

There is a growing feeling that VIEs are becoming unworkable – hardly surprising for a structure which is trying to tell Chinese regulators that the business is owned by Chinese and to foreign investors that it is owned by foreigners. That's a concern given that half of all overseas listed Chinese companies use it. So, why don't the Chinese simply allow private companies to list overseas with a dual share structure to preserve control? Well, maybe there's a desire for them to list at home.

Why are VIE's used?

Private companies in China have had difficulty in getting access to capital and have looked to foreign investors as a source of funds. Unfortunately, Chinese companies need permission to list overseas and foreign companies are restricted from operating in certain domestic sectors.

How are they structured?

The solution has been to create a domestic vehicle that contains the restricted businesses and is owned by a Chinese individual. However, through a series of legal agreements, as opposed to share ownership, the economic interest is transferred to a domestic vehicle which, in turn, is owned by a foreign listed company. As the economic interest ultimately lies with the foreign company, it is able to consolidate the VIE.

Challenges to the VIE structure

Chinese regulations are designed to keep certain sectors out of foreign hands so a structure that puts them back in to those hands will come under scrutiny. There are many regulatory, shareholder and operational risks that have surfaced in scandals such as Alibaba, Sina.com and New Oriental Education. It is felt that VIEs are becoming unworkable, particularly for assets heavy businesses.

Where to now and how to fix it?

If China allows private companies to directly list abroad in the same manner as state-owned enterprises, VIEs are no longer necessary. Control could be maintained through a dual class share structure. One major beneficiary would be the elimination of the regulatory problems that have been so conducive to fraud.

Largest US-listed Chinese Companies with VIE Structures

Companies	BBG	Industry	Mkt Cap (US\$m)	YTD US\$ (%)
Baidu	BIDU	Internet	40,314	-1
Netease	NTES	Internet	6,764	15
Sina Corp	SINA	Internet	4,587	33
Youku Tudou	YOKU	Internet	3,357	32
Focus Media	FMCN	Advertising	3,126	25
Qihoo 360	QIHU	Internet	2,953	58
Ctrip.Com	CTRP	Internet	2,653	-21
New Oriental	EDU	Commercial	2,347	-37
Sohu.Com	SOHU	Internet	1,666	-12
Renren	RENN	Internet	1,562	14

Source: Forensic Asia Limited

Forensic Asia

1801-02, Wing On House
71 Des Voeux Road
Central, Hong Kong

Regulated by the SECURITIES
AND FUTURES COMMISSION
of Hong Kong

Paul L. Gillis, PhD, CPA

Guanghua School of
Management
Peking University
Beijing, China
gillis@gsm.pku.edu.cn

Follow us on Bloomberg
(FRSC), **twitter** or
facebook

Visit our sister companies:

Asianomics
ChartAsia

Accounting Matters

Variable Interest Entities in China

Investors in Chinese companies soon encounter an obscure accounting term – the variable interest entity, or VIE. A VIE is a company that is included in consolidated financial statements because it is controlled through contracts, rather than the more conventional control that is obtained through ownership. The contracts attempt, often imperfectly, to mimic the control and economic interest of direct ownership.

A VIE is a company that is included in consolidated financial statements because it is controlled through contracts

VIEs are widely used in China. Of the 225 Chinese companies listed on the NYSE and NASDAQ, 108 (48%) use the VIE structure (see Figure 2). Chinese companies traded on other exchanges, including the OTCBB in the U.S., the Hong Kong Stock Exchange, the Toronto Stock Exchange, the London Stock Exchange, and others, also use VIEs. Some multinational companies use VIEs to hold their part or all of their China operations.

Why are VIEs used?

After the Communists took power in China in 1949, private business disappeared and all economic activity was conducted by state-owned enterprises. Following the disastrous Cultural Revolution and the death of Mao Zedong, Deng Xiaoping, in December of 1978, set China on a path of reform and opening up that led to the China becoming the second largest global economy.

China's stock markets reopened in 1990 after having been closed in the early 1950s. Initially the stock markets were used to reform state-owned enterprises by providing capital and instituting corporate governance.

Private enterprise emerged as the opening up process began and entrepreneurs prospered in the new environment. By 2002, the share of GDP produced by the non-state sector exceeded two-thirds. Private companies, however, had great difficulty accessing capital. As late as 2006, a study found that 98% of Chinese companies could not access bank loans. In 2000, only 1% of companies listed on China's stock exchanges were privately owned. That began to change in 2001 when Jiang Zemin invited businessmen to join the Communist Party, signalling the beginning of reforms that would lead to the establishment of Chinese venture capital and private equity firms, the SME board on the Shenzhen Stock Exchange, and ChiNext, China's answer to NASDAQ. These new institutions would increasingly meet the capital needs of China's entrepreneurial sector.

These new capital institutions would lag the development of the private sector in China. Starved for capital locally, privately owned firms looked to overseas markets. Foreign investors were keen to participate in China's economic miracle. Yet, as companies prepared for public listings in overseas markets, obstacles loomed in their way. China required its companies that wanted to list overseas to obtain permission from the State Council, China's highest executive organ. The big state-owned enterprises like PetroChina that listed in the U.S. had no difficulty obtaining this permission, but it was viewed unlikely that a privately controlled business would be able to do the same. Instead the private companies formed offshore companies, typically in the Cayman Islands, to serve as the company that would actually list on the foreign exchange.

China required its companies that wanted to list overseas to obtain permission from the State Council but only SOEs were likely to get approval

Accounting Matters

Variable Interest Entities in China

Using offshore companies as the listing vehicle created a new problem for these companies. China controls foreign investment through an investment catalogue that classifies industries as encouraged, restricted, or prohibited for foreign investment. Many of the sectors in which entrepreneurs were active are restricted, including the Internet sector. The Internet entrepreneurs faced a problem. By using offshore companies they had made their company foreign, yet foreign companies could not operate their business because it was in a restricted sector. The entrepreneurs could have gone to Chinese regulators and asked permission to have foreign investors, but they thought it unlikely they would be successful in doing so.

Necessity being the mother of invention, this is when the VIE concept was created. The VIE structure is commonly called the Sina structure, named after Sina.com which listed on NASDAQ in 2000. Actually the structure was developed for two Chinese Internet companies, Sina and Sohu, which both listed in 2000 and Price Waterhouse (PW) audited both. The solution to the restricted sector problem was to separate the business into two parts – the parts of the business that were open to foreign ownership were put into a wholly foreign owned enterprise (WFOE) that was owned by the Cayman Islands public company. The parts of the business that were restricted to foreign ownership were put into a Chinese company that was owned by Chinese individuals (the VIE). The challenge was to include the restricted part in the consolidated financial statements, which was considered to be an essential requirement for going public. The accounting rules at the time focused on stock ownership; if a company was more than 50% owned it was to be consolidated. Many companies were abusing these rules by creating special purpose vehicles to hold debt. Since these companies did not own more than 50% of the shares of the special purpose vehicle they did not consolidate it, keeping the debt off their balance sheet. Enron made extensive use of this technique, and its collapse led to the establishment of VIE rules.

In the Sina and Sohu cases, PW accountants convinced the U.S. Securities and Exchange Commission (SEC) that the Chinese company that held the Internet content provider license and was owned by Chinese individuals should be consolidated into the financial statements of the offshore parent company. They argued that a series of agreements between the public company and the VIE sufficiently mimicked ownership so that the VIE should be consolidated. The accounting rules were formally changed in 2002 after Enron collapsed, and Financial Accounting Standards Board (FASB) Interpretation No. 46: Consolidation of Variable Interest Entities established rules that require consolidation of entities when the parent company has the risks and rewards normally associated with ownership, but the accountants at PW had convinced the SEC to apply the concepts to the Sina and Sohu offerings at an earlier date.

Many of the sectors in which entrepreneurs were active are restricted and could not be owned by foreigners

Separate the business into two parts: that which operates in restricted businesses (VIE) and that which does not (WFOE)

The VIE was owned by Chinese individuals but controlled through legal agreements by the listed vehicle

Auditors persuaded the SEC that VIE be consolidated into the financial statements of the offshore parent company

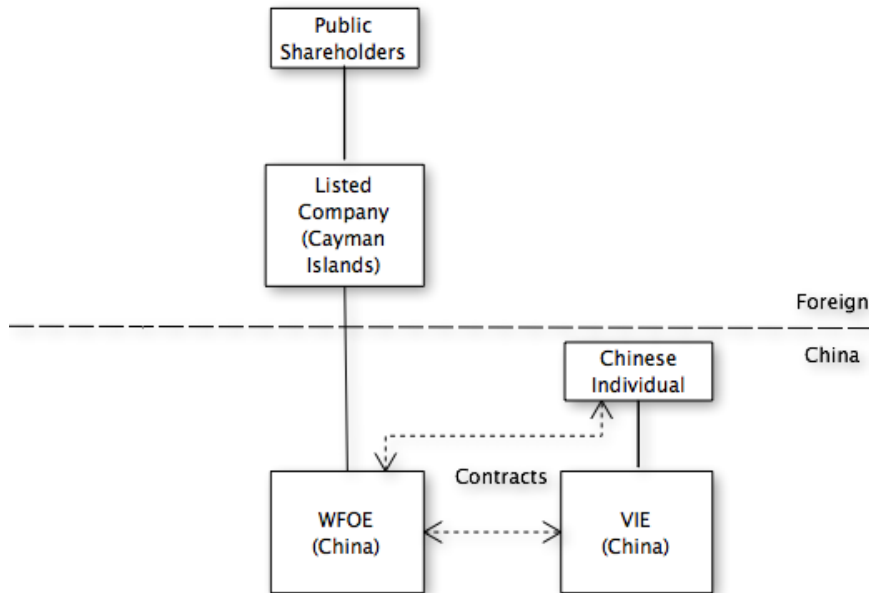
Accounting Matters

Variable Interest Entities in China

How are VIEs structured?

While there is some variation in VIE structures, an archetypal model has developed. Here is a diagram of the archetypal structure:

Figure 1: Structure of a Variable Interest Entity



Source: Paul Gillis

Some structures have Hong Kong companies between the Cayman Islands company and the WFOE. The objective of these intermediary companies is to minimize withholding taxes on dividends paid from China, but China's treaty shopping rules generally make this practice ineffective.

Starting at the top of the structure there are shareholders in the public company. The VIE structure is only used on overseas listed Chinese private companies. It is not used for State controlled companies like PetroChina or China Life, even when they are listed overseas. It is also not used with private companies listed on Chinese stock exchanges. While the VIE structure is most common on the NYSE and NASDAQ, it can also be found in companies listed on other foreign exchanges, including Hong Kong and Toronto. Because the VIE is an American accounting term, entities controlled through contracts are not called VIEs in those markets, but operate in the same manner.

The listed company for non-state controlled companies listing abroad is always an offshore company. The most popular location for incorporating these companies is the Cayman Islands, although the British Virgin Islands, the United States, and other jurisdictions are sometimes used. The listed company typically has no operations and serves only as a holding company.

The WFOE is a Chinese subsidiary that is wholly owned by the offshore listed company. A WFOE is the conventional entity used by multinational corporations to conduct business in China. Most overseas listed Chinese companies that do not use the VIE structure will conduct all of their China business in a WFOE. WFOEs are heavily regulated by Chinese authorities and must conduct their business within the scope of a business license that is granted to them. Companies using the VIE structure tend to conduct any part

While the VIE structure is most common on the NYSE and NASDAQ, it can also be found in companies listed on other foreign exchanges, including Hong Kong and Toronto

The WFOE is a Chinese subsidiary that is wholly owned by the offshore listed company

Accounting Matters

Variable Interest Entities in China

of the business that can be done by foreign invested enterprises in their WFOE. Often the WFOE obtains a business license that allows it to conduct a consulting business, and its only customer is the VIE.

The VIE is a Chinese company that is owned by an individual who holds Chinese nationality. The Chinese individual is typically the founder and chairman of the public company. In situations where the founder is not a Chinese citizen, another trusted employee is usually selected to own the VIE. This allows the VIE to claim it is domestically owned when it applies for permits to operate a business in a sector that is restricted for foreign investors. However, in order to consolidate the VIE in the financial statements of the public company, the VIE must meet certain accounting requirements.

FASB Interpretation No. 46: Consolidation of Variable Interest Entities (FIN 46) contains the accounting rules for VIEs. It has been amended and is now known as FIN 46R, and is included in the FASB Codification of Accounting Standards in Section 810. The rules as presently written require an entity to be consolidated where the parent company has the power to direct the activities of the entity which most significantly impact economic performance, has the obligation to absorb the expected losses of the entity, and has the right to receive the expected residual returns of the entity. When the VIE is initially formed, none of those conditions are met. In order to consolidate the VIE, a series of agreements are put in place to meet those requirements. These VIE agreements vary somewhat between companies, but most follow what has become a standard protocol.

What are the standard VIE agreements?

The concept that underpins a VIE structure is that control is obtained through legal agreements rather than through share ownership. Taken together, the agreements are intended to provide the WFOE with substantially all of the economic benefits from the VIE and the obligation to absorb all of its losses. The typical VIE will use five agreements to achieve this:

Loan agreement

The first two agreements deal with capitalizing the VIE, and attaining some sort of collateral for the loan given to provide funds for the capitalization. To achieve this, a loan agreement is set up and the equity in the VIE is pledged as collateral in the event of any failure to comply with the agreement.

The loan is normally given to the owners of a VIE by the WFOE and is typically in the form of an RMB denominated, interest free loan running for a number of years with the potential for extension. A loan from the offshore public company would face regulatory problems with the State Administration of Foreign Exchange. Regulatory problems remain, however. The authorized business scope of the WFOE is unlikely to include making loans to Chinese individuals, although no companies appear to have been challenged on this issue.

The loan agreement typically transfers most shareholder rights from the Chinese shareholder of the VIE to the WFOE, giving the WFOE the power to vote shares in the VIE, collect dividends, and make other important corporate decisions.

The VIE is a Chinese company that is owned by an individual who holds Chinese nationality

The rules as presently written require an entity to be consolidated where the parent company has the power to direct the activities of the entity

Control is obtained through legal agreements rather than through share ownership

The loan is normally given to the owners of a VIE by the WFOE

The loan agreement transfers most shareholder rights from the Chinese shareholder of the VIE to the WFOE

Accounting Matters

Variable Interest Entities in China

Equity pledge agreement

In order to establish security for this loan the owners of the VIE pledge their equity as collateral. Because an equity pledge is a form of security interest, it needs to be registered with the relevant Chinese authorities before it is perfected. If there is no registration, the equity pledge agreement may be unenforceable. In the past, companies have had difficulty getting these equity pledges properly registered. Pressure from the SEC has led to greater compliance by companies in seeking the registration of equity pledge agreements.

Owners of the VIE pledge their equity as collateral

Call option agreement

The call option gives the WFOE the legal right to purchase the VIE at a set price. This price is typically the amount of the loan granted to the founders to capitalize the VIE, or the “lowest permissible price under PRC law”. However, because the VIE is usually in an industry that is restricted to foreign investment, the call option cannot be exercised by the WFOE and would instead need to be transferred to another Chinese individual.

Gives the WFOE the legal right to purchase the VIE at a set price

Technical service agreement

The major challenge with VIE arrangements is the requirement that the parent company have a right to the residual profits of the VIE. This is typically accomplished through an agreement or series of agreements that name the WFOE as the exclusive provider of technical services to the VIE. The services provided by the WFOE to the VIE vary by company and industry, but often include website maintenance, programming, sales support, fulfilment services, curriculum development, etc. The agreements give the power to set the pricing for these services to the WFOE, and often explicitly provide that the WFOE can extract all of the profits of the VIE through these service agreements. In practice, however, many companies do not extract all of the profits through service agreements. Some companies also use an asset licensing agreement, under which the WFOE licenses certain assets, typically including intellectual property, to the VIE in exchange for royalty fees.

WFOE can extract all of the profits of the VIE through service agreements

Power of attorney

The founders of the VIE typically give a power of attorney to the WFOE that assigns to it all of the normal shareholder rights, including voting, attending shareholder meetings, and acts necessary to execute the call option agreement.

Give a power of attorney to the WFOE

Challenges to the VIE structure

Despite its widespread use for privately held Chinese companies listing abroad, the VIE structure has come under considerable attack in recent years. These risks fall into three broad categories: regulatory risks, shareholder misappropriation risks, and operational risks.

Regulatory Risks – Will the government shut down my company?

The raison d’être for VIEs is to avoid the effect of regulation. Companies that use the VIE structure tell two inconsistent stories. To Chinese regulators they say that the business is owned by Chinese and not by foreigners. Yet, to foreign investors they claim that foreigners own the business. It is unsurprising that VIEs face regulatory challenges.

To Chinese regulators they say that the business is owned by Chinese and not by foreigners. Yet, to foreign investors they claim that foreigners own the business

Accounting Matters

Variable Interest Entities in China

Chinese regulators initially ignored the growing use of VIE structures, even as most of China's Internet sector was developed under this model.

Chinese regulators initially ignored the growing use of VIE structures

No PRC regulatory body has officially approved a VIE structure, yet many investors and advisors believe that they have tacit approval to use the structure. There have been several challenges to VIE structures by regulators in recent years.

The first regulatory attack on VIEs came in 2009 when the General Administration of Press and Publication (GAAP), and two other regulators published Xin Chu Lian [2009] No. 13, (Notice 13). Notice 13 specifically prohibited the use of contractual arrangements to control Chinese Internet game operators. No action, however, has been taken against companies in this sector that use the VIE structure and the rules have essentially been ignored.

The first regulatory attack on VIEs came in 2009...

A more serious attack on the VIE structure occurred in late 2010 when Jack Ma of Alibaba Group attempted to obtain a license for Alipay from the People's Bank of China (PBOC). The PBOC had decided to regulate online payment processors and as a first step required them to obtain a license. Alipay is the market leader among online payment processors in China. It operated as a WFOE that was wholly owned by the Alibaba Group, a Cayman Islands company owned in turn by Yahoo!, Softbank and Jack Ma, a Chinese individual and CEO of Alibaba Group. Jack Ma was apparently told by regulators that Alipay could not obtain the required license if it was a WFOE, so the entity was converted to a VIE with Jack Ma as shareholder. Jack Ma was then informed by regulators that the license would not be granted to a VIE, so the VIE was unwound and Jack Ma ended up owning Alipay entirely by himself. Yahoo! and its shareholders were obviously outraged at the loss of Alipay, and negotiations ultimately lead to a deal for Alibaba to buy out Yahoo!.

...and then a more serious attack in 2010...

Buddha Steel, Inc. pulled its planned IPO in March of 2011 after local regulators in Hebei province told the company that its VIE structure contravened current Chinese management practices related to foreign invested enterprises and, as a result, was against public policy. Steel is a restricted industry for foreign investment.

...and let's not forget Buddha Steel

In August 2011, the Ministry of Commerce issued regulations requiring a national security review when foreigners acquire domestic companies. These regulations specifically provide that the required review could not be avoided through use of VIE or similar structures.

National Security review needed

In September 2011, a report surfaced in the Chinese press that was purported to come from the China Securities Regulatory Commission (CSRC). The report advocated greater regulation of the VIE structure (particularly in sensitive areas such as the internet), and suggested that Chinese companies should be encouraged to list at home. The report was widely reported and led to a significant decline in the price of companies using the VIE structure. Over the next year, however, no significant changes in the regulation of VIEs transpired.

Greater regulation of the VIE structure

Shareholder misappropriation risks – Will someone steal my VIE?

The nightmare scenario for investors in companies using the VIE structure is that the Chinese shareholder of the VIE will one day take the VIE and refuse to acknowledge the VIE agreements. The VIE structure is dependent on the enforceability of the contracts between the WFOE and the VIE. If those

The Chinese shareholder of the VIE will one day take the VIE and refuse to acknowledge the VIE agreements

Accounting Matters

Variable Interest Entities in China

contracts can be breached, not only does the accounting treatment fail, but also the public shareholders lose the business that is in the VIE.

Lawyers have given opinions that VIE structures are legal under Chinese law, often using remarkable legal gymnastics to explain why specific rules such as GAPP's specific prohibition on the use of VIEs for online games does not apply to their Internet game company. The opinions are consistently caveated with a statement that Chinese law is unclear and that authorities might disagree. The opinions point out that if authorities disagree, the consequences could be disastrous, leading possibly to the business being shuttered. What they do not usually point out is that the shareholder of the VIE might take the position that the contracts are not enforceable and will simply decide to ignore them and take the VIE. Like most countries, China has a rule that says that contracts that frustrate public policy are not enforceable, and as we saw in the Buddha Steel case, local regulators and judges might decide that VIE contracts frustrate public policy.

The first case challenging VIE contracts came up with the company that started the VIE trend – Sina. In 2001, not long after Sina's IPO, its board removed a founder who was also the controlling shareholder of its VIE. In the end the founder agreed to sell his shares in the VIE to another insider, and a crisis was averted.

Nasdaq listed Agria Corporation nearly lost its VIE in 2008 when its COO, who also owned the VIE, resigned in a compensation dispute. The COO had no share interest in the public company. The dispute was settled through a significant payment of cash and shares to the COO and to management of the VIE, and Agria was able to retain control of its VIE.

Gigamedia, a Nasdaq listed, Taiwan based, online game company lost its VIE when it tried to replace the VIE owner as head of its China operations. The VIE owner took the company chops, registrations and other key documents for both the VIE and the WFOE. The company and the VIE owner are fighting it out in court, but Gigamedia had to start over in China.

The most serious case related to loss of the VIE to the VIE shareholder was that of Alipay and Jack Ma. As previously discussed, Jack Ma ended up with sole ownership of Alipay after the PBOC said that Alipay could not get an online payment processor license if it was controlled by foreigners either as a WFOE or through VIE agreements.

Operational Risks – Will the VIE actually work?

VIE structures have been in use in China for a little more than a decade. While the regulatory risks and risks of VIE shareholder misappropriation have gotten most of the headlines, there is growing concern that the VIE structure is unworkable for some companies. When most of the business in the company is conducted in the VIE, China's tax and business laws make it difficult and expensive to operate a VIE.

The problems arise in asset-heavy VIEs; those where most of the assets and most of the business is conducted in the VIE. Internet companies are examples of asset-light VIEs. They usually have a small proportion of the assets and business in the VIE, operating most of the business in their WFOE. An Internet company will typically put only the Internet content provider license and the servers necessary to host the site into the VIE, retaining all of the

Lawyers have given opinions that VIE structures are legal under Chinese law...

...but the opinions are consistently caveated with a statement that Chinese law is unclear and that authorities might disagree

The first case challenging VIE contracts came up with the company that started the VIE trend – Sina

The most serious case related to loss of the VIE to the VIE shareholder was that of Alipay and Jack Ma

There is growing concern that the VIE structure is unworkable for some companies

The problems arise in asset-heavy VIEs

Accounting Matters

Variable Interest Entities in China

programming, advertising sales, and fulfilment activities in the WFOE. Consequentially there is minimal profit in the VIE, and this profit can be easily extracted through the service agreements.

Education companies are good examples of asset-heavy VIEs. In this industry it is necessary to put the entire school into the VIE because of restrictions on foreign ownership. Because the school has to collect the tuition, all of the profit of education companies tends to end up in the VIE. That creates problems.

Under the typical VIE structure, the profits of a VIE are extracted to the public company through service contracts. Chinese tax laws impose a 5% business tax on service payments. The business tax is similar to a sales tax or value added tax (VAT); in fact, China is in the process of turning the business tax into VAT. This tax is a cost of using a VIE since it would not be payable (because there would be no service charge) if the operations were in the WFOE.

Tax is a problem

There is also concern that Chinese tax authorities might question why a company would pay 100% of its earnings to another company for services. That is especially likely when those services are of dubious value. The authorities might make a transfer pricing adjustment, disallowing a deduction to the VIE for part or all of the service fee. That would significantly increase the tax liability of the VIE (which usually pays tax at 25%). If the tax authorities adjusted the transfer price, they might also allow the WFOE to reduce the income it reports, resulting in a tax refund to the WFOE. But they might not. After all, the cash found its way to the WFOE, so the tax authorities might instead characterize the payment as a dividend to the individual shareholder of the VIE (which is taxed at 20%), followed by a payment from the individual shareholder to the WFOE (which might be characterized as interest on the loan, and taxed to the WFOE at 25%). The end result would be a disaster – raising the effective tax rate above 60%.

Why would a company pay 100% of its earnings to another company for services?

Because of this risk, many asset-heavy VIEs have not been making the payments on the service contracts. Another reason for not making the payments is that the companies typically need the cash in the VIE, not the WFOE. It is usually not in the authorized business scope of the WFOE to be making loans or capital contributions to the VIE, so if the cash is transferred to the WFOE it is difficult to get it back to the VIE where it is needed for operations or capital improvements.

Many asset-heavy VIEs have not been making the payments on the service contracts

Companies have not typically been accruing the taxes that would result if they made the service payments under the VIE agreements. They argue that they do not intend to ever make these payments. The problem with that argument is that it undermines the basis for treating the company as a VIE in the first place. One of the key requirements for consolidating a company as a VIE is that the parent company has a right to the residual profits of the VIE. If it has no intent to ever distribute the profits of the VIE to the public company, should the public company be considered to have a right to those residual profits?

Companies have not typically been accruing the taxes

The most recent scandal with respect to VIEs broke when New Oriental Education (NYSE: EDU) “EDU”, announced that it was under SEC investigation as to whether it should be consolidating its VIEs. Shortly after this announcement Muddy Waters, a short-selling research firm, released a report alleging that EDU was improperly consolidating certain operations that were

A scandal with New Oriental Education

Accounting Matters

Variable Interest Entities in China

actually franchise operations, not-for-profits, or state-owned. A special committee of the board was formed to conduct an investigation.

Where to now?

The problems with VIEs have led many investors to conclude that the structure is unsustainable. The problems are unsurprising because the structure is based on inconsistent statements. To investors, the company says that it owns its operations, yet to Chinese regulators it claims it does not control them. Neither statement is true and a structure built on lies is not likely to work for long.

The reasons why the VIE structure is needed are related to Chinese regulations restricting foreign investment in certain sectors, or which make it difficult for Chinese companies to directly list abroad. The solution to the problem can be found by addressing those regulations.

A number of state-owned enterprises have listed abroad without using offshore structures or VIEs. China's major telecommunications companies, China Mobile, China Unicom, and China Telecom are all listed on the New York Stock Exchange yet do not use either an offshore holding company or a VIE. Like the Internet industry, the telecommunications industry is restricted for foreign investment. These state-owned enterprises had the political power to obtain permission to directly list ADSs abroad and to have foreign investment. Private companies have not had that level of political clout and as a consequence were forced into offshore holding companies and VIE structures.

The problem with VIEs and offshore companies could be eliminated if permission were given to private companies to directly list abroad. No change in law or regulations appears to be necessary, rather the government simply needs to give the same permission to privately owned companies to directly list abroad that it has given to the large SOEs.

Allowing private Chinese companies to directly list abroad would eliminate the only justification for using a VIE structure – to avoid Chinese regulations that prohibit foreign investment in certain sectors. It has the additional benefit of closing the regulatory hole that these companies have fallen into. Chinese regulators have been unable to effectively regulate overseas listed Chinese companies because the listing entity is usually a Cayman Islands company that is outside of their jurisdiction. U.S. regulators like the SEC and the Public Company Accounting Oversight Board (PCAOB) have likewise been unable to effectively regulate these companies because, despite being Cayman Islands companies, the officers and records are located in China and Chinese regulators will not grant them access. These regulatory holes have been a major factor in creating an environment conducive to fraud. While allowing private companies to directly list abroad does not solve the access issues for U.S. regulators, it would allow Chinese regulators to more effectively supervise the companies.

How to fix the VIE structures

If China decides to allow private companies to directly list abroad in the same manner as SOEs, the Cayman Islands and VIE structures are no longer necessary. If Chinese regulators decide to go in this direction, I expect they will

The VIE structure is unsustainable

SOEs can list overseas

Why not allow private companies?

It would help closing the regulatory hole

Ask US-listed Chinese companies to restructure

Accounting Matters

Variable Interest Entities in China

approach several leading U.S. listed Chinese companies and ask them to restructure. The companies will be allowed to directly list ADSs of a Chinese company on U.S. exchanges, but first they will be asked to merge the offshore parent company and the WFOE into the VIE. At that point the operating company in China would become the listed company. That is a big win for investors since they now have direct ownership in the entity that actually operates the business. The restructuring solves the regulatory problems, the shareholder moral hazard problems and the operational problems that have plagued the VIE structure. Investors can also hope that Chinese regulators take a more active role in supervising the company, perhaps heading off some of the frauds that have so damaged the market for U.S. listed Chinese companies.

Investors would actually own the operating company

The original concern of Chinese regulators in restricting foreign investment in certain sectors was to make certain that Chinese, and not foreigners, were making the decisions that impact sensitive sectors. Those concerns remain, even though the offshore structures and VIEs have substantially undermined the policy. I expect that Chinese regulators will want to make certain that Chinese remain in control of critical decisions that may impact social stability or state secrecy. The easiest way to accomplish this would be through a multiple share structure. A shares, with full voting rights, would be issued to Chinese nationals. B shares, with limited voting rights would be traded as ADSs on U.S. exchanges. This structure would also facilitate the listing of A shares on Chinese exchanges, which I expect the companies will be encouraged to do. Chinese regulators have indicated they would prefer that the overseas listed companies come home to list, and this could be the first step in making that happen.

Use a multiple share structure to retain control

Another advantage of allowing Chinese companies to directly list abroad is that the CSRC could be made the first gatekeeper for access to foreign capital markets. Companies that wish to list overseas would need to seek the permission of the CSRC, which could stop listings of companies with state security issues or disreputable management. By making the CSRC the primary regulatory of overseas listed companies, it should be easier for overseas regulators such as the SEC and PCAOB to negotiate workable arrangements for obtaining the information needed to enforce foreign securities laws.

Accounting Matters

Variable Interest Entities in China

Figure 2: US Listed Companies With VIE Structure, in Descending Order of Market Capitalisation

Company	BBG	Industry	IPO/RTO	Market Capitalisation (US\$m)	YTD US\$ (%)
Baidu Inc-Sp Adr	BIDU	Internet	IPO	40,314	-1
Netease Inc-Adr	NTES	Internet	IPO	6,764	15
Sina Corp	SINA	Internet	IPO	4,587	33
Youku Tudou Inc	YOKU	Internet	IPO	3,357	32
Focus Media-Adr	FMCN	Advertising	IPO	3,126	25
Qihoo 360 Te-Adr	QIHU	Internet	IPO	2,953	58
Ctrip.Com-Adr	CTRP	Internet	IPO	2,653	-21
New Oriental-Adr	EDU	Commercial Services	IPO	2,347	-37
Sohu.Com Inc	SOHU	Internet	IPO	1,666	-12
Renren Inc-Adr	RENN	Internet	IPO	1,562	14
Changyou.Com-Adr	CYOU	Software	IPO	1,416	38
51job Inc-Adr	JOBS	Commercial Services	IPO	1,260	4
Giant Intera-Adr	GA	Internet	IPO	1,219	34
Home Inns & -Adr	HMIN	Lodging	IPO	1,163	-1
Shanda Games-Adr	GAME	Software	IPO	1,073	24
Soufun Holdi-Adr	SFUN	Internet	IPO	1,090	7
Spreadtrum-Adr	SPRD	Semiconductors	IPO	985	2
Asiainfo-Linkage	ASIA	Internet	IPO	880	57
Tal Educatio-Adr	XRS	Commercial Services	IPO	662	-14
E-House Chin-Ads	EJ	Real Estate	IPO	661	34
21vianet-Adr	VNET	Internet	IPO	619	21
Autonavi Hol-Adr	AMAP	Software	IPO	608	22
Elong Inc-Sp Adr	LONG	Internet	IPO	567	10
Perfect Worl-Adr	PWRD	Internet	IPO	546	23
E-Commerce C-Adr	DANG	Internet	IPO	435	24
Nq Mobile Inc- A	NQ	Software	IPO	381	52
Hisoft Techn-Adr	HSFT	Software	IPO	358	24
Fushi Copperweld	FSIN	Electrical Compo&Equip	RTO	349	21
Cninsure Inc-Adr	CISG	Insurance	IPO	324	-7
Synutra Internat	SYUT	Pharmaceuticals	RTO	309	7
Bona Film Gr-Adr	BONA	Entertainment	IPO	308	33
Isoftstone -Ads	ISS	Commercial Services	IPO	298	-39
3sbio Inc-Adr	SSRX	Biotechnology	IPO	299	32
Yingli Green-Adr	YGE	Electrical Compo&Equip	IPO	295	-51
Kongzhong-Adr	KONG	Telecommunications	IPO	284	65
Phoenix New -Adr	FENG	Media	IPO	275	-37
Noah Holding-Ads	NOAH	Diversified Finan Serv	IPO	264	-22
Xueda Edu Gp-Adr	XUE	Commercial Services	IPO	231	-4
Ambow Educat-Adr	AMBO	Commercial Services	IPO	209	-60
Charm Commun-Adr	CHRM	Advertising	IPO	200	-39
Bitauto Hold-Adr	BITA	Internet	IPO	180	8
China Nepsta-Adr	NPD	Retail	IPO	181	46
Cdc Corp-CI A	CDCAQ	Software	IPO	180	3,088
Chindex Intl Inc	CHDX	Healthcare-Products	RTO	177	22
China Digita-Adr	STV	Electronics	IPO	173	-8
Jiayuan.Com Inte	DATE	Internet	IPO	172	-6
Utstarcom Holdin	UTSI	Telecommunications	IPO	170	-21

Accounting Matters

Variable Interest Entities in China

Company	BBG	Industry	IPO/RTO	Market Capitalisation (US\$m)	YTD US\$ (%)
China Transinfo	CTFO	Software	RTO	144	63
Taomee Holdi-Adr	TAOM	Internet	IPO	135	-20
Airmedia-Adr	AMCN	Advertising	IPO	122	-49
The9 Ltd-Adr	NCTY	Software	IPO	121	-31
Chinacache-Adr	CCIH	Internet	IPO	113	24
China Distan-Adr	DL	Commercial Services	IPO	108	56
Chinaedu Cor-Adr	CEDU	Commercial Services	IPO	105	0
Linktone Ltd-Adr	LTON	Internet	IPO	93	94
Ata Inc-Adr	ATAI	Software	IPO	98	-39
Syswin Inc-Ads	SYSW	Real Estate	IPO	94	111
China Nuok-Adr	NKBP	Pharmaceuticals	IPO	92	69
Acorn Intern-Adr	ATV	Advertising	IPO	81	-33
Kingold Jewelry	KGJI	Retail	RTO	79	30
L&L Energy Inc	LLEN	Coal	RTO	74	-24
Sky-Mobi Ltd-Adr	MOBI	Retail	IPO	70	-30
Cogo Group Inc	COGO	Computers	RTO	60	0
China Techfa-Adr	CNTF	Telecommunications	IPO	55	-42
Lentuo Inter-Adr	LAS	Retail	IPO	56	-24
Noah Educati-Adr	NED	Software	IPO	54	-33
Ku6 Media-Adr	KUTV	Internet	IPO	50	-17
Ninetowns In-Ads	NINE	Software	IPO	43	-15
Agria Corp - Adr	GRO	Agriculture	IPO	41	-29
Mecox Lane-Adr	MCOX	Internet	IPO	37	-45
Sinocoking Coal	SCOK	Coal	RTO	38	-21
Origin Agritech	SEED	Biotechnology	RTO	33	-39
Tri-Tech Holding	TRIT	Environmental Control	IPO	32	-15
China Informatio	CNIT	Telecommunications	RTO	27	-21
Daqo New Ene-Adr	DQ	Chemicals	IPO	30	-49
Vimicro Inte-Adr	VIMC	Semiconductors	IPO	31	-38
Trunkbow Interna	TBOW	Telecommunications	RTO	29	-58
China Financ-Adr	JRJC	Internet	IPO	28	-22
Visionchina -Adr	VISN	Advertising	IPO	27	-79
Advanced Battery	ABAT	Electrical Compo&Equip	RTO	24	-26
Chinacast Educat	CAST	Commercial Services	RTO	24	-92
China Natural Ga	CHNG	Pipelines	RTO	21	na
Telestone Techno	TSTC	Telecommunications	RTO	18	-64
China Hgs Real E	HGSH	Real Estate	RTO	15	-45
Efuture Informat	EFUT	Software	IPO	15	-14
Skystar Bio-Phar	SKBI	Pharmaceuticals	RTO	13	-40
Shengkai Innovat	VALV	Miscellaneous Manufactur	RTO	12	-43
Andatee China	AMCF	Transportation	IPO	12	-61
Biostar Pharmace	BSPM	Pharmaceuticals	Other	11	-38
Chinanet Online	CNET	Advertising	RTO	11	-55
Tianli Agritech	OINK	Agriculture	IPO	10	-19
China Jo-Jo Drug	CJJD	Retail	RTO	10	-38
China Yida Holdi	CNYD	Media	RTO	9	-77
Dehaier Med Sys	DHRM	Healthcare-Products	IPO	9	32
Euro Tech Hldgs	CLWT	Distribution/Wholesale	IPO	8	56
Qkl Stores Inc	QKLS	Food	RTO	8	-64

Accounting Matters

Variable Interest Entities in China

Company	BBG	Industry	IPO/RTO	Market Capitalisation (US\$m)	YTD US\$ (%)
Cleantech Soluti	CLNT	Metal Fabricate/Hardware	RTO	7	-13
China Advanced C	CADC	Building Materials	RTO	8	-81
Sino-Global Ship	SINO	Transportation	IPO	6	0
Recon Technology	RCON	Oil&Gas Services	IPO	7	465
Kingtone Wir-Adr	KONE	Software	IPO	4	-15
Jingwei Internat	JNGW	Software	RTO	3	na
Tibet Pharma	TBET	Pharmaceuticals	IPO	1	-95
China Cgame Inc	CCGM	Internet	RTO	1	-81

Accounting Matters

Variable Interest Entities in China

Figure 3: Past Forensic Asia Research

Date	Author	Title	Hyperlink
13 Sep 12	Quincy	Sell Chinese Banks	Download...
11 Sep 12	Gillem Tulloch	Asian Financial Stress: A north-south divide	Download...
05 Sep 12	Keith Neruda	China Telcos: Time to put the Mobile/Unicom pair trade back on	Download...
03 Sep 12	Gillem Tulloch	Summer's Over: China Prop/Everbright/Jain/Country Visits	Download...
13 Aug 12	Gillem Tulloch	Worldwide Financial Stress: BRICing apart?	Download...
09 Aug 12	Keith Neruda	Bharti Airtel (Sell): Time for Plan B	Download...
03 Aug 12	Gillem Tulloch	Thailand Visit (O/W): A crowded trade	Download...
25 July 12	Forensic Asia	Angels & Demons: Introducing ChartAsia	Download...
24 July 12	Keith Neruda	China Unicom (Sell): Not yet a fundamental buy signal	Download...
20 July 12	Gillem Tulloch	China Property: Making sense of it all	Download...
09 July 12	Chris Roberts	Asian Equities: Unfinished bear	Download...
07 July 12	Gillem Tulloch	Day 6: Boom town	Download...
06 July 12	Gillem Tulloch	Day 5: Bullet train to Beijing	Download...
05 July 12	Gillem Tulloch	Day 4: Shanghai frustration	Download...
04 July 12	Gillem Tulloch	Day 3: Wenzhou deteriorating	Download...
03 July 12	Gillem Tulloch	Day 1&2: Zhenzhou powering ahead	Download...
28 June 12	Gillem Tulloch	China Corporate Solvency: Accrued interested expenses rising	Download...
24 June 12	Gillem Tulloch	Greentown China (Sell): Dead man walking?	Download...
20 June 12	Gillem Tulloch	Suspicious Behaviour: China's deteriorating working capital	Download...
12 June 12	Forensic Asia	Angels & Demons: It's all about China	Download...
11 June 12	Gillem Tulloch	Greentown China (Sell): Mad or desperate	Download...
05 June 20	Gillem Tulloch	China (U/W): Corporate balance sheets at breaking point	Download...
29 May 12	Gillem Tulloch	A balance sheet goes missing	Download...
25 May 12	Keith Neruda	China Unicom (Sell): Lower rates don't address core concerns	Download...
22 May 12	Gillem Tulloch	China Property: Are presales real?	Download...
15 May 12	Forensic Asia	Angels & Demons – Potpourri	Download...
09 May 12	Gillem & Keith	Indian Company Visits: Be greedy...	Download...
03 May 12	Keith Neruda	Bharti: Trading at 50x balance sheet adjusted PE	Download...
26 Apr 12	Forensic Asia	Angels & Demons: Mad & bad	Download...
26 Apr 12	Keith Neruda	China Unicom: Financing costs make themselves felt	Download...
23 Apr 12	Keith Neruda	China Mobile 1Q12 results	Download...
18 Apr 12	Gillem Tulloch	China Property: Just a bad dream?	Download...
16 Apr 12	Gillem Tulloch	Bo Xilai and China Everbright (Sell)	Download...
11 Apr 12	Gillem & Keith	China Mobile: A short debate on the pros and cons	Download...
04 Apr 12	Gillem Tulloch	Greentown China results: Going, going...	Download...
02 Apr 12	Gillem Tulloch	Shimao results: Don't buy the hype	Download...
30 Mar 12	Gillem Tulloch	Indian corporate overview	Download...
23 Mar 12	Keith Neruda	China Unicom (Sell): Valuation levers worsening	Download...
21 Mar 12	Gillem Tulloch	Philippine corporate overview	Download...
15 Mar 12	Keith Neruda	Profiting from mispriced balance sheets	Download...
07 Mar 12	Gillem Tulloch	Asia 2011 reporting season/Shimao Property presales fall 31%	Download...
24 Feb 12	Gillem Tulloch	US road show/China 2011 earnings disappoint	Download...
17 Feb 12	Gillem & Keith	Indian company visits – First thoughts	Download...
16 Feb 12	Gillem & Keith	Indonesian company visits	Download...
09 Feb 12	Keith Neruda	Bharti (SELL): Overvalued, illiquid balance sheet	Download...
03 Feb 12	Gillem Tulloch	China earnings disappoint	Download...
27 Jan 12	Gillem Tulloch	Reliance Communication: Under-Reporting Liabilities	Download...
13 Jan 12	Gillem Tulloch	India's foreign debt problem	Download...

Source: Forensic Asia