China Journal of Accounting Research 8 (2015) 111–131

Contents lists available at ScienceDirect

China Journal of Accounting Research

journal homepage: www.elsevier.com/locate/cjar

Short sellers' accusations against Chinese reverse mergers: Information analytics or guilt by association?☆

Hongqi Liu [a,b], Nan Xu [a,*], Jianming Ye [b,c]

[a] Southwestern University of Finance and Economics, Sichuan, China
[b] Baruch College, City University of New York, NY, USA
[c] Xiamen University, China

ARTICLE INFO

Article history:
Received 6 August 2014
Accepted 16 February 2015
Available online 20 March 2015

Keywords:
Chinese reverse mergers
Fraud accusation
Guilt by association
Information analytics
Short sellers

ABSTRACT

This paper studies short sellers' trading strategies and their effects on the financial market by examining their accusations of fraud against Chinese reverse merger firms (CRMs) in the US. We find that short sellers rely on firms' fundamental information, especially relative financial indicators, to locate their "prey." Specifically, they compare a target firm's financial indicators (e.g., growth and receivables) with both the industry average and the firm's history. We find no evidence that short sellers accuse CRMs simply because of their reverse merger label. Additionally, we test the accuracy of short sellers' accusations in the long run and find that accused firms are more likely to delist and less likely to recover from price plunges. Our results also indicate that CRMs' high exposure to short sellers' accusations stem from adverse selection problems: firms with high litigation risk are more likely to choose reverse mergers to access the US capital market. Overall, our results support the view that short sellers are sophisticated investors and shed some light on their decision processes.

© 2015 Sun Yat-sen University. Production and hosting by Elsevier B.V. This is an open access article under the CC BY-NC-ND license (http://creativecommons.org/licenses/by-nc-nd/4.0/).

1. Introduction

The effect that short sellers have on the financial market is a topic of great debate. On the one hand, advocates argue that short sellers are informed investors who are able to identify overpriced stocks and business

* Corresponding author. Tel.: +86 13880900676.
E-mail addresses: Hongqi.Liu@baruch.cuny.edu (H. Liu), sara870515@hotmail.com (N. Xu), Jianmng.Ye@baruch.cuny.edu (J. Ye).
☆ Our project was supported by the China Scholarship Council.

http://dx.doi.org/10.1016/j.cjar.2015.02.002
1755-3091/© 2015 Sun Yat-sen University. Production and hosting by Elsevier B.V.
This is an open access article under the CC BY-NC-ND license (http://creativecommons.org/licenses/by-nc-nd/4.0/).

misconduct, and thus their participation improves market efficiency (Miller, 1977; Jones and Lamont, 2002; Lamont and Stein, 2004). On the other hand, dissenters argue that short sellers use abusive trading strategies, dampen investor confidence in the financial market and decrease market liquidity (Cox, 2008). In this debate, although many papers have suggested that short-sellers are "smart guys" who can unearth overpriced companies and contribute to the efficiency of the stock market, their strategies for locating overvalued firms and their decision processes are still unknown.

We disentangle this debate by analyzing short sellers' motivations for accusing many US Chinese reverse merger firms (CRMs) of financial fraud. Between 2010 and 2011, short sellers accused 62 CRMs of fraud, leading to an almost 50% reduction in the CRMs' equity value. Short sellers clearly acted as crucial "fraud detectors" in the process, because most of these scandals started with short sellers' reports that questioned the credibility of the firms' financial reports. However, the real motivation behind short sellers' accusations against CRMs remains unknown. How do short sellers locate their prey? Do they base their accusations on information analytics or guilt by association? What kind of information do they use in their decision processes? This paper fills this gap in the literature.

We find no evidence that short sellers accuse CRMs simply because of their association with other ill-reputed CRMs (referred to as guilt by association). Specifically, we find that short sellers pay attention to unusually high growth in profitability and accounts receivables. In particular, they identify targets by comparing financial indicators with the industry average or with firms' histories. Firms with poor internal control, a small proportion of outside directors, a low level of managerial shareholdings and low-quality audit reports are more likely to be targets of short sellers. We further check the long-term performance of accused firms to test the accuracy of short sellers' accusations. Accused firms are more likely to delist from exchanges and less likely to recover from price plunges following short-sellers' accusations. Our results also suggest that CRMs' high exposure to short sellers' accusations stems from adverse selection problems: firms with high litigation risk are more likely to choose reverse mergers to access the US capital market.

Two competing hypotheses attempt to explain the strategies behind short sellers' fraud accusations. The *information analytics hypothesis* regards short sellers' research reports as reliable outputs produced by careful analysis. Therefore, their intensive attacks against CRMs are well-founded: firms targeted by short sellers are indeed inferior to their counterparts in terms of information disclosure. Many papers provide corroborating evidence of the informativeness of short sellers' actions. They argue that short sellers are able to identify stock overpricing and firm misconduct (e.g., Jones and Lamont, 2002; Christophe et al., 2004, 2009; Diether et al., 2009; Karpoff and Lou, 2010). At the same time, many argue that it is not necessarily true that short sellers are betting against information. Short sellers could take advantage of investors' negative perception of the CRM society and indiscriminately accuse any member of the society of "guilt by association." As an example, Dennis E. Nixon, the Chairman of Bancshares, claimed that his bank was attacked by short sellers who viewed it as guilty because of its association with banks in crisis and their troubles. Moreover, former SEC Chairman Christopher Cox (2008) noted that even "far-better" financial companies, such as JPMorgan Chase, could be vulnerable to guilt by association. We refer to this view as the "*guilt by association hypothesis.*"

To empirically test the two hypotheses, we collect data on all US-listed Chinese firms, including IPO firms (CIPO) and CRMs, and short sellers' reports accusing Chinese firms of fraud. We test the two hypotheses in two phases. In the first phase, we directly test whether a CRM is more likely to be attacked by short sellers after controlling for other factors and study the information they use in their decision process. In the second phase, we examine the post-accusation performance of accused firms to further test the validity of short sellers' accusations.

In the first phase, we use a dummy variable indicating the identity (CRM or CIPO) of a Chinese firm and conventional factors that are known to affect the occurrence of firm misconduct to explain a firm's probability of being accused. Because the factors affecting the probability of financial misstatement may also decide a firm's choice between reverse merger and IPO in the first place, we use two-stage IV approaches and propensity score matching to mitigate the endogeneity problem. We find no evidence that short sellers are more likely to accuse CRMs, after controlling for other factors. We document that short sellers target firms that have abnormally high growth in profitability and a higher proportion of accounts receivables relative to the industry average or firms' histories. Short sellers also pay attention to firms with weak fundamentals. These results indicate that CRMs' high exposure to short sellers' accusations stems from firms' adverse selection at the initial stage.

Download English Version:

https://daneshyari.com/en/article/1004385

Download Persian Version:

https://daneshyari.com/article/1004385

Daneshyari.com