CHINESE REVERSE MERGERS: ACCOUNTING FRAUD AND STOCK PRICE COLLAPSE

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ABSTRACT

Investing in stock is a risky business. However, Chinese reverse mergers (CRM) have introduced a new level of risk. Research has shown that many Chinese reverse merger companies have used the process as a way to gain access to U.S. markets without having their financial statements inspected. Many Chinese companies are corrupted by fraudulent accounting practices and have taken advantage of the reverse merger method to mislead investors. This article highlights many common fraudulent accounting practices, which have led to the downfall of many CRM firms. The second objective of this article is to look at the role that investigative research companies play in revealing these companies’ true financial condition. For example, CRM firms’ stock prices commonly exhibit significant decline when Muddy Waters Research announces CRM firms’ fraudulent accounting practices. We examine 7 CRM firms to highlight both the incidence of fraudulent accounting practices and the markets reaction when these practices are brought to light. Finally, this article seeks to enlighten and encourage unsuspecting investors to pursue due diligence procedures before investing in Chinese reverse merger companies. Many CRM companies engage in unethical business and accounting practices. Investors should be wary before investing in these firms.

Keywords: Chinese reverse mergers, accounting fraud, Muddy Waters research, risk

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