operation of the enterprise.

4.3. Improving Internal Oversight

Huishan Dairy needs to optimize its internal oversight system to maximize its effectiveness. Firstly, based on the regulations and the actual situation of the company, the company has established an internal control system including an audit committee and an independent internal audit organization, defined the responsibilities and authorities, established the supervision process and methods, and focused on the supervision of the implementation of internal control. Secondly, it establishes standards for measuring internal control loopholes, analyzes the causes in depth, evaluates the effectiveness of internal control through supervision, identifies defects in a timely manner and puts forward suggestions for improvement, and promotes the efficient operation of the internal control system. The internal audit organization shall regularly review the implementation of internal control

in production and operation and report the results of supervision to the audit committee of the board of directors.

At the same time, core corporate departments such as dairy processing, accounting, asset management and sales are encouraged to take the initiative to integrate into internal control supervision, forming a cross-departmental supervision network, such as accounting supervision of sales expenses and asset management supervision of financial collateralization behavior, to ensure the seamless integration of various links. Through the establishment of an internal supervision platform and data assessment mechanism, the supervisory relationship has been clarified to ensure the strict implementation of daily supervisory activities.

4.4. Optimize Control Activities and Regulate Corporate Procurement

As a whole industry chain dairy company, Huishan Dairy should strengthen the cost control of raw material procurement, especially the management of high-priced imported alfalfa grass. Given that Huishan has a certain degree of alfalfa productivity but relies on outsourcing, it needs to accurately assess its demand, combining its own production, farms and storage capacity. When purchasing, the company flexibly adopts various methods such as bidding, agreed supply and quotation to balance quality and cost. We will improve the acceptance process, ensure that data is updated to the information system in real time, and work closely with the accounting department to regularly check the data to ensure that the accounts are in line with the facts, so as to effectively control costs and improve operational efficiency.

Financial report is the wind vane of business operation, comprehensively demonstrating the efficiency of internal control and the Group's financial status, and is a key reference for investment decisions. Huishan Dairy needs to strengthen the control of financial reporting, covering preparation, disclosure and utilization. Before preparation, clear rules should be defined and inventories should be verified; during the process, data should be true and complete, and accounting standards should be complied with, especially the measurement of biological assets and the recognition of capital expenditures should not be changed arbitrarily. For large enterprises such as Huishan, the consolidated statement should be clear in methodology and complete in scope. When disclosing, follow the regulatory requirements, hire an auditor with strong independence and excellent qualification, and the board of directors should strictly consider it to avoid the problem of non-independence of audit. At the same time, the company pays attention to internal application, regularly analyzes financial reports, refines operational strengths and weaknesses, and forms analytical reports to guide the optimization of production, processing, procurement and other departments, so as to maximize the value of the reports.

5. CONCLUSION

This article takes Huishan Dairy as a case study, and based on the Muddy Waters short report, it analyzes the current status of its internal control, reveals key internal control issues, and proposes targeted optimization strategies. For insufficient risk identification, it is suggested to build a comprehensive risk identification system; for procurement misreporting, it is suggested to strengthen the procurement process and supplier management; and in the area of financial reporting control, it is suggested to standardize the compilation process and strictly select external audits. In addition, additional issues not covered in the report, such as optimizing the shareholding and board structure, establishing an internal information platform, and strengthening the supervisory atmosphere, were also discussed with a view to improving the overall effectiveness of Huishan Dairy's internal control.

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