I MAGINE that the S-chip (Singapore-listed China stocks) fraud with its “missing cash phenomenon” and the penny stock scandal never happened – because there was a way to prevent them. While accounting information and disclosures may be abused to deceive, instead of being used to inform, there is a countermeasure if one only looks for it. For fraud perpetrators actually, if inadvertently, leave behind a trace of their accounting transgressions in the footnotes of annual reports.

In their paper “Tunnelling Through Intercorporate Loans: The China Experience”, published in the Journal of Financial Economics, professors Charles Lee, Jiang Guohua and Yue Heng said that during the 1997/98 Asian financial crisis, many firms that experienced the crisis, helped to facilitate the building and subsequent bust of the Alan Bond empire. During the 1997/98 Asian financial crisis, many firms that experienced the worst price declines had made related-party loans. Specifically, firms with unusually high related-party loans – measured by ORecta as a percentage of total assets, or ORecta – are more likely to experience worse future operating performance, qualified audit opinion, share suspension, and regulatory investigations.

The average risky ORecta measure is around 8 per cent (median 4 per cent). Thus, if a company’s ORecta were to jump abruptly from, say one per cent to 15 per cent in a year, it would be a red flag. An ORecta of 30 per cent would put the company in the highest risk group of insiders’ stealing of corporate wealth.

FORMER DARLING Consider one such S-chip example. Sports shoe retailer China Hongxing Sports (CHS) is a former stockmarket darling, with its “missing cash phenomenon” and high profit margin (over 15 per cent) and market value at its peak in October 2007 crossed S$1 billion. On Feb 25, 2011, CHS shares were suspended with the shocking announcement that auditors Ernst & Young had uncovered irregularities in the cash and bank balances, accounts receivables, accounts payables and other expenses during the course of its audit of the China incorporated subsidiaries’ 2010 accounts.

In essence, we need a forward-looking system sensitive enough to detect accounting fraud before it happens and causes harm. This will help the investing public make better-informed decisions, as well as spur these companies to curb or unwind the fraudulent transactions.