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Research and Analysis of Connected Transactions and Firms' Listing Denials

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Abstract: In recent years, IPO declarations of proposed listed companies in China's A-share market have been rejected more and more frequently due to the issue of connected transactions, which has aroused concerns. The purpose of this paper is to explore in depth the reasons for the rejection of the A-share listing of proposed listed companies and to propose countermeasures to solve the problem of abnormal connected transactions. This article first defines the scope of connected transactions and their problems, analyzes some cases of proposed listed companies being rejected due to connected transactions in recent years, and deeply explores the problems of hidden connected relationships, connected transaction fraud, and connected transaction de-connectedness, etc., and demonstrates the specific manifestations and impacts of these problems through example analysis. Given the findings, the article puts forward a series of recommendations and insights, including maintaining the operational independence of enterprises, improving the sustainable profitability of enterprises, and tightly controlling the truthfulness of corporate information disclosure. These suggestions aim to help enterprises avoid the problems of connected transactions, enhance the success rate of IPO, and promote the healthy development of the capital market.

Keywords: Connected Transactions, Proposed Listed Companies, Independence

1. Introduction

In recent years, in China's A-share market, proposed listed companies have been rejected more and more frequently in the process of initial public offering (IPO) filing due to the issue of connected transactions. According to statistics, the actual passing rate of IPOs in 2023 is only 51%. 2022-2023, the IPOs of many companies, such as Caofeidian Wood, Dafeng Agricultural and Commercial Bank, Frog Pumps, Shanshi Water Conservancy, D.MAG, and Teconnect Technology, were rejected due to the issue of connected transactions. It should be clear that the connected transaction itself is not a direct factor leading to the rejection of the IPO of proposed listed companies, and it is urgent to investigate the deep-seated reasons for the rejection of the A-share listing of proposed listed companies and put forward corresponding countermeasures to solve the abnormal connected transactions.

In recent years, a few researchers have explored the issue of connected transactions and de-connectedness in the pre-listing financial review of enterprises. Under the registration system, connected transactions may lead to financial fraud, make the company rely on the related parties, and jeopardize its ability, and the doubtful price may lead to irrational resource allocation and damage the

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interests of small and medium-sized shareholders. The series of problems reflects the deficiencies of the corporate governance structure, which makes it difficult for investors to evaluate the proposed listed company's insufficient or inaccurate disclosure of information on connected transactions.

Wang believed that the core views of enterprises' understanding and management of affiliation on the road to IPO include: from simple understanding to refined understanding; there are contradictions like affiliation; affiliation may be de-affiliated; enterprises should manage affiliation legally; and the SEC examines de-affiliation, with the ultimate focus on ensuring that affiliation transactions are legally compliant [1]. Han and Liu took Zhuhai Yuansheng Electronic Science and Technology Co., Ltd. and Baoli Qianli as the research objects respectively, to analyze the impact of the connected transactions on the company's performance and the examination of the Securities and Futures Commission (SFC), summarize the common means, motives and purposes of violation, and put forward the governance measures from the theory of fraudulent motive, which is an important inspiration for the enterprises to be listed [2,3]. Dong analyzed the literature and took D Meat Company as an example to study the public offering of shares and found that the reasons for its IPO failure include strategic mistakes, insufficient profitability, and internal governance problems. In this regard, he proposes countermeasures such as rebuilding the listing team, improving disclosure, upgrading operational capability, and enhancing internal control [4].

Zhang studied Chunhui Energy Company, a cogeneration company, and found that its affiliated sales are far below the average unit price, analyzes its high cost of heating at low prices and the company's loss of the original price of its hazardous waste disposal business, and ultimately raises questions about the price of its affiliated transactions [5]. Xue and Yan both used the literature method, case study method, data analysis method, and inductive method, respectively, through the data analysis of domestic and foreign listing failure companies, that the tax problem has become a larger obstacle to enterprise listing, the proposed IPO enterprises should improve the tax risk management. The article puts forward countermeasures and suggestions from the aspects of sustainable profitability [6,7].

Zhang analyzed the identification of related parties of IPO enterprises by the exchange, the status quo of related party transactions, the types and risks of related party transactions, the impact of related party transactions on the company, and the key points of the Securities and Futures Commission's audit of related party transactions and its response to them, to promote the enterprises to correctly deal with the related transaction issues [8]. Sun and Du took the process and results of Zhongtian Precision's two IPO applications as an example to explore the reason for the effect of major customer dependence on enterprise IPO listing, which affects the independence of enterprises, causing major customer-related transactions, unequal dependence, and other non-compliant issues, ultimately leading to the failure of enterprise IPO listing [9]. Zhu et al. analyzed the importance of connected transactions, their tax risks, and their causes through literature analysis, arguing that some tax risks will exist in the process of connected transactions during the IPO of enterprises in the context of the registration system reform, and clarify how enterprises and the government should respond to & deal with avoiding the problems of connected transactions [10].

Because of the phenomenon that IPO filing is rejected due to abnormal connected transactions, this paper aims to start from the problem of connected transactions, explore the deep-rooted reasons for the rejection of A-share listing of listed companies, and put forward corresponding countermeasures to solve the abnormal connected transactions. It should be clear that the connected transactions themselves are not the direct factors leading to the rejection of IPOs of proposed listed companies, this paper specifically examines what connected transactions have led to the rejection of IPOs and why these connected transactions have led to the rejection of IPOs, and also discusses how the proposed listed companies should deal with these abnormal connected transactions.

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2. Connected Transactions and A-share Rejection

According to the information published by China Finance and Economics, it can be seen that in the first half of 2023, a total of 196 enterprise IPOs were listed, of which 175 passed the meeting, 11 suspended the vote, and 10 were rejected. Among the rejected proposed listed companies, 7 of them have the problem of abnormal related transactions. Generally speaking, there are two core reasons why the IPOs of proposed listed companies were rejected due to the abnormalities of related transactions, namely, the doubt of the company's independent and sustainable profitability caused by the defects of business independence and the suspicion of fraudulent related transactions.

2.1. Types

2.1.1. Definition of Connected Transactions

Comprehensive "Enterprise Accounting Standard No. 36", "Company Law", "Administrative Measures for Disclosure of Information by Listed Companies" and other official definitions, connected transactions are the transfer of resources and other transfers between related parties, and because of the process of arbitrariness between the related parties for the price, leading to the company's probability of the existence of a transfer of benefits, inflated profits or excessive dependence on the problem.

2.1.2. Problematic Areas of Related Transactions

Independence defects due to connected transactions: This is due to the close relationship between related parties or affects the company's independent operation and decision-making. For example, the company may rely excessively on the cooperation or procurement of related parties, limiting the ability to independently expand and obtain resources, including the greater influence of related parties or interference in the decision-making process, financial dependence, conflict of interest, and so on.

Purchase, sale, and fund transaction fraud through related transactions: It refers to the use of purchase and sales activities and fund transactions between enterprises and related parties to conduct unfair purchase and sales transactions or the use of funds borrowing and guarantee activities between related parties to manipulate the enterprise's capital status and financial statements, to achieve the misrepresentation of the financial situation and mislead investors.

Concealment of related relationships and hidden related transaction fraud: Refers to an enterprise's intentional concealment or failure to truthfully disclose its relationships and transactions with related parties in order to mislead external investors, etc., including false contracts, fictitious transactions, price manipulation, and other means designed to conceal financial and operational conditions and bring about improper benefits.

Disassociation of related transactions: Refers to the act of disguising or concealing connected transactions as unrelated transactions, intending to circumvent disclosure requirements or regulatory provisions, using intermediary links, false contracts, price manipulation, concealment of interests, and division of transactions.

2.2. Data

Selected cases of proposed listed companies whose IPO filings were rejected due to contingent connected transaction issues from 2022 to 2023.

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2.2.1. Kailuo Technology

The Listing Committee is skeptical about the issuer Jiangsu Shuangkai's acceptance of customers, which requires the issuer to explain its acceptance ability and transaction methods and list its operating income and profit and measure it, and is skeptical about the reasonableness of Jiangsu Shuangkai's non-important subsidiaries, and whether there are connected transactions with the supplier.

2.2.2. Xinghe Shares

The Listing Committee is skeptical about the pricing of the customers introduced by the third-party personnel, the single customer with rapid sales growth, and whether there is a connected transaction between the issuer and the third-party personnel and customers.

2.2.3. Electric Flag Shares

As major labor suppliers are controlled by the same person with short establishment and survival time, the Listing Committee is doubtful whether major labor suppliers only see a connected relationship and whether the labor procurement contract constitutes a benefit transfer from a related party.

2.2.4. Asian Fishing Port

There are massive missing subsidiary business documents, abnormal fund transactions, negative gross profit margin of the main agency business, and employees representing the payroll. The Listing Committee is doubtful about the potential interrelated relationship between the supplier and the issuer's subsidiary, the existence of abnormal fund flows, and the authenticity and pricing reasonableness of the procurement of such processing services.

2.2.5. Tecron Technology

Whether the issuer's introduction of major customers such as Yilong Electronics through agents is stable and sustainable, whether the agency fee rate is fair, and whether the Listing Committee has doubts as to whether the agents have any affiliation with the issuer or the customers and whether there are any other benefit arrangements.

3. Case Study on Connected Transactions

3.1. Hidden Affiliated Relationship and Independence Deficiency Issues

3.1.1. Concealment of Connected Relationship and Hidden Connected Transaction Fraud

D.MAG New Material Technology Co., Ltd(D.MAG) circumvented the issuance and listing conditions and regulations by concealing and falsifying the identification of the issuer's real controller.

In terms of shareholding structure, D.MAG's direct controlling shareholder is GIANT's wholly-owned subsidiary, Dajin Holdings, but since neither GIANT nor D.MAG is deemed to be the real controller due to GIANT not having a single shareholder holding more than 5% of the shares during the reporting period, and privately GIANT has become the real controller with 60.39% of the shares.

D.MAG sells products at low prices through connected transactions to transfer cost risk: During the reporting period, the pricing of products sold by the Company to GIANT differed significantly from the price of unrelated transactions, and sales to it accounted for more than 20% of the total

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turnover, and a large number of sales enabled D.MAG to effectively transfer the cost of raw materials to GIANT to realize the transfer of cost risk, thereby alleviating its capital turnover pressure.

D.MAG has the suspicion of inflating the turnover through the related transactions and whitewashing the performance: The amount of D.MAG's connected sales accounted for more than 20% of its turnover, of which the proportion of connected sales in the hubs and accessories business and the bicycle ring business was as high as 91.94% and 55.63%. D.MAG's operating income and net profit will have a significant decline in 2022, in order to ensure its operating income meets the financial performance requirements of the Supervisory Committee for companies listed on the IPO, there is a situation that D.MAG will whitewash its operating income through a large number of low-priced connected transactions to achieve the expected performance.

3.1.2. Independence Defects Due to Connected Transactions

GIANT is both the largest shareholder and the largest customer of D.MAG: D.MAG's direct controlling shareholder is GIANT's wholly-owned subsidiary, Dajin Holdings, with a 60.39% shareholding, and at the same time, D.MAG has a large number of connected transactions with GIANT. There is a situation in which GIANT has been able to realize the purchase of a large number of products at prices much lower than the prices of the non-connected transactions by interfering in the internal management of D.MAG, in order to provide benefits and resources to itself.

D.MAG's over-reliance on connected transactions: During the Reporting Period, the amount of D.MAG's connected sales accounted for more than 20% of its operating revenue, with the proportion of connected sales in the hubs and accessories business and the bicycle rim business being as high as 91.94% and 55.63% respectively. Such high reliance on connected transactions may hurt the Company's long-term development.

3.2. De-association of Connected Transactions and Connected Transaction Fraud

3.2.1. De-connectedness of Connected Transactions

Lixuan Technology Co., Ltd(Lixuan) did not recognize the "related" Weiyi Technology as a related party, which is suspected of concealing the relationship of interest.

From 2019 to 2021, Lixuan's top supplier will always be Yiyi Technology, with its purchases accounting for 15.66%, 18.15%, and 15.84% of the total purchases respectively. Lixuan's senior executive Yang Lihui was the manager of Ningbo Hengyou, a subsidiary of Yewei Technology, and also held 30% of the shares of Cixi Changyi, a company controlled by the real controller of Yewei Technology, and served as a supervisor of the company.

In addition, several suppliers are related to the controllers of Lixuan and have obtained a large number of orders from them.

Some of Lixuan's suppliers are enterprises controlled by relatives of the actual controller, and even several suppliers provide products exclusively for Lixuan "with no other customers except the issuer". However, in its disclosure, Lixuan concealed all of the above kinship relationships and did not include the above series of "kin" suppliers in the scope of affiliated companies, circumventing disclosure requirements or regulatory requirements and including affiliated transactions in the scope of normal transactions.

3.2.2. Linked Transactions Constitute Fraudulent Purchases, Sales, and Financial Transactions

Lixuan profited from the connected transactions mainly by obtaining more orders and lowering purchase costs.

Lixuan agreed with three wrapping paper factories controlled by relatives to double the results of the number of purchases and launched purchases against Cixi Zonghan Zhiqiang Plastic Products Factory controlled by relatives in the dip molding processing service provider, with the transaction amount rising from several tens of thousands to tens of millions over three years. During the reporting period, the number of purchases made by the Company to enterprises controlled by relatives of the actual controller rose from 74.4593 million yuan in 2019 to 183 million yuan in 2021, doubling in three years.

Lixuan has achieved rapid growth in a short period by practicing unfair purchase and sale transactions and manipulating the capital position and financial statements of the enterprise.

Lixuan reached a reconciliation of the issuer's revenues and profits or costs and expenses by conducting large-scale purchase transactions with enterprises associated with relatives of the actual controller, such as nephews, brothers-in-law, brothers-in-law, and in-laws. At the same time, Lixuan's balance of prepayment to Lixuan Metal (under the actual control of relatives) far exceeded that of other suppliers, and there was a suspicion of transferring funds for profit and manipulation of financial statements.

4. Conclusion

In this regard, it is of primary importance for enterprises to maintain operational independence. Avoiding related-party transactions is an important factor affecting the independence of enterprises, especially in an enterprise with strong dependence on large customers, if it generates related transactions with large customers, it will aggravate the damage to the company's independence. To cope with the risk of large customer dependence and improve the probability of the success of the enterprise IPO, an independent internal structure of the enterprise should be constructed, and only with a clear division of labor among the various departments of the enterprise, and with clear rights and responsibilities of each position, can the independence of the operation be maintained.

Secondly, to improve the sustained profitability of the enterprise. Enterprises need to develop new customers, the customer structure to be optimized, and appropriately increase the original small customer resource investment, and then increase the number of customers, customer structure to achieve decentralization and flattening, to achieve the purpose of reducing dependence on large customers. At the same time, to do a good job of customer relationship management. Enterprises should carry out customer relationship management, integration of customer resources, strengthen multilateral exchanges and information sharing, and customers to build a trust, friendly, and win-win partnership. In addition, enterprises should strictly control the authenticity of corporate information disclosure and improve the quality of information disclosure.

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