

# Research on the Impact and Mechanism of Short Selling Mechanism on Corporate Financial Fraud

-- Taking Coretronic as an Example

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**Abstract:** This paper focuses on the impact of the short - selling mechanism on corporate financial fraud, and conducts a case study on Coretronic. By analyzing the whole process of Coretronic being shorted, this paper deeply explores the impact and mechanism behind it. The study finds that the short - selling mechanism exposed Coretronic's financial fraud, leading to a sharp drop in its stock price, operational difficulties, damaged reputation and blocked financing. Mechanistically, it effectively restricts financial fraud through information disclosure, market constraints and regulatory promotion, providing valuable references for the improvement of capital market supervision and the prevention of financial fraud.

**Keywords:** Short - selling mechanism; Financial fraud; Coretronic.

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## 1. Introduction

In the context of the vigorous development of the capital market, financial fraud has repeatedly occurred, seriously threatening the fairness and stability of the market. In order to pursue higher market value, attract investment or meet financing conditions, enterprises do not hesitate to falsify financial data, which not only misleads investors' decisions, but also damages the reasonable allocation of market resources.

As a special balancing force in the capital market, the short - selling mechanism injects new supervisory vitality into the market. It gives investors the right to borrow stocks and sell them first when they expect the stock price to fall, and then buy them back at a low price to make a profit. This mechanism drives short - selling institutions to deeply explore the potential problems of enterprises. Once flaws such as financial fraud are found, they will issue reports to attract market attention, thus deterring fraudulent enterprises.

Coretronic, once a leader in the IC component e - commerce industry, was exposed for financial fraud due to being shorted, becoming a focal event in the capital market. Taking it as a breakthrough point, a deep exploration of the impact and internal mechanism of the short - selling mechanism in discovering and curbing corporate financial fraud is of great practical significance for improving capital market supervision and strengthening investor rights protection.

## 2. Literature Review

### 2.1. Research on Short - selling Mechanism

Short selling, as an important trading strategy in the capital market, is an operation method adopted by investors based on the bearish expectation of the overall stock market or the future trend of specific stocks to protect their assets and achieve profits. In the operation system of mature capital markets, the short - selling mechanism mainly includes two types: active short selling and passive short selling. Active

short selling is manifested in that investors take the initiative to use credit trading means, such as short selling on margin, or use derivative financial instruments such as stock index futures to lay out short positions in advance, intending to obtain price difference benefits from the decline of stock prices [1]. Passive short selling is that investors sell the stocks in their hands and stay on the sidelines to avoid potential investment losses when they predict that the macro market trend is downward or the prospects of individual stocks are bleak [2].

Numerous empirical studies have shown that the short - selling mechanism plays a non - negligible role in maintaining the stability and efficient operation of the capital market. A study by Bris, Goetzmann and Zhu on the capital markets of 46 countries around the world found that in developed markets where short selling is allowed, the volatility of stock returns is 23% lower on average than in emerging markets where short selling is prohibited [1]. This data strongly confirms the significant effect of the short - selling mechanism in curbing excessive market speculation [1]. Taking China's capital market as an example, after the formal implementation of the margin trading mechanism in 2010, the intraday price fluctuation range of the constituent stocks of the CSI 300 Index narrowed significantly, with a decrease of up to 18.7% (Li Ke et al., 2014), and the phenomenon of sharp market fluctuations was effectively curbed [3].

In terms of price discovery function, the short - selling mechanism promotes market participants to conduct more in - depth and comprehensive mining and analysis of enterprise fundamental information. When there is short - selling power in the market, the stock price of the enterprise can more timely and accurately reflect its intrinsic value. For example, some short - selling institutions will issue short - selling reports once they find problems such as excessive valuation and suspected financial fraud of the enterprise through careful study of the enterprise's financial statements and business models. This behavior not only transmits negative information of the enterprise to the market, breaks the information asymmetry, but also can guide the stock price to return to a reasonable range [4].

The short - selling mechanism also has a positive impact on the optimization of corporate governance. Studies have shown that the management of enterprises facing short - selling threats will take the initiative to improve the quality of corporate information disclosure and improve the internal supervision mechanism out of considerations of maintaining the stability of the company's stock price, their own reputation and career development. The research results of Hutton, Marcus and Tehranian show that compared with enterprises without short - selling pressure, the financial report transparency of enterprises facing short - selling threats has increased by 27% [4]. This means that the short - selling mechanism exerts pressure from the outside, forcing the management to standardize their management behavior, improve the level of corporate governance, and finally promote the improvement of the overall quality of the capital market.

## 2.2. Review of Coretronic's Shorting Incident

Coretronic was listed on the Hong Kong Stock Exchange in July 2014, with UBS as the exclusive sponsor. In 2017, Fenghuo Research released a short - selling report entitled "The Century Fraud Spanning 10 Years", accusing Coretronic of exaggerating its revenue and net profit, and that its online platform and the so - called "China's largest hardware innovation platform" Hard Egg were scams. The report pointed out that there was a major discrepancy between Coretronic's industrial and commercial files and the disclosed figures. As shown in the study of Bloomfield & O'Hara, short - selling institutions rely on professional investigation capabilities to expose the contradiction between the enterprise's disclosed information and underlying data, and the breaking of this information asymmetry is the key premise for the market constraint mechanism to play a role [5]. It claimed that most of the GMV was false, the return on equity, growth rate and return far exceeded the industry performance but were unreasonable, there was a huge gap between the net profit and cash flow. Such financial index deviations are regarded as typical signals of financial fraud by Skinner (2007). When the net profit and cash flow of an enterprise continue to be mismatched, it often indicates the existence of earnings management or revenue fiction [6]. The share repurchase was also suspicious.

## 2.3. Impact of Short - selling Mechanism on Coretronic's Financial Fraud

**Sharp decline in stock price:** After the short - selling report was released, Coretronic's stock price fell sharply, and once fell nearly 30% in the afternoon and was suspended for trading. This reflects the market's attention to and concern about the content of the short - selling report. Investors' confidence in the company was seriously hit, resulting in the stock value returning to a level closer to its real fundamentals, and the stock price bubble of the financially fraudulent enterprise was pricked.

**Damaged corporate reputation:** Being publicly accused of financial fraud by short - selling institutions has caused great negative impacts on Coretronic's reputation. Whether it is partners, customers or potential investors, they will question the company's integrity, which may lead to the reduction of business cooperation and the loss of customers, thereby affecting the company's long - term development.

**Increased regulatory attention:** Such short - selling incidents often attract the attention of regulatory agencies.

Regulatory authorities may launch an investigation into the company, urge the company to more strictly comply with information disclosure regulations and laws and regulations, and improve the level of corporate governance, so as to avoid the recurrence of similar financial fraud.

## 2.4. Mechanism of Short - selling Mechanism on Coretronic's Financial Fraud

**Information disclosure mechanism:** Short - selling institutions found and exposed the relevant evidence of Coretronic's financial fraud through in - depth investigation and analysis, such as the problems of the online platform and the differences between the industrial and commercial files and the annual report data, transmitted the negative information of the company to the market, broke the information asymmetry, and enabled investors to have a more comprehensive understanding of the company's real situation.

**Market constraint mechanism:** The existence of the short - selling mechanism makes the company face the pressure of being shorted. This pressure prompts the company's management to treat financial reports and information disclosure more carefully and not to engage in financial fraud easily. Because once discovered and exposed by short - selling institutions, the company will face serious consequences such as stock price decline and reputation damage, thus forming a constraint on the management's behavior.

**Mechanism of increasing violation costs:** After Coretronic was shorted, its market value shrank significantly, and the wealth of the company and major shareholders also decreased. At the same time, it may also face investors' litigation and regulatory penalties, which greatly increases the violation costs of the company's financial fraud. This makes enterprises have to weigh the costs and benefits of fraud when considering financial fraud, thus inhibiting the motivation of financial fraud to a certain extent.

To sum up, taking Coretronic as an example, the short - selling mechanism plays an important role in discovering and exposing corporate financial fraud. Through the mechanisms of information disclosure, market constraints and increasing violation costs, it has significant impact consequences on financially fraudulent enterprises, which helps to purify the market environment, protect investors' interests and improve the efficiency of market resource allocation. However, it should also be noted that there may be problems such as malicious shorting by short - selling institutions, and the relevant regulatory system needs to be further improved to ensure that the short - selling mechanism can play a positive role within a reasonable range.

## 3. Argument Analysis

### 3.1. Qualitative Analysis Method

Through the in - depth analysis of various phenomena, behaviors and relationships in Coretronic's shorting incident without quantification. For example, carefully interpreting the content of the short - selling report, analyzing the logic and basis of the allegations of financial fraud against Coretronic; studying the management decisions and response measures of the company before and after being shorted, and judging the impact of these factors on the development of the event and the subsequent operation of the enterprise in nature, so as to deeply understand the action mechanism and impact consequences of the short - selling mechanism in this case.

### 3.2. Quantitative Analysis Method

Use specific data to describe and analyze the case. Collect the stock price data, market value changes, financial indicators (such as net profit, cash flow, etc.) of Coretronic before and after being shorted, and through statistical analysis, comparative analysis and other methods, intuitively show the range of stock price slump, the scale of market value evaporation. As shown in Hong & Stein's study on market crashes, when short - selling restrictions are broken (or short - selling reports are released), stock prices often release accumulated negative information through sharp declines [2]. The phenomenon that Coretronic's stock price fell by nearly 30% on the day of being shorted is in line with the "price collapse under the intensification of differences of opinion" theory proposed by them and the degree of financial index anomalies. It reveals the impact consequences of the short - selling mechanism on corporate financial fraud in a quantitative way, making the analysis results more persuasive.

### 3.3. Comparative Analysis Method

On the one hand, compare Coretronic with non - shorted enterprises in the same industry, find out the differences from the aspects of financial indicators, market performance, corporate governance, etc. Refer to the model of the relationship between disclosure quality and enterprise value constructed by Leuz & Verrecchia, and compare the information transparency indicators (such as the detail of annual report notes, the frequency of related party transaction disclosure) of Coretronic and its peers [7]. Their research points out that enterprises with opaque information are more likely to become short - selling targets, highlighting the particularity of Coretronic's financial fraud and after being shorted. On the other hand, compare Coretronic's own situation before and after being shorted, such as business volume, market share, investor confidence, etc., to clearly present the impact changes brought by the short - selling mechanism.

### 3.4. Causal Analysis Method

Explore the causal relationship between Coretronic's financial fraud and being shorted, as well as the causal chain of a series of consequences caused by the shorting incident. For example, analyze how the financial fraud behavior caused the attention of short - selling institutions and the release of reports, and how the release of short - selling reports led to the consequences such as sharp stock price decline, collapse of market confidence and regulatory intervention, clarify the causal logic between various factors, and thus deeply understand the internal mechanism of the impact of the short - selling mechanism on corporate financial fraud.

### 3.5. Process Tracing Method

Sort out the whole process of Coretronic from listing to being shorted and subsequent development in chronological order, including the company's business development process, the interaction process with short - selling institutions, the regulatory investigation process, etc. By tracking this complete process, analyze the role of the short - selling mechanism at different stages, as well as the enterprise's response strategies and effects in the process of event development, and comprehensively grasp the dynamic evolution of the case and the impact path of the short - selling mechanism.

## 4. Conclusion

Through the in - depth analysis of Coretronic's shorting incident, the short - selling mechanism shows multi - dimensional and deep - level impacts on corporate financial fraud in the capital market. From the sharp decline in Coretronic's stock price after the short - selling report was released, the significant shrinkage of market value, to the collapse of market confidence and the serious damage to reputation, and then to the increase of compliance pressure brought by regulatory intervention, these impact consequences fully confirm the effectiveness of the short - selling mechanism in exposing financial fraud problems. The information disclosure mechanism in its action mechanism breaks the information barrier between the enterprise and investors, the market constraint mechanism standardizes the behavior of the enterprise management from the inside, and the mechanism of increasing violation costs curbs the enterprise's fraud motivation from the level of interest balance. The three work together to maintain the order of the capital market and protect the interests of investors.

However, the Coretronic case also exposes the potential risks existing in the actual operation of the short - selling mechanism. Some short - selling institutions may use false information to carry out malicious shorting for personal gain, interfering with the normal order of the market. This kind of behavior not only damages the legitimate rights and interests of enterprises, but also may mislead investors and cause market panic. Therefore, regulatory authorities need to further improve relevant laws and regulations, build a more sound regulatory system for short - selling behavior, and strengthen the control over the qualifications of short - selling institutions, the information disclosure process, the authenticity verification of short - selling reports, etc., to ensure that the short - selling mechanism runs on the track of legality, compliance, fairness and justice.

For enterprises, the lesson of Coretronic warns them to abandon the fluke mind of financial fraud, strengthen the construction of internal governance system, improve the transparency and authenticity of financial information, take the initiative to accept market supervision, shape a good corporate image with honest operation, and enhance market competitiveness. At the same time, participants in the capital market should also view short - selling behavior rationally, improve their own risk identification and judgment capabilities, avoid blind follow - up, and jointly create a healthy and orderly capital market environment. In the future, with the continuous improvement and standardization of the short - selling mechanism, it will play a more important and stable role in preventing corporate financial fraud and promoting the high - quality development of the capital market.

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