

The Dilemma of Information Disclosure and Equity Dilution of Listed Companies

Yuzheng Shen

*School of Mathematics and Physics, Xi'an Jiaotong-Liverpool University, Suzhou, China
Yuzheng.Shen23@student.xjtlu.edu.cn*

Abstract: The issue of information disclosure and equity dilution in listed companies has become increasingly crucial due to its significant impact on investors' confidence and market stability. This study explores the causes and effects of financial fraud and stock dilution in companies like Kangmei Pharmaceutical, Luckin Coffee, and Toshiba, as well as incidents of equity dilution involving Tesla and NIO. The paper investigates how weak internal corporate governance, insufficient external regulatory oversight, and poor transparency contribute to these problems. The main findings suggest that financial misrepresentation is often driven by management incentives, and that stock dilution, when not managed properly, can lead to investor skepticism and significant declines in stock prices. The study emphasizes the need for stronger internal governance, more stringent disclosure regulations, and enhanced investor education. The research aims to contribute to the understanding of how companies can improve their financial reporting practices and protect shareholders' interests. Policy recommendations include enhancing external regulatory oversight, improving internal governance mechanisms, and educating investors to better understand the implications of equity issuance and financial fraud.

Keywords: Diluted earnings per share, Corporate governance, Information disclosure, ESG.

1. Introduction

The issue of information disclosure and stock dilution in listed companies has garnered significant attention due to its crucial impact on investor confidence and market stability [1]. Inadequate transparency has been linked to numerous high-profile financial fraud cases, undermining trust in financial markets and leading to significant economic consequences [2].

This research investigates the key issues of financial misrepresentation, equity dilution, and their consequences on the financial markets, focusing on the cases of Kangmei Pharmaceutical, Luckin Coffee, Toshiba, Tesla and NIO. The purpose of this paper is to explore how poor corporate governance, ineffective external regulatory oversight, and lack of timely disclosure have led to corporate scandals and financial misstatements. By analyzing these real-world cases, the study aims to identify the common drivers behind equity dilution and information disclosure failures. It also investigates how such practices have affected investor behavior and market stability.

Quantitative research methods are essential for financial cases [3]. At present, only limited qualitative analysis has been carried out based on existing data.

The significance of this research lies in its potential to offer insights into the root causes of corporate financial misconduct, as well as suggest strategies for improving transparency in financial

reporting. The paper emphasizes the need for stronger internal controls, better external regulatory frameworks, and enhanced investors' financial literacy to prevent future corporate scandals and promote sustainable financial growth. Through this analysis, the paper seeks to contribute to the ongoing discourse on reinforcing the financial markets and safeguarding investor interests.

2. Information Disclosure of Listed Companies

Among the issues in corporate governance, insufficient information disclosure is quite representative. There are several valid examples which demonstrate their damage to the interests of investors and the whole market.

2.1. Case Description

Firstly, the Kangmei Pharmaceutical financial fraud case is one of China's largest corporate scandals. Kangmei Pharmaceutical intentionally concealed its true financial status, fabricating profits and failing to disclose significant liabilities. From 2016 to 2018, Kangmei fabricated financial statements by inflating its cash holdings by 299 billion RMB and manipulating revenues and expenses, which misled investors and regulatory authorities. To be more detailed, the company overstated its cash reserves, creating an illusion of financial stability, which took investors into believing it was a profitable and well-managed enterprise. Despite being a publicly listed company, Kangmei operated with minimal regulatory intervention. The China Securities Regulatory Commission failed to detect early warning signs, exposing gaps in market surveillance and enforcement actions. Regulatory agencies lacked the tools and resources to identify fraudulent financial reporting in real-time, allowing Kangmei to operate deceitfully for years. It is the lack of transparency violated China's financial reporting regulations and led to significant investor losses.

Moreover, the Luckin Coffee financial fraud case is another significant example of insufficient information disclosure and corporate financial manipulation, severely damaging investor trust in Chinese companies listed on U.S. stock markets. Instead of disclosing the fraud in a timely manner, the company continued to publish misleading earnings reports to maintain investor confidence. The company artificially inflated revenues by recording fake transactions, falsely reporting increased customer demand and successful store expansion. These fraudulent sales misrepresented Luckin's financial health, leading to an artificially high stock valuation. As a result, Luckin admitted to fabricating approximately \$300 million in sales revenue in 2020, which deceived investors, regulatory agencies, and the public market.

Last but not least, the Toshiba accounting scandal also revealed that insufficient information disclosure may be a serious threat to the investors and severely damaged the markets' trust and corporate credibility. The scandal, which unfolded in 2015, suggested that Toshiba had overstated its profits by approximately \$1.2 billion over seven years (2008–2015), primarily by manipulating accounting practices and delaying the disclosure of financial misstatements. More specifically Toshiba engaged in deliberate accounting fraud by inflating its operating profits across multiple business units, including semiconductors, infrastructure, and nuclear power sectors. The company misstated costs, delayed expense recognition, and used improper revenue recognition practices, creating a false image of financial stability and profitability. These actions misled investors, regulatory bodies, and the public, violating Japan's financial disclosure regulations. Rather than publishing early warning signs, Toshiba's management did not disclose the accounting fraud for years. Top executives, including three former CEOs, pressured employees to meet unrealistic profit targets, fostering a corporate culture of concealment and financial manipulation. The company only admitted to financial misconduct after an independent investigation in 2015, confessing that fraudulent accounting practices had been systematically used for years.

2.2. Cause Analysis

These cases highlight the risks of weak internal governance, ineffective external audits, and regulatory gaps, emphasizing the need for stricter oversight and transparent financial reporting.

The reason that companies are likely to take risks to violate the transparency law is that there is a positive correlation between the pre-issue information and stock returns and trading volume [4]. According to Jing Wu and Chee Yoong Liew, firms tend to disclose information to attract investors before raising equity [4]. Therefore, to show their good business condition and future prospects, firms will always try their best to decorate their balance sheet even willing to break the law. In addition, the huge profit in the stock market may be a crucial trigger of firms' managers getting involved in the information forgery event. Yi-Mien Lin, Shwu-Jen You and Fung-Jiao Lin claimed that the investors act negatively to the stock market when the internal management layer hold a relatively higher proportion of equity [5]. Under the circumstances, managers and firm owners may be unwilling to fully disclose information or disclose some information that does not make sense to prevaricate the superintendent under the profit-driven considering instead of being responsible for the whole company [5]. To trace the main cause, there should be a higher priority on the current insufficient external supervision strength. HuanYu Zhi suggest that less than one third of listed companies in China obey the information disclosure regulation [6]. Worsen, about eighty percent of disclosed information is qualitative and vague which is not enough to infer corporate performance and meet the requirement of the core of information disclosure, namely ESG [6]. Given the various sorts of information generated in the process of companies operating, YuChen Peng pointed that listed firms tend to keep silent about major charges while admitting minor ones when they disclose information, which reduce the credibility of regulators and themselves [7]. From the three cases of scandal about information disclosure in different businesses, it's vital to emphasize internal governance, external supervision and perfection of ESG regulation.

2.3. Optimize Strategy

To enhance transparency and investor confidence, listed companies must address information disclosure issues through a combination of internal corporate governance improvements and external regulatory measures. The following three key strategies may help optimize information disclosure.

Firstly, optimizing the internal corporate governance structure can forbid the corporate executives put their own interests ahead of the interests of the whole company and decrease the possibility of falsifying financial statements led by the senior management of enterprises. Companies could establish independent audit committees to oversee financial reporting and set maximum shareholdings for corporate executives. With formal regulations, the independent audit committees can easily monitor the share ownership by corporate executives, which helps reduce direct interest binding between company and runners. It is also approachable to hire independent directors to cooperate with executives. Secondly, external supervision should also be more rigorous. To ensure compliance with disclosure standards, regulatory organizations such as securities commissions and stock exchanges should enhance their monitor and inspection. Given the massive amount of information, stipulate timely and accurate reporting of financial and ESG data and respectively establish standards for different business on their compulsory ESG data needed to be disclosed plays a crucial role in increasing quality of information. Advanced technology like artificial intelligence can also be applied in dealing with and monitoring the information. As the red line to protect the market and investors, legal framework improvement should be put on the agenda. However, the proportion of ESG data disclosure is not optimistic among China's listed companies, which only about 50 percent of companies with market capitalization between \$10 billion and \$100 billion publish their information while one-tenth of them less than \$10 billion do so (please see Figure 1). It may be

effective to provide priority to the firms that disclosure beyond regulatory requirements, which not only encourages voluntary disclosure but also build investors' trust to the market and firms. Additionally, harsher litigation mechanisms can allow investors who are taken in by false account to seek compensation for damages caused by misleading disclosure.

Only when optimizing internal governance, strengthening external regulatory supervision and reinforcing legal frameworks, can companies significantly improve their information disclosure quality, reduce financial fraud risks, and enhance market transparency. These holistic approach fosters sustainable corporate growth and investor protection in Stock markets.

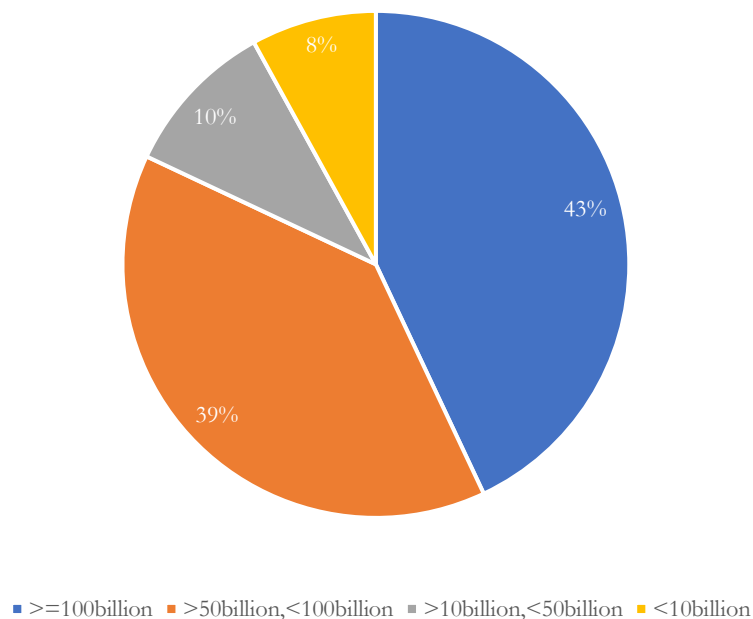


Figure 1: Participation ratio

Data source: Disclosure of ESG related reports of companies of different sizes [6]

3. Stock Dilution

In addition to information disclosure issues, equity dilution is also worthy of attention. The following are examples of how new issue of shares contributes to equity dilution and lead to back fire in the listed companies.

3.1. Case Description

In the first place, the Tesla stock dilution case in 2020 to 2023 is a key example that illustrates how equity dilution, business expansion, and shareholder expectations interact and mutual restraint corporate financing. During this period, Tesla issued new shares multiple times, which raise billions of dollars to fund its global expansion, battery development, and Gigafactory construction. This, however, leads to dilution of existing shares. In this process, the company conducted several stock offerings, issuing around \$12 billion in new shares in 2020 alone which capitalize on its skyrocketing stock price. While the stock dilution reduced per-share earnings, damaging the interests of shareholders, it provided Tesla with critical funding to accelerate growth. Fortunately, with the huge injection of fund, Tesla managed to expand production capacity, including the construction of

Gigafactories in Texas, Berlin, and Shanghai. The company also invested in autonomous driving technology and battery innovation, ensuring long-term growth. In consequence, investors largely accepted the dilution thanks to the raised capital that fueled Tesla's rapid expansion and dominance in the electric vehicle market. In this case, shareholders tend to see dilution as a necessary trade-off for long-term value creation.

While on the contrary, NIO failed to replicate the success of Tesla. In the NIO stock dilution case, it issued new shares multiple times which included an \$8.8 billion ADS offering in 2020 and a \$20 billion offering in 2022. However, these issues diluted shareholder equity, reducing EPS and triggering concerns about long-term profitability. In contrast to Tesla, NIO faced with worsened global market conditions. First, the rising interest rates and tightening monetary policies reduced investor appetite for high-growth stocks. Moreover, the competition in China's electric vehicle was intensified. As a consequence, investors initially supported NIO's expansion, driving its stock to \$66.99 in early 2021. However, by 2023, the stock had plummeted below \$10, an 85% decline, as investor sentiment shifted due to continuous dilution and uncertain profitability. In the circumstances, NIO highlighted that excessive equity financing may back fire when investors' high expectation failed to meet the fragile market environment.

3.2. Cause Analysis

Given that Paul ASQUITH and David W. MULLINS, Jr. suggest that issuing new shares is commonly regarded as the signal of stock price drop and contributes to investors' concern about the earning per share due to equity dilution [8], listed firms still be inclined to issue equity to meet their requirement of expansion and increasing capital needs [9]. It appears that companies are likely to rank equity financing as gambling. Mark R. Huson, Thomas W. Scott and Heather A. Wier state that the issuance of dilutive securities is an approach of rapid financing without instant negative influence on current earnings [9]. However, if the company succeeds in utilizing the money to expand its capacity and occupy the market position as an oligopoly enterprise, it will not only be safe from price reduction but also regain the trust of investors. While on the contrary, stock funding may accelerate the slump in stock price and investors' confidence reduction when market environment is unstable, especially when interest rate hikes and economic downturns occur [10]. This is the bet between future growth potential and equity value that multiple companies are undergoing, which create uncertainty in the stock market and fear to investors.

3.3. Optimize Strategy

To manage equity dilution issues, listed companies should control stock dilution incidents through a combination of internal shareholding structure adjustment and external investor education and financial literacy reinforcement. The following three key strategies may help optimize equity dilution.

Firstly, with respect to the listed firms that intend to obtain a large amount of financing in a short period of time, they could explore alternative financing methods such as debt or convertible securities, which do not cause direct dilution of existing shares, instead of issuing new shares unrestrictedly. Moreover, for the companies that have already issued stock over capacity and experiencing equity dilution, they might turn to share buyback programs for help. Carry out the share repurchase plans allows companies to reduce the number of shares in circulation on the market, mitigating the impact of prior equity issuances on share dilution, stabilizing the stock prices and shareholder' confidence. Thirdly, for the sake of shareholders' benefits, it is considerable to cultivate the investors with financial literacy. Investors often perceive dilution negatively, but they may not fully understand the long-term benefits of strategic equity issuance. Although issuing new shares by reducing ownership

percentage, it can also lead to greater returns in the long run if the funds raised are used wisely, which proves that profits is always binding with risks.

By focusing on internal optimization of equity structures and external education efforts, companies can effectively manage equity dilution issues while maintaining investor trust and ensuring long-term business growth.

4. Conclusion

This study examines the challenges of information disclosure and equity dilution in listed companies in recent years, focusing on cases where financial misrepresentation and governance failures led to severe consequences including investors' low confidence, market crash and government institutions' low authority. The research explores how inadequate transparency, regulatory inefficiencies, and corporate misconduct contribute to market instability and investor distrust.

The objective of this paper is to analyze the causes and impacts of financial fraud and stock dilution through real-world cases such as Kangmei Pharmaceutical, Luckin Coffee, and Toshiba, as well as stock dilution incidents involving Tesla and NIO. By evaluating these cases, the study aims to provide insights into the risks of poor financial reporting, weak internal governance, and investor reactions to equity issuance.

Key findings indicate that corporate fraud often stems from management incentives to manipulate earnings, ineffective oversight, and weak regulatory enforcement. Additionally, stock dilution, if not strategically managed, can trigger market skepticism, investor dissatisfaction, and significant stock price declines. Stronger governance, stricter disclosure regulations, and enhanced investor education are crucial for mitigating these risks.

However, this study has limitations, including the focus on select case studies, which may not fully capture broader market trends. To present a more comprehensive figure of the entire market situation, future research could explore quantitative assessments of financial fraud impact, comparative studies across different regulatory environments, and the effectiveness of emerging disclosure technologies in preventing corporate misconduct.

References

- [1] Wang, H. C., & Chang, H. J. (2008). *The association between accounting information disclosure and stock price*. *Global Journal of Business Research*, 2(2), 1-8. <https://www.proquest.com/pqdweb?index=0&did=37782961&SrcMode=1&sid=14&Fmt=2&VInst=PROD&VType=PQD&RQT=309&VName=PQD&TS=1104758370&clientId=28271>
- [2] Utama, A. N. B., & Purwoko, B. (2024). *Corporate governance and financial transparency: A legal perspective on reducing fraud in global financial markets*. *International Journal of Business, Law, and Economics*, 5(2). Retrieved from <https://ijble.com/index.php/journal/index>
- [3] Chase, K., Greenidge, K., Moore, W., & Worrell, D. (2005). *Quantitative assessment of a financial system—Barbados* (IMF Working Paper No. WP/05/76). *International Monetary Fund*. <https://www.imf.org>
- [4] Wu, J., Liew, C. Y., & Wu, J. (2024). *Examining the effects and moderating influences on environmental, social, and governance information disclosure on enterprise value-at-risk: Evidence from Chinese listed companies*. *International Journal of Business and Society*, 25(1), 148-179. <https://doi.org/10.3736/ijbs.6905.2024>
- [5] Lin, Y.-M., You, S.-J., & Lin, F.-J. (2008). *The effects of pre-issue information releases on seasoned equity offerings*. *Journal of Business Finance & Accounting*, 35(9 & 10), 1138–1163. <https://doi.org/10.1111/j.1468-5957.2008.02106.x>
- [6] Huanyu, Z. (2024). *Research on the analysis of ESG information disclosure problems and optimization measures of listed companies in China*. *China Business Review*, 33(13), 164-168. <https://www.cnzgs.com>
- [7] Peng, Y. (2023). *The legal justification and rule construction of mandatory ESG disclosure system*. *East China Economic and Trade University Law Review*, (4), 152-164.
- [8] Asquith, P., & Mullins, D. W., Jr. (1986). *Equity issues and offering dilution*. *Journal of Financial Economics*, 15, 61-89.

- [9] Huson, M. R., Scott, T. W., & Wier, H. A. (2001). *Earnings dilution and the explanatory power of earnings for returns*. *The Accounting Review*, 76(4), 589–612.
- [10] Core, J. E., Guay, W. R., & Kothari, S. P. (2002). *The economic dilution of employee stock options: Diluted EPS for valuation and financial reporting*. *The Accounting Review*, 77(3), 627-652.