



Case

Jinan Qingqi Motorcycle Co., Ltd

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Accepted 1 September 2004

Abstract

The case deals with the decision in mid-1997 of StarInvest, an American investment company, on whether to subscribe to a new issue of 230 million B shares by Jinan Qingqi Motorcycle Co., Ltd. Qingqi Motorcycle is incorporated in the People's Republic of China, and B shares were tradable only among foreign investors. The case solution is in the form of policy report from Daniel Campbell, asset manager at StarInvest, to his Investment Committee. The report contains his assessment of the opportunities and risks from China investment in general, and his recommendations on the Qingqi Motorcycle stock issue in particular. The objective of this case is to introduce students to the unique accounting issues and investment environment in China. From working on this case, the students should become familiar with the developmental steps and basic features of China's accounting standards and capital markets. An important theme that should be emphasized by the instructor is that institutional environments are more important at influencing the accounting information in a country than the accounting standards as written on paper. The case has been used in an international accounting course offered to the MBA students. It could also be used in a similar course offered at the undergraduate level. Students having completed an introductory financial accounting course should have the required knowledge and skills to work on this case. The case can be used either as an individual assignment or as a group assignment.

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1. Introduction

In mid-1997, Jinan Qingqi Motorcycle Co., Ltd. (“Qingqi Motorcycle”), a company incorporated in the People’s Republic of China (PRC) as a carve-out from a state-owned group of closely related facilities, was preparing to sell shares to foreign investors for the first time. The newly issued shares were designated as B shares under PRC rules, and trading in them was restricted to foreign investors. The company planned to offer 230 million shares.

Prior to the B-share offering, Qingqi Motorcycle had issued 741,817,400 shares to domestic investors (designated as A shares), of which 53.58% were stated-owned, 5.07% owned by legal persons, and the remaining shares were publicly owned.¹ Apart from ownership restrictions, the two classes of shares had the same entitlements, including dividends and voting. The A shares had been listed on the Shanghai Stock Exchange since 1993, and the B shares would also be listed on Shanghai. The B-share offering by Qingqi Motorcycle immediately generated widespread interest among international investors, who want to tap into the growth opportunities in China.

Daniel Campbell, asset manager of StarInvest, an American investment company, had been seeking for some time to make StarInvest’s first portfolio investment in the PRC. Campbell had reviewed Qingqi Motorcycle’s B-share offering prospectus, and immediately felt attracted to taking up some of the issue. He noticed that Qingqi Motorcycle had been consistently profitable over the past several years, and took some comfort from the fact that a worldwide accounting firm had audited Qingqi Motorcycle’s most recent financial statements.

Nevertheless, Campbell felt additional information was needed before he could make an overall evaluation of the firm’s financial situation. He was particularly concerned about interpretation of PRC financial statements, which could constitute an on-going management problem for StarInvest, which conducted routine periodic reviews of its investments. Campbell realized that Chinese companies issuing B-shares were required to issue financial statements according to both Chinese Accounting Standards and International Accounting Standards (IAS). He recognized that IAS standards were internationally recognized as being of high quality and frequently were mentioned in the same context as US GAAP. Nevertheless, Campbell thought there could be PRC-specific factors that might affect the quality of the earnings reported by Qingqi Motorcycle. Consequently, he decided he would like to know the major differences between these two sets of accounting standards, and how these differences were reflected in Qingqi Motorcycle’s most recent financial statements, as well as any other factors affecting earnings quality.

In addition, Campbell was aware of some of the country-specific opportunities and risks associated with investing in the PRC, and had heard some discussion among analysts specializing in international stocks that there were some anomalies

¹ The term ‘legal persons’ is used the Chinese Law to refer to legal entities and organizations. It is similar to the Western concept of institutions.

in the pricing of A-shares relative to B-shares. Campbell decided to collect additional information on these topics.

Campbell's problem is that while a quick decision is needed, there are strategic aspects of the decision that require careful assessment. The urgency arises because the issue will only be open during the two-day window of 29–30 May, with full payment due by June 3. He is under heavy pressure from one of the underwriters to commit to an investment, and fears the issue will be taken up quickly. On the other hand, Campbell realizes that this is a precedent-setting strategic decision for StarInvest because it would be its first portfolio investment in the PRC, so he needs to cover his tracks. *Issues that arise include: (1) How do we assess country-risk and company-risk in PRC? (2) How do we process and interpret financial statement information in PRC, including EPS? (3) How are PRC stocks priced?* Campbell therefore decided to assign several staff members to research various aspects of the problem and to prepare a policy report summarizing their findings and making a recommendation to his Investment Committee on whether to subscribe to the Qingqi Motorcycle stock issue.

Three staff members at StarInvest have been assigned tasks of preparing background information relevant to the Qingqi Motorcycle issue. Their reports have been completed and are attached. Robert Silverman, an analyst with previous business experience in East Asia, has prepared a memo on the general information on China's economic reform and stock markets. Diane Wang, an expert on international accounting and investment issues, has prepared two reports. One report focuses on the pricing of A-shares relative to B-shares, and the other focuses on accounting standards and practices in China. Finally, Patrick Gordon has summarized the information contained in Qingqi Motorcycle's offering prospectus. Campbell now has to prepare his policy report, summarizing the staff members' findings and making his recommendation to the Investment Committee.

2. Case requirement

Please prepare an investment recommendation letter on behalf of Daniel Campbell to the Investment Committee of StarInvest. The letter should address the three (italicized) issues raised above. It should also contain an investment recommendation and provide the rationale behind the recommendation.

3. Staff memoranda

3.1. Memorandum I

To: Daniel Campbell

From: Robert Silverman

Re: Opportunities and risks arising from China's economic reform and stock markets

Since it adopted its “opened door” policy and started on the path of economic reform in 1978, China has experienced an average GDP growth of about 10% annually. The sheer size of the economy, together with this growth, makes the PRC an attractive long-term investment proposition. Along with growth, China’s economic structure has experienced fundamental changes that present further investment opportunities. In 1978, state-owned-enterprises (SOEs) accounted for 78% of industrial output, but by 1996 that percentage had shrunk to 28%. Over this time period, collective ownership, individual ownership, and foreign ownership gained in significance.

To be sure, SOEs still play critical roles in China’s economy even though their importance has been decreasing. SOEs tend to be large enterprises concentrated in sectors such as heavy industries or banking services, which are considered backbones of China’s economy. SOEs also provide employment for well over half of China’s urban workers.

A large percentage of SOEs have been losing money over the years. Due to various concerns, including social stability, the Chinese Government has been reluctant to let these firms fail. State banks generally bail out poorly performing SOEs with state funds. SOEs also often borrow from each other. Not surprisingly, non-performing loans are rampant in the state sector.

As part of the effort to reform SOEs and to alleviate capital shortages experienced by these firms, China started experimenting with corporatization of SOEs and the development of its securities markets. The Shanghai Stock Exchange and the Shenzhen Stock Exchange were established by the Chinese Government in 1990 and 1991, respectively. In order to be listed on the Stock Exchanges, firms need to satisfy various requirements, including having reported profits for the past three consecutive years.

At first, listed firms were only permitted to issue shares to domestic investors (called A-shares). Since 1992, selected firms have also been allowed to issue shares to foreign investors (B-shares). As of 1997, A-shares are traded only among domestic investors and B-shares only among foreign investors. Even though the two classes of shares have identical voting rights and dividend rights, B-shares are generally traded at deep discounts relatively to A-shares. This issue is discussed more fully in a separate report by Diane Wang. I will only add that it is widely believed that the PRC government will not let B-share investors lose substantial amounts, because they want PRC to have a reputation for safe investment.

The number of listed companies has increased rapidly over the years. At the end of 1996, over 500 A-share stocks and close to 100 B-share stocks were listed on the Shanghai and Shenzhen Exchanges, with total market value of RMB 984 billion (over \$100 billion).

I have established that the automotive industry (which includes motorcycles as a very large segment) has been designated by the PRC government as an area for special development. The government has protected the domestic industry by import restrictions and tariffs. The State Planning Commission promulgated a document “Policies on Automobile Industry” back in 1994, establishing an objective of industry consolidation to achieve scale economies. It provided tax incentives and preferential access to capital for producers with 10% or more of the national market (I

have been able to establish that Qingqi Motorcycle combined with its parent company has a 16% market share). This substantially reduces the risk exposure of Qingqi stock, in my assessment.

There are some political and economic risks, however, including:

- The central government could decide that reforms are proceeding too quickly, and withdraw them. The government could come under pressure to bar foreigners from making (or expatriating) excessive profits in the PRC. An international crisis could cause wholesale expropriation. It is important to recognize that, in Chinese terms, economic reforms are extremely young.
- At some stage the PRC government will have to “cut loose” some of its SOEs and let them default on their debts. That most likely will cause a major ripple in the country’s economy and equity markets when it happens.
- The official policy on the auto industry is not set in stone. My research indicates that there are offsetting policies on transportation and on the environment. Beijing in particular has traffic and pollution problems. I understand there is some pressure within the government to cut back on the industry.
- China has come under pressure from the World Trade Organization (WTO) and the International Monetary Fund (IMF) to reduce tariffs and import quotas. Effective from April 1996, China reduced the preferential motorcycle tariffs from 120% to around 50–70%. Further reductions could still be coming. There is a risk of substantial import competition from formidable producers such as Honda and Suzuki.
- Currency controls create additional risk. The Renminbi (RMB) is not a fully convertible currency at this point. Foreign exchange transactions occur within an officially set range above or below the exchange rate set by the People’s Bank of China. Furthermore, only current account (as opposed to capital account) foreign exchange transactions can be conducted without prior official approval. There can be no assurance that there will not be a significant revaluation of the RMB should the government choose to relax currency controls.
- Chinese stock markets are at a very early stage of development. The market capitalizations of stocks, especially for B-shares, are substantially smaller than in more developed financial markets. This means that liquidity is lower and price volatility is higher for Chinese stocks.
- Finally, the judicial system in China is still in a very early stage of development, and shareholder lawsuits against firms or auditors are extremely rare if not unheard of. Our rights as investors would not be the same as we experience in our domestic portfolio or in our investments in better-developed economies.

There are other risks we need to consider. I have just read an article called “*King of the Red Chips: Ma’anshan Steel and the Debacle of the ‘Public’ SOE in China*”.² It gives a chilling account of how a listed carve-out from a former SOE failed misera-

² Steinfeld, Edward S., 1998.

bly, because they never did get the property rights of the carved out enterprise properly established, and they did not adapt their corporate governance to handle competition. Corporatizing SOEs is uncharted waters.

As always, there is a balancing of opportunities and risks, though the PRC is different in that regard from any country in which we currently have exposure.

3.2. *Memorandum II*

To: Daniel Campbell
From: Diane Wang
Re: Accounting in China

Before 1978, China had a centrally planned economy, in which SOEs played dominant roles. The accounting system was Russian style fund accounting, characterized by detailed and rigid rules. Since the sole owner of the SOEs also happened to be the government, the distinctions between profits and taxes were often rather blurred.

Along with the economic reform and the inflow of foreign investment to China, the accounting system in China also experienced fundamental changes. Over the years, China selectively adopted Western accounting standards and practices for certain forms of businesses, notably for joint ventures with foreign investments (in 1985) and for share-issuing companies (in early 1992).

A milestone in China's accounting reform was the 1992 issuance of The Accounting Standards for Business Enterprises (ASBE), which became effective on July 1, 1993. The ASBE was issued by the Ministry of Finance and requires *all* Chinese business enterprises (including the SOEs) to follow international accounting practices.

While Chinese Accounting Standards bear strong resemblance to the IAS after the promulgation of ASBE, differences still exist between the two sets of standards (see [Appendix A](#)). Unlike Anglo-American settings, Chinese Accounting Standards originated from the public sector. The need to generate tax revenue and safeguard state assets contributes to the rigidity of these standards in areas such as inventory valuation, bad debt allowances, and depreciation.³

For example, lower of cost or market inventory valuation is generally not allowed. Provision for bad debts is allowed only up to a limit of 3% of the total receivables outstanding. A provision for permanent impairment in the value of long-term assets is generally not allowed. The government establishes depreciation schedules, including minimum percentages of residual values and useful lives for various assets.

The existence of special equity adjustments and appropriations of profits suggest that one should interpret Chinese earnings information with caution. The Equity section is generally separated into several subsections according to Chinese Accounting

³ Xiang, 1998; Baydoun, Nishimura, and Willet, 1997; Ernst & Young International Business Series, 1994; Pricewaterhouse Coopers, 1998.

Standards. *Registered Capital* represents paid-in capital at par. *Capital Reserves* include: (i) paid-in capital in excess of par; (ii) donations; (iii) appreciation arising from asset revaluations. Capital Reserves can be used to offset prior years' losses and for issuance of bonus shares. *Statutory Reserves* include both *Statutory Surplus Reserve (SSR)* and *Public Welfare Fund (PWF)*. A company may distribute current year profits to its shareholders only after transferring 10% of the profit to the SSR (except where the SSR has reached 50% of the registered capital) and 5–10% of the profits to the PWF. A company is required to use its SSR for activities such as making up for prior losses or expanding production and operation. The use of PWFs follows strict government rules. They can only be used for collective employee benefits such as housing subsidies or medical treatments. In a sense the reserve is more like a liability than a part of the equity. Finally, *Unappropriated Profits* are available for distribution to shareholders.

Chinese companies issuing B-shares are required to publish financial statements based on both the Chinese Accounting Standards and the IAS. The IAS-based financial statements are audited by international accounting firms.

The main difference between Chinese accounting and Western accounting is likely to lie in the area of enforcement rather than standards per se. China has a rather small accounting profession and suffers from severe shortages of qualified public accountants (Tang, 2000). Audits of the Chinese Standards financial statements are usually performed either by the state audit bureaus or state-owned auditing firms. It is not uncommon that the auditing firm and the audited SOE belong to the same Ministry. Given concerns about auditor independence, efforts have been made to sever ties between auditing firms and the state. However, strong informal ties (*Guanxi*) are likely to remain between former state-owned auditing firms and the SOEs.

A related problem with earnings quality arises from the network of non-market relationships that determines the company's access to its product and factor markets. In the US, we are accustomed to most accounting records arising from independent, arm's-length transactions. This is not the norm in the PRC, and it affects data quality, because earnings can be turned on or off by varying the prices at which related companies transfer inputs and products among themselves. Qingqi Motorcycle is particularly prone to this problem, because it retains its dependence on its former parent SOE for inputs, management and sale of its output (The Prospectus Summary prepared by Patrick Gordon provides further information on this issue).

Earnings manipulation will also impair the quality of accounting information. PRC firms preparing for B-share listings overstate their earnings prior to listing, apparently to meet the PRC government's security regulations. These regulations require an accounting return on equity (ROE) of at least 10% for three consecutive pre-listing years (Haw, In-Mu, Qi, Wu, & Zhang, 2005).

Accounting fraud is a further issue in the PRC. Many firms' internal control and external audit systems do not appear strong enough to deal with it.

Note: A useful summary of the differences between IAS and China-GAAP standards is attached (Appendix A).

3.3. Memorandum III

To: Daniel Campbell
 From: Diane Wang
 Re: Anomalies in the Pricing of A-shares Relative to B-shares

I've briefly reviewed the relevant literature, and have dug up the following results. They seem to be reliable (there is no academic argument about them), but I don't know what to make of them. Without further time to investigate, it's a puzzle.

1. *A-shares and B-shares*. The evidence here is very strong (Abdel-khalik, Rashad, Wong, & Wu, 1999; Bailey, 1994). It includes:
 - A-shares routinely trade at 2–4 times the price of B-shares.
 - The B-share discount is positively correlated across companies.
 - However, returns on B-shares are hardly correlated with international stock indexes, or even with returns on China-related stocks listed in the US or in Hong Kong.
 Consistent with this B-share discount, Qingqi Motorcycle's A-shares currently are trading around Rmb12, a multiple of 3 times the B-share issue price. (They were trading around Rmb2 until 12 months ago, and have steadily risen since.)
2. *Market effects generally*. A result that could be related is that the "market factor" in lesser-developed countries appears to be much stronger than we are used to in the US, or in other developed countries. Prices move much more in tandem (Morck, Yeung, & Yu, 1997).
3. *Effect of earnings announcements on prices*. Strangely, IAS earnings numbers do not seem to be any more related with price movements than PRC-Standards earnings (Ball, Robin, & Wu, 2000; Chen, Gul, & Su, 1999).

3.4. Memorandum IV

To: Daniel Campbell
 From: Patrick Gordon
 Re: Prospectus Summary

Jinan Qingqi Motorcycle Co., Ltd (Qingqi Motorcycle) was formed by a 1993 merger of the First Assembly Factory, Second Assembly Factory and Engine Factory of the Qingqi Group Company (Qingqi Group). The Qingqi Group retains considerable motorcycle production facilities in direct and indirect competition with Qingqi Motorcycle. Its history can be traced back to the Jinan Bicycle Parts Manufacturing Factory established in 1956. Qingqi Motorcycle retains unusually strong ties with the Qingqi Group in terms of ownership, governance, production, marketing, and technology arrangements.

Qingqi Motorcycle is principally engaged in the development, manufacture and sale of motorcycles. China's motorcycle industry has experienced tremendous growth over recent years. The national sales of motorcycles grew from approximately 1.7 million units in 1992 to 8.9 million units in 1996, a compound annual growth of over

50%. The Chinese Government has designated the automobile industry (including motorcycles) to be developed into a pillar industry over the next decade or so, which means companies in the auto industry are often entitled to preferential treatment related to tax, financing and investment.

For the year ended December 31, 1996, the Company manufactured and sold 799,051 motorcycles, which puts the Company in third place in terms of market share among motorcycle manufacturers in China (first if combined with the Qingqi Group).

Qingqi Motorcycle's profits after tax (based on IAS) were RMB 110,376,000, RMB 126,435,000, and RMB 256,392,000 for 1994, 1995, and 1996, respectively. The local auditor for the Company is Shangdong Certified Public Accountants, who audits the company's Chinese Standards financial statements. Arthur Andersen is the auditor for IAS-based financial statements. The management is forecasting profits of RMB 408,248,000 (based on IAS) for the year ending December 31, 1997.

After the B-share offering, foreign investors will hold 23.67% of the shares. State, legal person and local public ownership will be 40.90%, 3.87% and 28.56%, respectively. According to the management, proceeds from the B-share offering will mainly be used for purchasing production facilities and technical equipment.

What caught my attention in particular from the prospectus is Qingqi Motorcycle's unusually strong ties with Qingqi Group, its former parent SOE. These ties can be reflected in the following areas:

- **Ownership:** Qingqi Group has been appointed by the provincial government to manage the State-owned shares in Qingqi Motorcycle, which represents 53.58% of the total issued share capital of the Company before the B Share issue and 40.90% immediately after the completion of B Share issue. The chairman of Qingqi Group has also been appointed as the shareholder representative of the State-owned shares.
- **Governance and Management:** Four of the seven directors and certain of Qingqi Motorcycle's senior management are also directors and/or employees of Qingqi Group. Conflicts of interest may arise due to the considerable influence Qingqi Group has over the business decisions of Qingqi Motorcycle.
- **Sales:** Qingqi Motorcycle has entered into a product sales contract with Qingqi Group, requiring Qingqi Group to purchase at least 95% of the annual production of Qingqi Motorcycle.
- **Supply:** Qingqi Motorcycle also has supply contracts and import and export agency agreements with Qingqi Group for purchasing of raw materials and various components. Currently, Qingqi Motorcycle purchases most of the required raw materials and domestic components from the Qingqi Group.
- **Services:** Under a service contract, Qingqi Group has agreed to provide a series of services to Qingqi Motorcycle, including supply of water, electricity and steam required for production and business, transportation services, research and development, management services, and social services including medial, educational, catering, retirement and other social welfare benefits for Qingqi Motorcycle's employees.

- Technology: Qingqi Motorcycle relies heavily on Suzuki's technology, which is obtained through a license agreement the Qingqi Group has entered with Suzuki.

It concerns me that Qingqi Motorcycle is dependent on another entity in almost every aspect of its business. Should Qingqi Group fall into hard times, it undoubtedly will have severe adverse effects on Qingqi Motorcycle. In addition, Qingqi Group itself is a producer of motorcycles and some of its products are identical to those of Qingqi Motorcycle. The companies have a non-compete agreement. The ability and willingness of Qingqi Group to honor these agreements is crucial to Qingqi Motorcycle's financial success.

Another useful piece of information is the non-exclusive license agreement between Qingqi Group and Suzuki. It is risky to be that dependent on a potential competitor like Suzuki. Qingqi Group probably could reach a similar agreement with an alternative technology supplier, but that would be disruptive all the way up its sub-contractor supply line. In addition, Suzuki has also transferred its technology to other motorcycle manufacturers in China, including Jincheng Group Company Limited, one of Qingqi Motorcycle (and Qingqi Group)'s chief competitors.

In summary, Qingqi Motorcycle is in a fast growing industry and has good past financial performance. However, for better or worse, its fortunes are closely tied to its former parent SOE, Qingqi Group. The same ties also suggest that many of the transactions in its accounting records may not be arms-length and that all its financial information should be interpreted with caution.

Note: I've attached the auditor's report and a reconciliation from Chinese to IAS financial statements ([Appendix B](#)).

Appendix A. Major differences between Chinese accounting standards and IAS

	Chinese accounting standards	IAS
Allowance for bad debts	Provision for bad debts is allowed. However, it has to be within the limits set by the State	Provision based on prudence concept
Inventory	Inventories are generally carried at cost rather than at lower of cost or market value Provision for obsolete inventory is permitted subject to approval from finance and tax authorities	Valuation and provision based on prudence concept

Depreciation	Estimated residual values and useful lives are specified by the State	Estimated residual values and useful lives are decided in light of the assets' economic benefits to the enterprise
Intangibles amortization	Minimum amortization period prescribed by the State	Amortization over the estimated period of economic benefits
Long-term investments	Provision for permanent diminution in the valuation of long-term investments is not allowed	Permanent diminutions in value are recognized
Foreign currency translations	With approval from State, large gains or losses may be amortized over periods of up to five years ^a	Gains and losses are included in income immediately

^a The abolishment of the dual currency exchange rate system in January 1994 led to a devaluation of RMB by approximately 33% to RMB 8.7 to US\$1. The effect of the devaluation was allowed to be amortized over a five-year period by the State. However, for B-Share reporting under IAS, the full effect of the devaluation was immediately recognized.

Appendix B. Reconciliation from PRC standards to IAS financial statements

Jinan Qingqi Motorcycle Co., Ltd., Balance sheet – 12/31/96 (RMB)

	PRC Standards	Adjustments	IAS
Current assets			
Cash and equivalents	118,298,105	(9,160,140)	109,137,965
Short term investment	0	0	0
Notes receivable	43,614,420	(43,614,420)	0
Account receivable	512,128,101	(512,128,101)	0
Minus: bad-debt allowance	0	0	0
Net account receivable	512,128,101	(512,128,101)	0
Receivable to parent company	0	491,933,507	491,933,507
Other receivable	87,412,898	(67,986,248)	19,426,650
Inventory	535,186,260	(13,476,837)	521,709,423
Raw material	465,164,777	(21,425,645)	443,739,132
Work in process	54,701,615	7,948,808	62,650,423
Finished goods	0	0	0
Self-made work in process	14,919,779	0	14,919,779
Other material	400,089	0	400,089

Receivable to related parties	0	40,238,055	40,238,055
Prepayment	33,784,482	(6,571,816)	27,212,666
Deferred expense	13,610,018	(1,331,519)	12,278,499
Total current assets	1,344,034,284	(122,097,519)	1,221,936,765
Construction in process	272,378,738	16,185,246	288,563,984
Fixed assets	409,467,189	0	409,467,189
Less: accumulated depreciation	(85,533,940)	0	(85,533,940)
Net: fixed assets	323,933,249	0	323,933,249
Disposal of fixed assets	11,824	0	11,824
Total fixed assets	596,323,811	16,185,246	612,509,057
Intangible assets	22,565,217	0	22,565,217
Total assets	1,962,923,312	(105,912,273)	1,857,011,039
Current liabilities			
Short-term debts	20,000,000	0	20,000,000
Notes payable	3,218,000	0	3,218,000
Account payable	533,084,469	81,116,910	451,967,559
Prepayment from customer	185,669	(838,850)	1,024,519
Payable to related parties	0	(4,970,988)	4,970,988
Other payable	57,981,549	10,765,392	47,216,157
Employee benefit payable	7,884,325	0	7,884,325
Dividend payable	1,440	0	1,440
Deferred expense	22,178,876	16,544,725	5,634,151
Total current liabilities	644,534,328	102,617,189	541,917,139
Total liabilities	644,534,328	102,617,189	541,917,139
Shareholders equity			
Registered capital	494,544,960	0	494,544,960
Capital reserve	502,977,802	0	502,977,802
Capital surplus	85,302,789	(16,166,455)	101,469,244
Legal defined surplus	46,777,099	(3,962,523)	50,734,622
Public benefit surplus	38,530,690	(12,203,932)	50,734,627
Surplus drawn by the company	61,649,105	(8,697,545)	70,346,650
Retained earning	173,914,328	28,159,084	145,755,244
Total equity	1,318,388,984	3,295,084	1,315,093,900
Total liability and equity	1,962,923,317	105,912,273	1,857,011,039

Profits & loss for year ended 12/31/96 (RMB)

	PRC Standards	Adjustments	IAS
Sales revenue	3,256,024,307	28,658,416	3,227,365,891
Less: sales tax	(186,139,960)	1,056,136	(187,196,096)
Total	3,069,884,347	29,714,552	3,040,169,795

Cost of goods sold	(2,714,754,674)	(23,342,859)	(2,691,411,815)
Gross profit	355,129,673	6,371,693	348,757,980
SG&A expense	(59,916,319)	727,068	(60,643,387)
Profit from operation	295,213,354	7,098,761	288,114,593
Other income	116,610,885	104,846	116,506,039
Other expense	(107,258,910)	(75,489)	(107,183,421)
Financial income (expense), net	8,195,595	1,409,100	6,786,495
Interest expense	0	1,409,100	(1,409,100)
Interest income	8,203,378	0	8,203,378
Bank charges	(7,783)	0	(7,783)
Non-operation income	35,282	0	35,282
Non-operation expense	(1,115,019)	0	(1,115,019)
Income before tax	311,681,187	8,537,718	303,143,969
Tax income	(46,752,178)	0	(46,752,178)
Net income	264,929,009	8,537,218	256,391,791
Allocation of net income	(42,388,642)	0	(42,388,642)
legal-defined surplus	(26,492,900)	0	(26,492,900)
public benefit surplus	(26,492,900)	0	(26,492,900)
Total	169,554,567	8,537,218	161,017,349
R/E, beginning	4,359,761	19,621,866	(15,262,105)
R/E, ending	173,914,378	28,159,084	145,755,244

International accountant's report from Arthur Andersen

29th May 1997

To:

The Directors

Jinan Qingqi Motorcycle Co., Ltd.

Hai Tong Securities Limited

Yamaichi International (H.K.) Limited

Ladies and Gentlemen,

Jinan Qingqi Motorcycle Co., Ltd, (the "Company"), a joint stock limited company, was incorporated in the Peoples Republic of China (the "PRC") on 25th November, 1993. Part of its shares are listed on the Shanghai Stock Exchange.

The statutory accounts of the Company for each of the three years ended 31st December, 1996 were prepared in accordance with the accounting principles and the relevant financial regulations applicable to joint stock limited companies in the PRC. They have not been audited by us, but were audited by a firm of Certified Public Accountants in the PRC. The accounting policies adopted in the preparation of the statutory accounts differ in certain respects from International Accounting Standards ("IAS"). Adjustments have been made for the purpose of restating these financial statements to conform to IAS.

We have audited the statement of results of operations of the Company for the year ended 31 st December, 1996 and the statement of net assets of the Company as at 31 st December, 1996 as set out in Notes 4 and 5 respectively. Our audit was made in accordance with International Standards on Auditing issued by the International Federation of Accountants and, accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

We have also performed a limited review of the financial statements of the Company for the two years ended 31st December, 1994 and 1995. The scope of our review was limited to identifying adjustments needed to restate these financial statements to conform to IAS. The adjustments were identified primarily through inquiries of and discussions with management of the Company, and our knowledge gained from the audit of the financial statements of the Company for the year ended 31 st December, 1996.

In our opinion, for the purpose of the Information Memorandum dated 29th May, 1997, the statement of results of operations of the Company for the year ended 31st December, 1996 and the statement of net assets as at 31st December, 1996 together with the notes thereon give a true and fair view of the results of operations of the Company for the year ended 31 st December, 1996 and the net assets of the Company as at that date in conformity with IAS. The results of operations of the Company for the two years ended 31st December, 1994 and 1995, as restated to conform to IAS under the principal accounting policies set out in Note 3 below, are presented in Note 4 below for information and comparison purposes only. We do not express an opinion on them.

Appendix C. Teaching note

China, being the world's most populous country, has generated tremendous investment interest in the West due to the rapid growth of its economy over the past decades. The objective of this case is to introduce the students to the unique accounting issues and investment environment in China.

From working on this case, the students should become familiar with the developmental steps and basic features of China's accounting standards and capital markets. An important theme that should be emphasized by the instructor is that institutional environments are more important at influencing the accounting information in a country than the accounting standards as written on paper. This case therefore illustrates the importance of investigating the institutional environments carefully before offering interpretations of the financial information. The case also offers a rich set of institutional factors for the students to analyze. For example, the prevalent business culture in Asia, including China, is to conduct business through *guanxi* (connections). With China, a former command economy, we also have the added twist of significant State influence. Many of the issues associated with early stage economic reforms and emerging markets are also presented in the case.

The case has been used in an international accounting course offered to the MBA students. It could also be used in a similar course offered at the undergraduate level. Students having completed an introductory financial accounting course should have the required knowledge and skills to work on this case. The case can be used either as an individual assignment or as a group assignment.

C.1. Investment recommendation

A good case solution will follow a format like the following recommendation to the investment committee.

To: Investment Committee
From: Daniel Campbell, Asset Manager
Re: Jinan Qingqi Motorcycle Co., Ltd B Share Issue

Jinan Qingqi Motorcycle Co., Ltd. (“Qingqi Motorcycle”) is a carve-out from a PRC state-owned group. It is issuing 230 million B shares at Rmb4.00 (\$0.482) under PRC rules, which restrict ownership to foreign investors. It has 742 million A shares held by PRC-only investors, 54% of them stated-owned. They have the same dividend and voting entitlements and are listed on the Shanghai Exchange.

I recommend we participate in the issue, primarily to gain experience in balancing risks and opportunities in the PRC. Strategically, we have to participate in PRC at some point: it is a huge, growing marketplace, trying to open to the world. But we have found it difficult to assess this particular investment in normal terms. Our difficulty is summarized in the following sections. It shows we have a lot to learn about the PRC.

My best assessment is that domestic PRC political factors will place both upper and lower bounds on the outcome to foreign investors. The government does not want a reputation of foreigners losing, because they are trying to attract outside capital and technology, but I’m not sure the government would like to see foreigners winning big either.

Nevertheless, my recommendation is made on other grounds. This assessment has proved so difficult to make that it shows we need to gain experience, and this seems as good an opportunity as any.

The financials are summarized in [Table 1](#). Points worth noting are:

- At Rmb4.00, the issue is priced at 11–15 times trailing earnings, depending on how earnings are calculated. The market/book at the issue price is 2 1/4–2 1/2.
- The A-shares are trading at around Rmb12, so their multiples are 3 times these levels: earnings multiple of 35–45 and book value multiple of about 7. That makes our entry price of Rmb4.00 look comparatively cheap.
- Liquidity ratios look fine.
- There is no long-term debt.

Table 1
1996 Actual and 1997 projected financial analysis

	1996 ASBE	1996 ASBE net of legal reserves	1996 IAS	1996 IAS net of legal reserves	1997 IAS
Number of shares 000s	741,817	741,817	741,817	741,817	971,817
Net income 000s	264,929	211,943	256,392	203,406	408,248
EPS	0.36	0.29	0.35	0.27	0.42
P/E	11.2	14.0	11.6	14.6	9.5
Stockholders equity 000s	1,318,389	1,233,086	1,315,094	1,213,625	2,235,094
BVPS	1.78	1.66	1.77	1.64	2.30
P/BVPS (Market/Book)	2.25	2.41	2.26	2.44	1.74
Return on equity (ROE)	20.09%	17.19%	19.50%	16.76%	18.27%
CA 000s	1,344,034		1,221,937		
CL 000s	644,534		541,917		
LT Debt 000s	0		0		
Current ratio (CA/CL)	2.09		2.25		
Long term debt ratio	0		0		
Sales 000s	3,069,884	3,069,884	3,040,170	3,040,170	
COGS 000s	2,714,755		2,691,412		
Gross profit 000s	355,130		348,758		
SG&A 000s	59,916		60,643		
Pretax income 000s	311,681		303,144		
Tax 000s	46,752		46,752		
Inventory 000s	535,186		521,709		
Gross profit margin on sales	11.57%		11.47%		
Net profit margin on sales	8.63%	6.90%	8.43%	6.69%	
SG&A% of Sales	1.95%		1.99%		
Tax% of pretax income	15.00%		15.40%		
Inventory turnover	5.07		5.16		

Notes:

1. P/E calculated at Rmb4.00 subscription price.
2. 1997 Forecast figures include 230,000,000 shares at Rmb4.00 each.
3. Legal reserves do not include Rmb 61,649,105 “Surplus drawn by company.”
4. Jinan Qingqi has no long-term debt, and interest revenue exceeds interest expense.
5. ASBE is under PRC accounting standards, audited by the local firm Shandon Certified Public Accountants. Arthur Andersen is the auditor for the international-standard (IAS) financials.

- The profit margins are very small, but normal standards of interpretation don't apply here. There is essentially no SG&A (less than 2%), presumably because the Qingqi Group performs these functions. There is no interest expense. Tax rates are low, too.

The financials are subject to the provisions that: (1) Chinese accounting is different; (2) Chinese stock markets are different. The major differences are summarized in the following sections of this report.

Opportunity and risk from investing in China

The PRC currently offers limited opportunities for portfolio diversification and profitable investment. Opportunities are expected to expand as the economy opens

and grows. An investment at this point would give us a position in the PRC that we could learn from and evaluate over time.

As always, there is a balancing of opportunities and risks, though the PRC is different in that regard from any country in which we currently have exposure. We will have to learn more about how to assess PRC investments, as the following should make clear.

C.1.1. Opportunities

- Government’s “opened door” policy and economic reforms create opportunities.
- Corporatization of SOEs and development of securities markets create opportunities for portfolio investment in new equity issues.
- Average GDP growth rate of 10% since 1978.
- Size of the economy.
- Automotive (includes motorcycles) industry is designated for special import restrictions and tariff protection, tax incentives and access to capital.
- Qingqi Motorcycle financials look good: consistently profitable, no long-term debt.
- IAS financials are audited by a worldwide accounting firm (see below).
- Deal looks good: issuing at P/E of 9.5 (97 forecast) to 14.6 (96 trailing).

Risks

- Depth of commitment to economic reform really is unknown.
- Potential for expropriation.
- Widespread SOE default on debt would scare the equity market.
- Change in auto industry policy due to environmental problems (traffic and pollution).
- WTO and IMF pressure to eliminate tariffs and import restrictions.
- Currency risk: Rmb is not convertible, revaluation risk.
- Judicial system is not investor-friendly and PRC Government remains the majority shareholder.
- Corporate governance is crude and property rights of carved out SOEs can be murky.

Special problems with accounting in China

We will have long-term problems with the analysis and interpretation of PRC financials.

Accounting standards

Companies with B shares report under two separate standards:

1. Accounting Standards for Business Enterprises (ASBE) issued by the Ministry of Finance
2. International Accounting Standards (IAS).

IAS and ASBE standards are similar. Differences largely reflect the PRC government's problems in generating tax revenue and safeguarding state assets, and include:

- Lower of cost or market inventory valuation is generally not allowed.
- Provision for bad debts is limited to 3% of receivables.
- The PRC government establishes fixed depreciation schedules.
- Impairment in the value of long-term assets is generally not recognized.

Up to 20% of profits cannot be distributed to stockholders, and is kept in two Statutory Reserve accounts: Statutory Surplus Reserve (SSR) and Public Welfare Fund (PWF).

Enforcement

An important difference between Chinese Accounting and Western Accounting is likely to lie in enforcement rather than standards per se. Note that IAS-based financial statements are audited by international accounting firms (Arthur Andersen audits Qingqi Motorcycle), but audits of ASBE financials are usually performed either by the state audit bureaus or state-owned auditing firms. Strong formal and informal ties are likely to remain between former state-owned auditing firms and the SOEs.

Data quality

There are data quality issues for financial statement information. Interpretation of Chinese financials requires caution. Notably:

- The network of relationships that determines the company's access to its product and factor markets is not an arm's length market: transactions can be manipulated to achieve desired objectives (such as earnings).
- The extent of welfare obligations to employees is not contractually determined, and is not shown on balance sheets. The employer traditionally has provided housing, education and health services.
- There can be hidden *Guanxi* obligations.
- SOEs also often disguise non-performing loans among themselves.
- Fraud is an issue.
- Apparently, firms preparing for B-share listings manipulate their earnings upward during the years prior to listing, to meet the PRC government's requirement of 10% ROE for three consecutive years before listing.

Anomalies in the pricing of A-shares relative to B-shares

We also are going to have special problems understanding their share markets.

1. A-shares and B-shares.

- B-shares trade at a 35–50% discount relative to A-shares.
- The B-share discount is positively correlated across companies.

- B-share returns are hardly correlated with international stock indexes.
2. Market effects generally. The “market factor” in lesser-developed countries is much stronger than in the US, or in other developed countries.
 3. Effect of earnings announcements on prices.
 - IAS earnings don’t seem to be preferred by investors.

C.2. Recent developments

There are several major developments for Qingqi Motorcycle since its B-share IPO in 1997. Students need not (and should not-given its ex post nature) rely on the knowledge of these developments to work on the case. However, it will be interesting for the instructor to bring out these issues during classroom discussion.

One major development was the opening of B-share market to domestic investors in February 2001. B-share prices increased substantially as a result. Qingqi Motorcycle B-shares had been trading below its issue price of RMB4 ever since its IPO, that is, until early 2001 when its price shot up along with the rest of the B-share market. At one point Qingqi Motorcycle B-shares were trading over RMB7. This substantial price appreciation was of course the reflection of larger economy-wide effects that are shown to be very strong drivers of share price movements in developing countries (see point 2 in the previous section).

Another new development was the delisting of Qingqi Motorcycle from the Shanghai Stock Exchange in April 2003 due to three years of consecutive losses. The Chinese stock exchanges always had the “three losses and you are out” rule, but it was never strictly enforced until recently. Qingqi Motorcycle was among the first companies to fall under the sword. The following table gives the company’s EPS (in RMB) since 1993:

1993 (A-share IPO)	1994	1995	1996	1997 (B-share IPO)	1998	1999	2000	2001	2002 (delis- ting)
0.150	0.157	0.174	0.357	0.484	0.320	0.020	-0.370	-0.820	-3.490

The pattern of EPS around the B-share IPO does suggest that the company was either managing earnings right before the IPO (again consistent with earnings management incentives due to the stock exchanges’ profitability requirements) and/or that it was able to time its B-share IPO in a period of good performance. Right before delisting, Qingqi Motorcycle B-shares traded around RMB2.

What’s ironic was that the recent losses were mainly due to provisions for bad loans to Qingqi Group, which highlighted the major point of the case. The listed carve outs of the SOEs are in many cases too intricately connected to its former parent that it is hard to view them as stand-alone entities.

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