

# ***Research on the Risk and Prevention of "Leverage Manipulation" of China's Real Estate Enterprises***

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**Abstract:** The real estate industry has the status of the pillar of the national economy. The "leverage manipulation" behavior of real estate enterprises not only damages the development of enterprises themselves, but also is not conducive to macro-control and consolidating the achievements of "deleveraging". This paper takes the real estate industry as the object to study the risks caused by its "leverage manipulation". The study found that the existence of this behavior in real estate enterprises continued to weaken the profitability of enterprises; Trigger the upstream and downstream crisis of the industrial chain; It is easy to cause thunderstorms in the capital market, which is not conducive to the stable development of finance; Masking the real debt level is not conducive to consolidating the deleveraging achievements and other risks, and put forward targeted suggestions to prevent such risks at the end of the article.

## **1. Introduction**

The real estate industry is the pillar industry of China's economy. At present, China's real estate industry is facing problems such as sales decline and limited financing channels. According to the fraud triangle theory, under the "three red lines" policy, new policies in the real estate industry. It is stipulated that if the leverage index of real estate exceeds a certain degree, financing is Unable, real estate enterprises are prone to "leverage manipulation" in order to maintain their financing ability and operation. "Leverage manipulation" means that real estate enterprises artificially manipulate the book leverage ratio of enterprises and control the measurement index of enterprise leverage below the standard level instead of reducing their actual debt risk [1, 2]. On the one hand, the behavior of real estate enterprises is speculation on the current regulatory system; on the other hand, it greatly increases the enterprise and market risk. Therefore, it is very necessary to study the behavior risk of "leverage manipulation" of real estate enterprises.

## **2. Existing Risks**

### **2.1. Masking the Real Debt**

During the 13th Five Year Plan period, China's supply side reform achieved phased results. On March 5, 2021, Premier Li Keqiang pointed out in the *2021 government work report* that China will continue to complete the important task of "three elimination, one reduction and one compensation".

During the 14th five-year plan period, China will consolidate the phased results of the supply side reform during the 13th Five-Year Plan period.

The real estate industry is the pillar industry of China's economy. The upstream and downstream ancillary industries account for 20% of China's GDP and have an important impact on China's economic development. At present, China's real estate industry is facing the impact of the epidemic, the weakening of residents' consumption expectations, the further reduction of profit space and other factors, which lead to the continuous depression of the real estate market. In addition, China's real estate enterprises mostly use the traditional high leverage and high turnover operation mode, as well as the financial risk of real estate enterprises continues to rise. Since 2021, there have been frequent fall into crisis in real estate enterprises. The reasons are that enterprises have low solvency, unreasonable debt structure and weak financial risk tolerance. They can't resist risks by themselves under the current market downturn. In this case, the concealment of the real debt level of real estate enterprises will increase the uncertainty of the management of the real estate industry and have an impact on macro-control, which is not conducive to consolidating the phased achievements of supply side reform in China.

## **2.2. Trigger the Events that Real Estate Enterprises in Capital Market Fall into Crisis**

Information transparency is particularly important for the healthy development of the capital market. The leverage manipulation of real estate enterprises will increase the information asymmetry of the capital market, reduce the information transparency of the market, and make investors unable to obtain the real enterprise financial situation in time. Covering up the real debt level in the case of poor enterprise operation and financial situation will increase the crisis in the capital market.

Due to the large financing demand of real estate enterprises, enterprises often have a large number of stock pledges. As of March 2022, there were 24 A-share companies with real estate and construction pledge rates of more than 80%. In addition, the stock pledge rate of some real estate enterprises has reached 100%. Among the listed companies in various industries in China, the proportion of equity pledge in the real estate industry has become the first.

Although the risk of stock pledge does not lie in the enterprise's own operation, it is directly related to the enterprise's stock price. The leverage manipulation of real estate enterprises will undoubtedly increase the uncertainty of the capital market. This behavior itself brings huge financial risks to real estate enterprises, resulting in the risk of falling stock prices. Falling share prices will hurt the refinancing ability of listed companies such as additional issuance, pledge and allotment. When the share prices of these companies fall all the way, there is a "barbarian" scavenging in the secondary market, which is very easy to change the control environment of enterprise.

## **2.3. Trigger the Upstream and Downstream Crisis of the Industrial Chain**

The real estate industry has a huge volume in China, and its upstream involves design, decoration, raw materials and other related industries. As the financing of real estate enterprises has been limited in recent years, many real estate enterprises will give priority to commercial bills when dealing with upstream suppliers temporarily default on payments. The cooperation between upstream suppliers and real estate enterprises in bulk business is the business model of most enterprises. Although this cooperation mode can bring revenue growth, due to the long payment cycle of real estate enterprises, the balance of accounts receivable and notes receivable of upstream suppliers is also increasing, which brings certain business risks.

According to the latest bill overdue list of *Shanghai Commercial Paper Exchange*. As of

December 31, 2021, the number of acceptances with overdue payment in December 2021 was 484, an increase of 100 over November last year, an increase of 26.04%. Among them, real estate enterprises are the "hardest hit areas" of bill default. According to statistics, there are 92 real estate enterprises. The failure of real estate enterprises to pay when due leads to the rupture of capital chain and operating losses of upstream and downstream enterprises in the industrial chain. For example, in 2021, *Sogal* achieved a revenue of 10.407 billion yuan, a year-on-year increase of 24.59%; However, the net profit attributable to the parent company was about 123 million yuan, a significant year-on-year decrease of 89.72%; Non net profit attributable to shareholders of listed companies was 31.67 million, a year-on-year decrease of 96.98%.

## **2.4. The Profitability of Enterprises Continues to Weaken**

The real estate industry is a capital intensive industry. On the one hand, the ability of enterprises to leverage funds is directly proportional to the scale of enterprises. For the real estate enterprises with traditional high turnover mode, the core is to continuously obtain funds. On the other hand, due to the large demand for funds, real estate enterprises must pay attention to the management of capital cost. [3] Real estate enterprises with "leveraged behavior" often hide their debts through explicit shares, real debts or off balance sheet liabilities because they want to control the enterprise debt ratio at a certain level. Such debt is usually large and costly, such as trust or private equity.

## **3. Suggestions on the "Leverage Manipulation" Behavior of Real Estate Enterprises**

### **3.1. Improve Leverage Measurement Indicators**

Leverage level is the basic means of financial report analysis. Generally, the leverage level is measured directly by the ratio of total assets to total liabilities. The more popular ones in the domestic real estate industry are the net debt ratio, net debt / equity ratio, and the asset liability ratio after deducting advance receipts. On the one hand, these two indicators can better investigate the debt level and solvency of real estate enterprises compared with the traditional debt ratio indicators, but on the other hand, these two indicators are also easy to be manipulated by real estate enterprises to a certain extent, which has achieved the purpose of reducing the leverage level. In addition, real estate developers in the high growth market often use debt to provide funds for their rapid development, its debt/ capital ratio is less effective in distinguishing relative credit risk.

The easiest adjustment is the net debt ratio. From the formula of net debt ratio, the liability with interest of enterprises, such as short-term loans, bonds payable and so on, cannot be adjusted by enterprises. Therefore, there are basically two ways for real estate development enterprises to reduce the net debt ratio: one is to expand the scale of net assets, and the other is to increase the amount of monetary funds. The method of expanding net assets is relatively simple, and it is effective to strengthen the use of cooperative development mode. The reason is that the cooperative development allows real estate enterprises to participate in the project development with less capital investment. If the equity proportion of the enterprise in the cooperative project is large enough and the project is consolidated, the equity of the partners will be included in the minority shareholders' equity, so as to expand the scale of net assets of the consolidated enterprise, which will help to reduce its net debt ratio on the whole. The second is to increase the amount of cash. Since cash is the value of the balance sheet, it is a time point rather than a time period. Accordingly, real estate enterprises can collect cash from joint ventures and associates at the key time point, that is, the time point of the balance sheet.

In view of the above aspects, this paper is based on the calculation formula of mainstream net debt ratio, combined with the possible means of leverage manipulation and management practice of

real estate enterprises, Put forward a new index for the leverage level of real estate enterprises: *new net debt ratio = (short-term loans + trading financial liabilities + non current liabilities due within one year + long-term loans + bonds payable + perpetual bonds and preferred shares + notes payable - unrestricted Monetary Funds - trading financial assets) / (total equity - perpetual bonds and preferred shares - non controlling shareholders' equity)*.

This indicator first adds a note payable account to the original indicator in terms of liabilities. At present, commercial ticket has evolved from commercial credit tool to short-term financing tool for real estate enterprises, and its internal core function has changed. From the financial data of real estate enterprises in recent years, the amount of accounts payable and bills of real estate development enterprises has increased rapidly. In addition, most of the real estate enterprises' crisis in recent years began with the overdue payment of commercial bills, which led to a series of debt defaults. Therefore, it is very necessary to consider the commercial bills factor for the leverage level of real estate enterprises.

Secondly, on the basis of the original indicators, the index subtracts the minority shareholders' equity in terms of shareholders' equity. At present, the real estate sales scale is often measured by full caliber sales. Therefore, in order to rapidly expand the sales scale, many real estate enterprises have adopted the mode of joint venture / joint venture in the real estate development mode in recent years. In the entity theory, minority shareholders' equity needs to be listed in the owner's equity in the consolidated balance sheet. The reason is that no matter how many shares the parent company holds in the subsidiary, the subsidiary is included in the consolidation scope according to 100% of the assets and liabilities. At this time, some net assets belong to minority shareholders, so minority shareholders need to be reflected in the owner's equity. However, from the perspective of the parent company, the minority shareholders of the subsidiary are not responsible for the debts borne by the parent company. Therefore, it is necessary to eliminate the minority shareholders' equity from the leverage level measurement index.

### **3.2. Audit Intermediaries Pay More Attention to the "Leverage Manipulation" Behavior of Real Estate Enterprises**

Real estate enterprises have the characteristics of large capital demand, diversified and complex external financing, long project cycle, scattered project construction and involving a large amount of working capital, which makes their audit work challenging. The fraud triangle theory holds that the occurrence of corporate management fraud is mainly the result of the interaction among the three factors of pressure, opportunity and excuse, in which pressure is the most direct cause and the primary condition of fraud. Traditional teaching and actual audit work are more aimed at earnings related fraud, such as income, profit and other fraud. The huge capital demand of real estate enterprises leads to the financing pressure of the company's management. Under the "three red lines" policy, net debt ratio and withholding asset liability ratio are important indicators to measure the leverage level of real estate enterprises, which determines whether enterprises can obtain financing. Therefore, the motivation of management fraud of real estate group mainly lies in reducing the debt ratio of enterprises, and there is "leverage manipulation", which is different from ordinary enterprises. Therefore, when auditing real estate enterprises, certified public accountants should pay extra attention to the motivation and pressure of enterprises to reduce debt ratio.

In order to reduce the audit risk of the real estate industry, auditors need to improve their understanding of the external environment of the real estate industry, including the current situation, characteristics and future development of the industry. Secondly, when carrying out risk assessment, auditors should always pay attention to the policy changes of the real estate industry; Focus on the debt ratio and other indicators of the audited entity and the average level of the industry, and

consider the reasons for significant differences or changes; Deeply understand the company's financing scale and projects under construction, and analyze its rationality and scientificity.

In terms of financing channels, the real estate industry tends to choose external financing. Due to the tightening of regulatory policies on the real estate industry in recent years, it is more difficult for the real estate industry to lend to financial institutions, resulting in the shift of financing channels to financial institutions or informal channels similar to private financing. Therefore, when conducting substantive procedures, certified public accountants should pay attention to the possible special financing matters as much as possible, and pay special attention to the Trust plan and PE investment commonly used in the real estate industry. [4] For such economic matters, the accounting firm itself must pay more attention to the economic essence of the new financing instruments, comprehensively consider the terms and contents of the financing instruments, implement more substantive procedures.

### **3.3 Real Estate Enterprises Increase Relevant Information Disclosure**

#### **3.3.1. Increase the Information Disclosure of Real Estate Enterprises, Joint Ventures and Project Subsidiaries**

At present, China's real estate enterprises continue to increase the development mode of cooperation in projects. Taking China's top 50 real estate enterprises as a sample and corresponding to their equity sales amount, it is concluded that the average equity ratio was 74.80% in 2019 and 69.4% in 2021. This model can disperse the financial risks of real estate enterprises and reduce the pressure on the balance sheet. Although the joint venture mode itself does not bring risks, but such operations are increasing, there may be huge risks in the name of joint venture mode development to achieve the purpose of financing. Joint ventures are usually not consolidated and are outside the balance sheet, so most real estate enterprises will not make too much disclosure.

The content of relevant project companies disclosed by real estate enterprises in the annual report is very limited, which undoubtedly aggravates the information asymmetry in the capital market. China's accounting standards stipulate that listed companies have the obligation to truthfully and completely disclose information, and shall not have false records, misleading statements or major omissions. It is particularly important to strengthen the information disclosure of real estate enterprises to the project company so that investors can obtain the following information as much as possible: the specific information of joint ventures and minority shareholders, such as legal person attribute, operation period, etc; The consolidated statements of the project company shall be true, complete and correctly classified, and the nature of such financing shall be presented and adjusted to relevant liability accounts; Disclose the actual financing interest rate, repayment period, relevant restricted assets and repayment plan of relevant investment plans; The time and method of profit distribution of relevant investment plans.

#### **3.3.2 Increase the Information Disclosure Related to Commercial Bills of Real Estate Enterprises**

In recent years, with the wide application of commercial bills in the real estate industry, the accumulated amount of commercial bills of real estate enterprises has increased sharply. According to the statistics of Shanghai Commercial Paper Exchange Corporation, the overall commercial bill acceptance balance of top 19 real estate enterprises reached 335.574 billion yuan in 2020, an increase of 36.59% over 2019, accounting for 9.27% of the total national commercial bill acceptance. At present, the due payment of commercial bills has become an important debt burden of real estate enterprises. It is very necessary to monitor the market circulation and timely payment

of commercial bills of real estate enterprises. On the one hand, real estate enterprises should take the initiative to regularly report the business ticket situation to market investors and regulators on a monthly or quarterly basis, improve the attention of enterprises to this information, increase the information transparency between enterprises and the market, and reduce information asymmetry. In addition, in the annual financial report, real estate enterprises should increase the disclosure information of accounts payable and notes, such as the top five suppliers of the company, the proportion of commercial bills in accounts payable and notes, the proportion of interest bearing commercial bills, and whether there is any overdue non-payment, etc. On the other hand, the bill exchange can regularly inform the market of the circulation, transaction and cashing of commercial bills of real estate enterprises, especially those enterprises that cannot cash within the time limit. Establish a unified market system, suspend the continued use of commercial tickets by enterprises that fail to cash within the time limit, and monitor their market transactions.

#### 4. Conclusion

Taking China's real estate enterprises as the research object, this paper studies and analyzes a series of risks that may be caused by the "leverage" behavior of real estate enterprises under the current policy environment and the measures that should be taken against the above risks. The study found that the "leverage" of real estate enterprises may lead to: Real estate enterprises masking the real debt, trigger the events that real estate enterprises in capital market fall into crisis, Trigger the upstream and downstream crisis of the industrial chain, The profitability of enterprises continues to weaken. And in view of the above risks, we should take the following measures: Improve leverage measurement indicators, Audit intermediaries pay more attention to the "leverage" behavior of real estate enterprises, Real estate enterprises increase relevant information disclosure.

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