Research on the IPO Listing Risks of Chinese Family-Owned Private Enterprises Based on a Rejection Case

ChunNgai To

School of Finance, Jinan University, Guangzhou, China

djynb@stu2021.jnu.edu.cn

Abstract. With the continuous improvement of the capital market and the trend of national economic development, China's IPO system has also changed in response to the country's circumstances and financial situation. Thanks to Chinese economic reform, more and more private companies want to IPO listing. In addition, most of these companies are family-owned private enterprises, which are the main group of IPO applicants due to their seniority and size. However, this type of enterprise started early, it still have many old and inadequate systems, as well as irregularities in disclosure and trading. These shortcomings will become the main risk of IPO failure. Shenghuabo Electric Co., Ltd. is a typical family-owned private enterprise, thus it will be used as an example for this paper. In addition, this article mainly analyses the reasons related to the enterprise's IPO being rejected, and gives corresponding solutions. The purpose of it is to provide assistance to family-owned private companies for future IPO listings.

Keywords: Family-owned private companies, IPOs, Internal control irregularities, Performance authenticity, IPO reboot.

1. Introduction

Initial public offering (IPO) has been a popular term on Wall Street and among investors. The Dutch, who sold shares of the Dutch East India Company to the public, are considered to have pioneered the contemporary IPO [1]. The origins of China's stock market can be traced back to the early 1990s, when the official opening of the Shanghai Stock Exchange and Shenzhen Stock Exchange signalled the beginning of conditions and platforms for IPOs in China.

China's IPO first adopted the approval system, enterprises need to compete for the audit target and amount, among which there is no lack of enterprises through bribery to pass the audit. Subsequently, the central government reformed the system, and on 17 March 2001, China officially opened the IPO approval system [2]. In order to comply with the development of China's capital market, China's State Council implemented the initiative to reform the registration system for stock issuance in March 2016 onwards. Eventually, the government's policy was finalized and the China Securities Regulatory Commission (CSRC) released on 17 February 2023 the rules of the system related to the full implementation of the registration system for stock issuance.

As the gradual relaxation of the IPO regime means that the efficiency of companies going public increases dramatically, the number of companies applying for IPOs will also increase [3]. In addition to this, although the full registration system of IPO relaxes the threshold of financial requirements, the regulator will be strict with each sub-division of the requirements, especially the main board [4]. Of those businesses that applied, family-owned enterprises account for the majority. However, most of this type of enterprises were established in the 70's and 80's, and their internal control system and the standardization of their business are poor, which do not meet the current listing requirements of the Securities and Futures Commission, and even lead to the IPO being rejected.

As a typical family-run private enterprise, Shenghuabo's IPO failure is the first case of IPO failure in 2024, so this case is representative. When analyzing the case of ShengHuabo, not only can we analyse the reasons for the company's IPO failure, but we can also provide references and help for the same type of companies to apply for IPO so as to facilitate the re-launching of IPO for this type of companies in the future.

2. Introduction and IPO Case Study of Shenghuabo Electric Co.

2.1. Introduction of Shenghuabo Electric Co., Ltd.

According to the information, Shenghuabo was born in 1986 in Rui'an City, Zhejiang Province. The enterprise is specialized in manufacturing automotive electrical parts. Meanwhile, its group has a total of 6 subsidiaries and branches, which are located in North America, Shanghai, Wenzhou City, Zhejiang Province, Rui'an City and other places. The total area is up to 160,000 square meters and there are 2,600 employees. Shenghuabo is committed to R&D and manufacturing capacity improvement and management, "low-cost and high-quality" is synonymous with his many customers agree that the enterprise's products cost-effective. In addition, it has won the honors of "Excellent Supplier" and "Best Supporting Unit" for many times.

The business of Shenghuabo includes market development, product design, molds design and manufacturing, production and sales. It runs through the whole industrial chain of design, manufacturing and sales. Its main products include: automotive electric wiper assembly, automotive seat motors, generators, glass lifters, other automotive electric appliances and other metal parts. Numerous categories of products are also distributed in various domestic and foreign car companies, such as the famous domestic car companies: SAIC, BAIC, Chery Automobile, etc. In the foreign market which is focused on: Ford, Volkswagen, Citroen and Renault.

2.2. Motivation for the IPO of Shenghuabo Electric Co., Ltd.

Initial public offerings (IPOs) represent an important stage of development for many firms as they try to gain access to the resources needed for growth and development [5]. By the end of 2023, the total number of small and medium-sized enterprises (SMEs) in China exceeded 52 million, thanks to the country's policies. The common financing problems faced by many SMEs are: high demand for capital and few ways to raise capital. The reason why SMEs have a high demand for capital is that most of them are committed to developing new technologies and researching new products. And the research and development cost is a lot of money, so IPO has become one of the financing methods for SMEs [6].

Shenghuabo's motivation for this IPO is to raise 902 million yuan for an annual production capacity of 4.5 million sets of wiper expansion project, an annual production capacity of 15 million seat motors expansion project, an intelligent transformation project for key components of the automotive wiper assembly, and to supplement working capital. In addition, 500 million yuan will be withdrawn from the total fundraising as the company's working capital supplement, accounting for 55.43% of the total fundraising. Shenghuabo said, this fund raising is to meet the company's expanding business scale of liquidity needs, enhance the company's anti-risk ability, optimize the company's capital structure, to protect the company's sustained and development after listing [7].

2.3. IPO Listing Process of Shenghuabo Electric Co., Ltd.

The timing of Shenghuabo's IPO was at the time of the alternation between the approval system and the registration system. Shenghuabo submitted an application for a Shanghai main board IPO to the SFC in May 2022, and after a five-month-long review and examination, it received feedback from the SFC in October. However, due to the official implementation of the full registration system in 2023, Shenghuabo's IPO was transferred by the SFC to the SSE for enquiry.

On 12 January 2024, the 2nd Review Meeting was held. The main questions asked on-site at the Listing Committee meeting which were as follows: i. the issuer's representative was requested to explain whether the issuer had undue control risks and whether the internal control system was sound and effectively implemented in light of the company's governance structure and historical internal control irregularities; ii. the issuer's representative was requested to explain whether the issuer's revenue was real and bad debt provisioning was adequate in light of the characteristics of the industry in which the company operated, its business structure, the target of its customers, its return on investment after the period, the difference between the cash flows from its operation and the net profit,

the accounts receivable turnover rate and aging of accounts, etc., to explain the authenticity of the issuer's income and the adequacy of the provision for bad debts; Thirdly, the representative of the issuer is requested to explain the financial transactions that existed between the issuer and its related parties with Qianshun Trade, Rui'an Wanshun, and Kunshan Patriot in the past, and whether the disclosure of the related parties and the related transactions is true, accurate and complete.

The whole process of Shenghuabo's IPO took a total of 621 days, two rounds of enquiry and one meeting. Finally, the result of the deliberation of the "Announcement of the Result of the 2nd Deliberation Meeting of the Listing Review Committee of the Shanghai Stock Exchange in 2024" shows that: Shenghuabo Electric Co., Ltd. was rejected for IPO because it did not comply with the conditions of issuance, listing or disclosure requirements.

3. Reasons for the IPO Rejection of Shenghuabo Electric Co., Ltd.

In the first half of 2023, a total of 219 enterprises made IPO applications in China, and the final results showed that 197 enterprises passed, 10 enterprises were rejected, and the remaining 10 enterprises were suspended. Upon calculation, the passing rate reached 89.95%, while the reasons for the rejected enterprises were mainly divided into the following five categories: inadequate information disclosure; segment positioning; abnormal internal control structure; going concern ability; and business authenticity [8].

3.1. Authenticity of Performance

On the relevant financial statements submitted by Shenghuabo at the IPO Deliberation Meeting, it is shown that Shenghuabo's core products are automotive wipers and automotive seat motors, and the statements show that the revenues of the two products in 2022 will be 1.296 billion yuan and 1.629 billion yuan. They account for 41.68% and 52.4% of the total sales respectively. In the past three years, the sales revenue of Shenghuabo for the growth trend, respectively, in 2020 to 2022 revenue of 1.928 billion yuan, 2.508 billion yuan and 3.194 billion yuan. It can be seen that this strong performance is to meet the IPO audit standards, but Shenghuabo was rejected in the deliberation.

The basis for the veto came from the ratio of cash flow from operating activities to net profit, this ratio is a measure of whether a company's revenue is actually converted into real cash flow in the current period, but rather accounts receivable to reflect this part of the purchase price. There are some differences between Sheng Hua Bo and its peers. In 2022, the annual financial statements of several related companies show that: Shenghuabo's "net cash flow from operating activities as a percentage of net profit" is 40.65%, and the average value of the same financial indicator of the six comparable companies in the same period is 147.22%, which is the same as that of the Top Group, Xiangyu Pump, Tenglong, Songzhi, Quanfeng Automobile and Hengshuai. 147.22%.

From Table 1, it is found that the cash flow of the comparable companies is basically higher than the profit (the ratio of net cash flow to profit is more than 100 per cent), while Shenghuabo is the opposite, showing that it is "substantially lower than the profit". This loophole just confirms the question of the authenticity of the results [8].

Table 1. Net cash flows of comparable companies as a percentage of profits

Company name	Net cash flow as a percentage of profit
Shenghuabo	40.65%
Top Group	134.44%
Xiangyu Pump	79.17%
Tenglong	94.90%
Songzhi	124.24%
Quanfeng	341.75%
Hengshuai	108.84%
Average except Shenghuabo	147.22%

3.2. Large Dividends before IPO Listing

In recent years, the regulators take the capital markets very seriously, and have made every effort to suppress the phenomenon of sudden dividends before the IPO. Shenghuabo in the three years from 2019 to 2021, the amount of dividends were 120 million yuan, 164.75 million yuan and 20 million yuan, total of about 300 million yuan, accounting for one-third of the amount of financing of this IPO.

It is worth questioning that the purpose of this IPO is R&D, production and replenishment of liquidity, which is undoubtedly contrary to the act of dividend distribution. The dividend of up to 300 million yuan proves that Shenghuabo has sufficient funds in these three years, the company not only did not use the funds for production and replenishment of liquidity, but also for dividends. Another IPO fundraising in 2022, this practice really makes the public and regulators suspicious [9].

3.3. Internal Control Irregularities

3.3.1 Internal control structure

Shenghuabo's shareholding structure in the A-share market is special compared to its peers, as the company's three de facto controllers are brother and sister (Shangsheng Wang, Shanghua Wang and Shaobo Wang). The three of them control all the shareholdings and actual benefits of Shenghuabo. Most of the important positions in the company are held by relatives of the three, for example, Jiajia Wang, the daughter of Shangsheng Wang, is the director and secretary of the board of directors of the company, Weiliang Li, the general manager, is the son-in-law of Shanghua Wang, Lihui Wang, the deputy general manager, is the daughter of Shangsheng Wang, and Jian Wang, the deputy general manager, is Shanghua Wang's son, etc [9]. This belongs to the typical family business, which is normally difficult to supervise internally in this kind of business.

3.3.2 Relationship between internal controls and dividends

From 2019 to 2021 up to 300 million yuan of dividends basically all belong to Shenghuabo company and the three actual controller's relatives. In addition, when asked about the destination of the dividends, the reply material shows that the 300 million yuan of dividends, the three actual controllers of Shenghuabo were obtained ShangSheng Wang 60.95 million yuan, ShangHua Wang 30.475 million yuan, ShaoBo Wang 30.475 million yuan. The dividend payments of the three were used for personal life, such as investment and finance management, purchase of property and daily expenses. It can be seen that none of the three used the dividends for any Shenghuabo development or liquidity replenishment [9], and the regulator has reason to doubt the company's motivation for listing.

3.3.3 Cases of irregularities in internal control

According to the reply materials to the audit enquiry, Shenghuabo has internal control irregularities in transactions. For example, Shenghuabo has a large number of related transactions from 2020 to 2022, as shown in Table 2, Shenghuabo purchased steel from Shanghai QianShun Trading Co., Ltd. for a total of 202 million yuan, accounting for 5.11%, 5.74% and 0.93% of the company's annual purchasing amount, respectively. And the actual controller of Shanghai Qianshun Trade Co., Ltd. (an associated company of Shenghuabo)is Fang Yi (a former employee of Shanghai Shenghuabo) [10].

Table 2. 2020-2022 Shenghuabo purchases steel from Qianshun Trading Co.

Year	Amount (yuan)	Percentage of total purchases
2020	70.9679 million	5.11%
2021	110 million	5.74%
2022	21.7034 million	0.93%

4. Response Strategies to the IPO Relaunch of Shenghuabo Electric Co.

An IPO re-launch is when a business or company wants to go public to raise funds through an IPO, but is suspended or rejected by the regulator for other reasons, such as the company's current status

does not meet the requirements for an IPO review. The premise of the re-launch is that the company learns from the failure of the initial public offering and improves as much as possible to meet the requirements of the IPO application.

4.1. Internal Control Structure and Dividends Need to be Adjusted

Currently, most of the important positions in the company are held by relatives or people with connections to the Wang family. Such an internal control structure and dividend distribution will give rise to numerous problems if the company goes public, such as shareholders outside the company not being able to receive dividends when the company pays dividends, the vast majority of the company's decision-making being controlled by family shareholders, etc., and corruption and irregular behavior of family employees within the company.

4.2. Financial Disclosure Needs to be Improved

Firstly, as an IPO applicant, Shenghuabo's information disclosure needs to fulfil the necessary disclosure requirements of truthfulness, accuracy, completeness and timeliness. One of the reasons why the authenticity of the performance became one of the reasons why Shenghuabo's IPO was rejected was because the enterprise added or deleted part of the data generated from the operating activities (cost, gross profit, net profit, etc.) in the financial statements when submitting the enquiry materials, which could be eventually found to be abnormal and questioned by the regulator after the verification of the data. False information may mislead regulators, investors and other relevant parties, thus preventing them from making scientific and reasonable decisions. For example, investors may make wrong investments due to wrong messages, which will eventually lead to losses. regulators will spend more time on verification due to data anomalies [11].

4.3. Internal Structure Needs to be Enhanced

Shenghuabo needs to improve its internal control structure and should establish a sound and fair general meeting of shareholders, board of directors, supervisory board, and management layer in the same way as other enterprises. The election method should also be fair and equitable such as voting system. Secondly, all employees should be made aware of the internal control structure so that they can supervise the company to an appropriate extent. Adjustments to the shareholding structure should be accompanied by adjustments to the ultimate benefit structure, so that shareholders outside the company can enjoy the right to dividends.

In conclusion, Shenghuabo needs to be truthful in disclosure, not only in the financial statements, but also in the changes in shareholding, distribution information, capital structure and other information to be true and effective. Income and expenditure assets need to be timely and accurate, strengthen the financial accounting capacity of small and medium-sized enterprises, strictly follow the requirements of enterprise accounting standards for financial accounting of the company's operating activities. Do not embellish the disclosure of information and optimise accounting data in order to meet the listing financial requirements, tax avoidance and other reasons [12].

5. Conclusion

The failure of the IPO application was due to the fact that the family-owned private companies followed unregulated operations throughout the years. This paper highlights such problems and provides reference examples and solutions. At the same time, IPO is a systematic and necessary process for enterprises to raise funds, and corporate disclosure, internal control structure and behavior are necessary conditions for passage.

In summary, Shenghuabo Co., Ltd. was rejected in its IPO application due to three fatal loopholes, namely, performance authenticity, internal control irregularities and large dividends before IPO declaration. After years of development of reform and opening up in China, there are many excellent enterprises, family-owned enterprises are the most products of the times, how to standardize internal

control and reform to the modern enterprise management style is the prerequisite and necessary way for such enterprises to develop and grow with the help of the capital market.

References

[1] Vutharkar S, Swamy C A N, Hitesh K. Failed IPO Stories: Stories of Initial Public Offering [M]. AI-Driven Intelligent Models for Business Excellence. IGI Global, 2023: 112-123.

[2] Zhang Zhenghui, Zhang Peng, Chen Dongda, Zhou Jin. Evolution of IPO Issuance Methods - From Approval System to Registration System [EB]. 2021(01).

[3] Ruan Yueli. A Brief Discussion on the Impact of IPO Registration System Reform on Film and Television Companies [J]. Accountant, 2016 (9): 2.

[4] Jiang Ling, Liu Tong. Case study of Jikai Gene's IPO rejection on the Science and Technology Board [J]. Henan Science and Technology, 2022 (16): 117-12.

[5] Payne G T, Trudell L T, Moore C B, et al. Ambiguous signals and information asymmetry in the initial public offering process: Examining ownership concentration, process time, and underpricing [J]. Group & Organization Management, 2023, 48 (5): 1467-1502.

[6] Gao Xiaomeng. Causes of SMEs' IPO Motivation Misconceptions and Their Countermeasures [J]. China's SMEs, 2022 (08): 77-79.

[7] Xie Bilu. 2024 Shenghuabo for the first single IPO was rejected, its large dividend attracted market attention [N]. Economic Reference News, 2024-01-22 (003).

[8] Sina Finance. 2023 January-July IPO withdraws the summary of enterprises, IPO was rejected five major causes [EB]. 2023-08-11.

[9] Fan Qianqian. Dividend more than 300 million to raise 500 million to make up for the cash flow, Shenghuabo become the first IPO rejected in the beginning of the year [N]. Daily Economic News, 2024-01-23 (005).

[10] Wang Lin. There are three companies on the meeting this week, Shenghuabo had been questioned for internal control irregularities [N]. Daily Economic News, 2024-01-09 (005).

[11] Deng Feng. Analysis of the Problems of Information Disclosure of Listed Companies in China and Countermeasures for Improvement [J]. Journal of Changchun Finance College, 2024 (04): 5-9.

[12] Cui Peng. Financial Problems and Improvement Measures in the IPO Process, taking Private Group Holding Enterprises as an Example [J]. China Business Review, 2019 (08): 177-178.