Chinese Style Accounting and Shareholder Management

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By some measures, the nation of China now makes up 18.2% of all global economic activity, compared with 12.4% for the U.S. Fully 18.47% of all the people in the world live in China, compared with less than 5% in the United States. Yet when you look at the MSCI All-World Index which is designed to capture the total world investment opportunity set, you find that the United States makes up just under 60% of the total market allocation, while China makes up… (wait for it)… 3.3%.

How is that possible?

There are actually a variety of good reasons, including the fact that the total share value of U.S. public companies is much higher than those domiciled in China. But perhaps the biggest reason why China punches low on the world's equity stage is the fact that its biggest companies in the biggest industries are largely owned and controlled by the Chinese Communist Party—which is far more concerned with forcing them to achieve its political goals than with actual profits and shareholder value.

The most recent example of stagnation came when three-fifths of the Hang Seng index of state-owned enterprises missed their earnings-per-share estimates, meaning that the utilities, telecommunications, and consumer staples firms were in decline, with no clear sign of improvement. What makes this even more troubling to current and potential investors is that the Chinese government basically dictates what will be reported about these companies, using accounting principles that could be fairly described as 'making stuff up to keep our bosses happy.'

The Chinese government is reportedly telling state-owned companies to focus on restoring overall growth and creating jobs, which is not necessarily the path to building shareholder value. One optimistic sign that maybe the country will break free from the heavy hand of Beijing bureaucrats came when China moved to streamline stock market listing rules by (according to the announcement of the policy) getting the government out of the business of approving new initial public offerings.

Investment bankers in China hoped that this would give a boost (and a certain amount of freedom) to the economy's private sector and introduce the kind of capitalistic entrepreneurship that is a normal part of the U.S. economy. Under the new system, China's stock exchanges will vet the IPOs, with the stated goal of focusing on improving corporate information disclosure.

More recently, enthusiasm has been tempered a bit by the fact that the stock exchanges, fearful of angering their masters in Beijing, have been impossibly rigorous in their 'investigations' of would-be new publicly-traded companies and that any decision will have to clear through the China Securities Regulatory Commission—which, you guessed it, is the same heavy hand of the government. The Commission's stated role (you guessed it again) will be to make sure all listings are in line with Beijing's broad industrial policy. One investment banker who had hoped to foster IPOs in China noted that all the applicants are being screened based on national policies, and hundreds of would-be new public companies have now abandoned their plans to be listed on the various exchanges.

Last year, the government reported a 3% growth after the abrupt end of the stultifying Zero-Covid policy, but almost nobody believes that actual economic growth was that high. This year, the Chinese leadership has set a target of 5% total GDP growth. No matter what happens in the Chinese economy between now and the end of the year, it's a pretty good bet that the government's statistical economists will be reporting that this goal was roundly achieved. With this level of transparency (or lack thereof), and these goals completely at odds with delivering shareholder value, the low percentage of Chinese companies in the global indices starts to make sense.

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