Why Did Evergrand Go Bankrupt: Financial Statement Analysis

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Abstract. On January 29, 2024, Evergrande, a former Chinese real estate giant, officially declared bankruptcy. People unfamiliar with the complete story may have doubts about it and want to know the reasons behind it, so the research will be on why Evergrand will go bankrupt. This research will try to explore the answer to this question by analyzing the internal behaviour of the company and comparing data, including profitability, solvency and liquidity, efficiency and investment ratios. The conclusion is that Evergrande's governance and PwC's negligence led to Evergrand's ultimate bankruptcy. The significance and importance of this research are to warn other real estate companies and even all companies in the market that good management must be carried out, internal control mechanisms must be strengthened, and financial cheating must be prevented by auditing institutions; regulatory authorities strengthen their scrutiny; enhance corporate social responsibility and keep consumers and investors' rights and interests to improve the sustainable developments of the whole society.

Keywords: Evergrand, PwC, financial statement, liquidity issue

1 Introduction

Evergrand, a former Chinese real estate giant, officially declared bankruptcy on January 29, 2024 [1]. This news marks that Evergrand is facing unprecedented financial difficulties and is ultimately unable to shake off its heavy debt burden. On March 16, 2024, Evergrande Group announced the Shanghai Stock Exchange, stating that the group had received administrative penalties and prior notice of market entry bans. The 2019 and 2020 annual reports of Evergrande contained false records, with a cumulative inflated revenue of 564 billion yuan and inflated profits of 92 billion yuan over the past two years. What is the concept of 564 billion? It is higher than the market value of China Telecom. Investors are curious about why PwC has audited Evergrand for over a decade without issues or whether it relates to PwC. This research explores this by analyzing Evergrand's corporate governance. This may become an

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important reason for Evergrand's bankruptcy. This research will provide valuable insights for potential real estate investors in Chinese companies, offering a comprehensive analysis of financial and corporate governance performance to these investors.

2 Corporate governance

According to PwC's illegal content, there are false records in Evergrande's 2019 and 2020 annual reports: Evergrande Real Estate falsified its finances by recognizing revenue in advance, resulting in an inflated revenue of 213.989 billion yuan in 2019, accounting for 50.14% of the current period's operating revenue, as inflated costs of 173.267 billion yuan, and inflated profits of 40.722 billion yuan, making up 63.31% of the total current period's profits. In 2020, Evergrande inflated its revenue by 350.157 billion yuan, making up 78.54% of the current operating revenue, corresponding to inflated costs of 298.868 billion yuan, and inflated profits of 51.289 billion yuan, making up 86.88% of the total current profit. Based on this calculation, Evergrande Real Estate has inflated its revenue by 564.146 billion yuan and profits by 920.11 billion yuan over the past two years. Both 2019 and 2020 were the peak periods of Evergrande's performance, indicating that over half of the profits in 2019 were falsified, and even nearly 90% of the profits in 2020 were falsified.

In just the past two years, there has been such large-scale financial fraud in PwC, a well-known auditing firm that has never discovered the problem. Moreover, in the key audit items of the audit report, the recognition of revenue and costs was not considered an essential audit item. This financial fraud occurred in the two highest proportions of profit and loss accounts. Based on the length of cooperation between both parties and the high proportion of fraud in just two years, there is sufficient reason to think that Evergrande is likely to engage in similar financial fraud in other years. So in January 2023, when PwC terminated its audit work on Evergrande due to "inability to complete work", a new audit team began to take over PwC's previous audit work. Half a year later, the new audit team quickly discovered that Evergrande had incurred a total loss of 812 billion yuan in 2021 and 2022. This loss amount is five times the total profits obtained by China Evergrande for 12 consecutive years since its listing, even if the profits for these 12 years are real. Therefore, with a high possibility, PwC has reached some tacit understanding with Evergrande Real Estate behind the scenes to not discover Evergrande's considerable losses in recent years. After all, PwC has a group of excellent auditors whose professionalism is beyond doubt. Therefore, there are some doubts about some collusion behind them, which may be due to the responsibility and cultivation of auditors and the company's regulatory mechanism.

3 Financial analysis and risk warning

To understand the reasons for Evergrand's bankruptcy, by comparing the financial reports of recent years to identify some of the long-standing bankruptcy trends.

3.1 Profitability analysis

Table 1. Profitability ratio from 2019 and 2022

	2019	2020	2021	2022
Operating income	477.6 billion yuan	507.2 billion yuan	250 billion yuan	230.1 billion yuan
Gross profit	132.9 billion yuan	123.5 billion yuan	-18.45 billion yuan	24.99 billion yuan
Earnings per share	1.3150	0.6130	-36.0060	-8.0210
Gross profit margin	27.84%	24.17%	-7.38%	10.86%
Net profit margin	7.02%	6.19%	-274.47%	-54.69%

Overview of financial performance in 2019 and 2022 in Table 1. Firstly, the highest-performing years were 2019 and 2020. For the profitability of 2019, the operating income for the whole year was 477.6 billion yuan, with a growth rate of 2.44%, gross profit of 132.9 billion yuan, basic earnings per share of 1.3150 billion yuan, sales gross profit margin of 27.84%, and sales net profit margin of 7.02%. At the same time, for the operating capacity in 2020, the operating income was 507.2 billion, with a growth rate of 6.22%, gross profit was 123.5 billion, basic earnings per share was 0.6130, sales gross profit margin was 24.17%, and sales net profit margin was 6.19%.

According to the financial reports in 2021 and 2022, profitability is the first thing to consider. The operating income for the two years was 250 billion and 230.1 billion, respectively, a decrease of half compared to the previous two years. The gross profit is -18.45 billion yuan and 24.99 billion yuan, respectively, because gross profit margin is sales gross profit to net sales revenue, a financial indicator that measures the proportion of sales revenue between the income and cost obtained by a company from selling products or services. The higher the gross profit, the higher the gross profit margin, indicating a more robust enterprise profitability [2]. This means that after deducting sales costs and other related expenses, the enterprise can retain more profits as part of its revenue. However, Evergrand's gross profit in 2021 and 2022 decreased by nearly 90% compared to 2019 and 2020 [3]. Subsequently, the basic earnings per share for 2021 and 2022 were -36.0060 and -8.0210, respectively, with sales gross profit margins of -7.38% and 10.86%, respectively. The sales net profit margin is -274.47% and -54.69%, respectively. The sales net profit margin is net profit divided by net sales revenue. The sales net profit margin can measure a company's ability to obtain net profit through sales revenue during a specific period, reflecting the amount of net profit brought by each yuan of sales revenue, thus showing the amount of sales revenue [4]. Compared with the previous two years, the level of revenue has also significantly decreased.

3.2 Liquidity&solvency analysis

Table 2. Liquidity and solvency ratio from 2019 to 2022

	2019	2020	2021	2022
Asset-liability ratios	83.75%	84.77%	122.45%	132.59%
Current ratios	1.37	1.26	0.75	0.71

For the two-year solvency in 2019 and 2020, the asset-liability ratios are 83.75% and 84.77%, the current ratios are 1.37 and 1.26. (Table 2)

Regarding debt-paying ability, the asset-liability ratios for 2021 and 2022 were 122.45% and 132.59%, respectively. Asset-liability ratio is total liabilities devided by total assets, which can know how much of a company's assets are financed by debt[5]. If a ratio can be high, it reveals that the company has certain risks in its financial structure, mainly manifested as an increase in financial risk, an increment in financing costs, and a descent in financing ability. From creditors' perspective, it would be better with a lower asset liability ratio. The asset-liability ratio of Evergrand has also significantly increased in the past two years compared to the previous two years. However, for real estate industries like Evergrand, the asset-liability ratio is usually higher because the industry's project development cycle is long, the capital demand is huge, and financing is often obtained through borrowing. However, Evergrand's operating income has not seen a corresponding increase, so this is a questionable point. Moving on to the current ratio, the current ratios for 2021 and 2022 are 0.75 and 0.71, respectively. The current ratio is equal to the ratio of current assets to current liabilities, which is the proportion of current assets to current liabilities per dollar[6]. Usually, the higher this ratio, the stronger the company can realise its assets and short-term debt-paying ability. Conversely, when the ratio is lower, the company would be weaker to repay its debts. Compared to Evergrand's current ratio in the previous two years, it also showed a downward trend.

3.3 Efficiency analysis

Table 3. Efficiency ratio from 2019 to 2022

	2019	2020	2021	2022
Inventory turnover rate	0.28	0.28	0.19	0.15
Current asset turnover rate	0.28	0.27	0.13	0.13
Total asset turnover rate	0.23	0.23	0.11	0.12

Regarding operational capacity, the inventory turnover rate for both years in 2019 and 2020 was 0.28 times, the current asset turnover rates were 0.28 times and 0.27 times, respectively, and the total asset turnover rate was 0.23 times. (Table 3)

Furthermore, for the operational capacity in 2021 and 2022, the inventory turnover rate is 0.19 and 0.15, respectively. The calculation formula of inventory turnover rate is the cost of sales divided by the average inventory, which reflects the speed at which the company's inventory is converted into cash or accounts receivable, as well as the level of inventory occupancy [7]. The higher the ratio, the faster the inventory conversion speed and the stronger the enterprise's liquidity. Conversely, if the ratio is lower, it indicates that there may be a backlog of inventory. The inventory turnover rate of the real estate industry may be low because the product of this industry is real estate, which involves a large amount of capital investment and a long development cycle. The inventory turnover rate of Country Garden is above 0.5 times that of Evergrand. At the same time, Evergrand's deposit and loan turnover rate in the past two years is also lower than that of 2019 and 2020. Evergrand's current asset turnover ratio in the past two years has been 0.13, calculated as sales revenue divided by the average current asset balance [8]. This reflects the efficiency of the company's current asset utilisation, that is, the ability of current assets to support sales revenue over a certain period. The turnover rate of current assets in the real estate industry may be low because this industry involves a large amount of long-term capital investment, such as land purchases and real estate development. The development cycle of real estate projects is long, and the speed of capital recovery is slow, which may lead to a low turnover rate of current assets. The turnover rate of Evergrand's current assets has also been decreasing in the past two years, and its income has also been declining, which is relatively standard. Then there is the total asset turnover rate, which is 0.11 and 0.12 respectively. The total asset turnover rate is sales revenue divided by average total assets, reflecting the enterprise's total assets turnover speed, that is, total assets' ability to support sales revenue in a certain period [9]. If the ratio can be higher, the enterprise would have the stronger sales ability and accelerate asset turnover through the method of low profit and high turnover, bringing an absolute increase in profits. Compared to Evergrand's total asset turnover ratio in 2019 and 2020, it is still declining.

3.4 Investment ratio

Table 4. Investment ratio from 2019 to 2022

	2019	2020	2021	2022
Net asset return rate	12.40%	5.52%	389.50%	23.78%

Finally, there is the return on investment, with a net asset return rate of 12.40% in 2019 and 5.52% in 2020. (Table 4)

In 2021 and 2022, the net asset return rates for 2021 and 2022 are 389.50% and 23.78%, respectively. The net asset return rate is net profit divided by average net assets, measuring the company's ability to obtain net profit using its capital [10]. The high or low return on equity can reflect a company's profitability and the return on investment to shareholders. If the ratio can be higher, the company can utilize its capital to generate profits, attract investors and increase its value more effectively. Macroeconomic factors, interest rate levels, land policies, market demand, and other factors influence the profitability of the real estate industry, and its profitability is closely related to asset value and investment return rate. Despite facing enormous debt pressure, Evergrand maintained a high profit level in 2021 through effective management and marketing strategies [11]. However, it is worth noting that high debt and profits do not directly equate to a high return on equity. The calculation of return on equity involves a comparison between net profit and average shareholder equity. Evergrand's high debt situation has, to some extent, affected the structure of its net assets. Although it has optimised its debt structure through sales and financial management, high debt itself has a specific impact on the calculation of return on equity, which may also affect Evergrand's return on equity in 2022 compared to the previous year.

4 Conclusion

In a nutshell, all these comparisons are sufficient to illustrate Evergrand's debt problems in recent years. Evergrand's debt scale is vast, and its structure is unreasonable, leading to enormous repayment pressure. The bond default and interest payment issues have further exacerbated its financial difficulties. At the same time, there is also a cash flow issue. Due to excessive expansion and diversification, Evergrand has continuously expanded its business scope in recent years, entering multiple fields. However, these new businesses have not brought stable cash flow and profits but have exacerbated financial pressure. In addition, there are other reasons, such as the Chinese government's continuously strengthening regulatory policies on the real estate market and stricter supervision of real estate enterprises. As one of China's largest real estate companies, Evergrand has been influenced by policies and strictly regulated by regulatory authorities. There is also intensified market competition. With the gradual saturation of the real estate market, Evergrand is facing fierce competition from other real estate companies, and its market share is gradually declining. Even including the damage to its brand image, Evergrand has experienced a series of negative events in recent years, such as unfinished properties and quality issues, which have damaged its brand image and affected consumers' trust and purchase intention. Finally, returning to PwC, there may be a special relationship between it and Evergrand. PwC, as a long-term audit firm of Evergrand, may have failed to detect the issue of financial fraud in a timely manner due to its long-term cooperative relationship with Evergrand and the complexity of Evergrand's financial fraud. In addition, PwC may turn a blind eye to all these risks due to the benefits provided by Evergrand, further exacerbating the risk of audit failure. Corporate reputation is like the cornerstone of a building, once shaken, the building may collapse. Financial integrity is not just about numbers, but also a reflection of value and responsibility.

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