Analysis on the Financial Fraud of Listed Companies in China

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Abstract. This paper studies the cases of counterfeiting of listed companies in China in recent years, analyses the causes and ways of counterfeiting, and seeks solutions. The means of financial fraud of listed companies mainly include fictitious income, early or late recognition of income, transfer costs, adjustment of assets preparation, capitalization of costs and related transaction fraud. Financial fraud of listed companies emerges in an endless stream. In addition to the internal reasons of enterprises themselves, there are also problems of weak external supervision. The results show that it is necessary to build a mechanism to prevent financial fraud from the three levels of government, intermediary agencies and companies.

Introduction

Listed companies refer to limited companies whose issued shares are empowered to be listed and traded on the stock exchange by the State Council or by securities regulators with the authorization of the State Council. In order to accept social supervision and protect the interests of investors, the listed companies' operating and financial information should be revealed in a timely, complete, honest and accurate manner [1]. Unfortunately, with the increasing expansion of China’s capital market, listed companies have been constantly involved in scandals like financial fraud, financial data falsity, and manipulations of the share price and investors’ decision-making, which have cast a shadow on investors’ confidence, disordered the capital market, and disjointed the resource allocation. Academics at home and aboard define financial fraud differently. The financial fraud defined in this thesis refers to relevant financial staff’s misconduct in revising financial information regardless of the accountant standards and affecting the decisions made by users of the financial report information for any personal or accounting entity’s sake, in which reasonable earnings management are excluded.

Analysis on Financial Fraud Methods of Listed Companies

In summary, the approaches to financial fraud of listed companies are as follows: fictitious income, early or delayed confirmation of business income, cost transfer, more or less provision for impairment of assets, expense capitalization, deferred or delayed confirmation costs, fabrication of non-recurring profit and loss items, false increase of assets and missed liabilities, profits created by asset restructuring, payment on account of latent losses and so on[2]. All the approaches referred above can generally be divided into three categories: income forgery, cost forgery and connected transaction forgery.

Income Forgery

With regard to the approaches of listed companies’ financial fraud, fabrication, and tampering, early or delayed income confirmation are most commonly seen. Fictitious income is adopted for events that have not happened, while tampering is based on events that have already happened. From the year 2008 to the year 2011, Wanfu Biotechnology made fictitious income worth nearly ten thousand yuan through fabricating its rice deals with a cereals and oil company. In addition, it got a false increase of up to 12 million yuan in sales revenue by means of tampering with the transaction data with a food company. Early or delayed income confirmation is adopted in an attempt to manipulate revenue in an inter-temporal way. In the case of the financial fraud of the Asia-Pacific...
Industry, Tongchuang Jiaye company, as a subsidiary of the Asia-Pacific Industry, was audited. The investigators of the CPA Association did not acquire the full-length acceptance record form of all projects after paying on-site visits to the quality supervision station where the construction project was located, which indicated that unfinished or unqualified projects still existed. Through further verification, investigators noticed that the sales revenue of the project was confirmed in advance or late. The sales revenue came from 215 residential houses as well as 6 shops.

**Cost and Expense Forgery**

Cost and expense forgery mainly consists of cost transfer, adjustment of provision for impairment of assets, and cost capitalization [3]. Cost transfer can result in the false increase and decrease of profits. Solid Technetium, a company invested and owned by the Asia-Pacific Industry, illegally dealt with the return of the quality claim which had been recorded on the cost account. It led to a false decrease of the net profit of 2012, and a false increase of the net profit of 2013. Likewise, in the financial fraud of the Asia-Pacific Industry, the Asia-Pacific Industry failed to calculate and withdraw the long-term equity investment of Solid Technetium in accordance with its due equity. As a result, up to 90% net profit was increased falsely. Expense capitalization refers to qualified relevant expenses which should be put into the corresponding assets, rather than into the current profit and loss, which is mainly related to the interest expense, as well as the R&D expenditures. In 2011 and 2012, the capitalization rate of ZQ Game’s R&D expenditure was as high as over 90%, which caused the inaccuracy of the financial information. After its overcapitalization was covered by media, its capitalization rate declined to 85.03%. Accordingly, it began to make huge intangible assets impairment to relieve its intangible asset bubble.

**Connected Transaction Forgery**

Connected transaction forgery is a trick to shift taxes, adjust profits and whitewash the statement in the process of the resource transfer or labor services among subsidiaries, parent companies, joint ventures and associated enterprises by the means of connecting purchase and sale, transferring assets, trusteeship management, inter-bank lending etc[4]. The difference between the connected transaction price and the market price can only be recorded as capital reserve. By no means can it be included in the income cost, nor can it be shifted into paid-in capital or used to cover the deficit. However, this financial fraud is ambiguous and covert because it is related to the fair pricing measurement of the connected transaction. In the first case of the financial fraud of the NEEQ, in order to get the recommendation of securities traders, Shen Xian Yuan company cheated unscrupulously by selling the acquired wild ginseng as home-planted ginseng to the affiliated enterprise Shen Xian Yuan Liquor Company at a selling price much higher than the acquisition cost. In this way, it gained a false profit increase of up to 73,729,327 yuan.

**Analysis of the Reasons for Financial Fraud of Listed Companies**

In 2001, the Enron Corporation was exposed to have created false profit which has accumulated to be USD 0.586 billion from 1997 to 2001. In 2001, GUANGXIA INDUSTRY CO., LTD was exposed to have fraud financial statement with a false net profit increase of RMB 0.771 billion in totals from 1998 to 2001; In 2012, Wangfu Biotechnology was publicly criticized for the false operation revenue. The actual income is RMB 0.188 billion lower than the data in the report over the same period. Finance fraud emerges one after another in listed companies abroad and domestically. In addition to the reasons from the enterprises themselves, the inadequate external supervising also contributes to the problems.

**Accounting Firms Lack Independence in Auditing**

The audit objects of accounting firms are enterprises, but from the perspective of the whole industry, supply and demand are not balanced. The relationship between them is always twisted and the audited enterprises have certain initiative. Due to the extremely fierce market competition,
accounting firms have continuously brought down their service cost, striving to get more business. And when problems occur, they tend to make adjustment through communication with customers. In the case of finance fraud of the Asia-Pacific Industry, during the several years of financial fraud, it has paid Ruihua Certified Public Accountants the auditing cost of RMB 300,000 to 550,000, which is highly above the industrial criterion. In order to maintain such a good customer, it's not difficult to understand why Ruihua kept silent when it discovered the problems in the long-term equity investment of the Solid Technetium. In addition to the awkward position of the auditing firm which makes it hard for it to be independent, the overall poor quality of the incapable auditors can be another important cause. Being a quite influential accounting firm domestically, Ruihua is large in scale with plenty of employees and high operation income. However, as such a leading enterprise in the industry, its certified public accountants have approved a series of wrong accounting treatments made by the Solid Technetium in the compensation payment for quality. Besides, due to fast business development, Ruihua has introduced undergraduates as interns to participate in the annual auditing or even the preparation of the worksheet. This is not an isolated case in the industry.

**The Cost of Financial Fraud of Listed Companies is too Low**

One of the reasons why listed companies dare to seek private interests through financial fraud is that the cost of violation is too low in China [5]. On one hand, the legal punishment is too gentle. Based on the penalty measurement for fraudulent issuance of stock and bond, the parties involved shall be maximally sentenced to an imprisonment of less than 5 years or detention, together with a fine of just 1%-5% of the illegal fund raising. Most listed companies having exposed financial fraud are not prevented to be listed in the market. The most severe punishment they receive is the penalty of the top level specified. Thus, it can be seen that the inadequate punishment intensity has in a certain extent become the “protective umbrella” for the free riding or illegal and criminal activities of the cheaters. On the other hand, the execution of the civil compensation is too weak. By referring to the compensations in the financial fraud cases over the years, it has been discovered that lots of obstacles have prevented the investors from obtaining compensation through civil procedure. The biggest obstacle is the difficulty in obtaining evidence. Second to it is the long time taken to obtain evidence? And the last one is that the too little compensation amount. The root of the occurrences of these problems is the imperfection of the laws and regulations. Without the guidance of detailed legal provisions, the court cannot give the parties with loss of profit a fair arbitration.

**Listed Companies Want to Avoid the Risks of Delisting**

The fundamental reason for finance fraud lies in the enterprises’ unsatisfactory performance. The listed companies normally commit finance fraud to avoid to be “*ST”, or to raise fund through issuing shares. The purpose of whitewashing their finance statements by the listed companies is nothing more than fawning on “money holders” [6]. Only with good relevant indexes shall the investors possibly continue their investment by holding shares, and can the enterprises thereby attract more capital as far as possible. According to our relevant regulations, for any listed companies with continual loss for 3 years, the shares thereof shall be probably delisted from the market. If the loss cannot be reversed in the end, the listed company shall be stopped being listed in the market. It’s just under the pressure of delisting and cessation of listing that the listed companies with poor finance situations choose to get through the crisis with finance fraud.

**Concealment of Financial Fraud Means is increasing**

From the previous cases, the listed companies have taken more and more concealing and diverse means of finance fraud. For quite a few listed companies, it takes quite a long time to discover their finance fraud, which makes some listed companies take chances. The listed companies are usually large in scale and have multiple subsidiaries engaged in diverse business scopes with large span of distribution areas. All these characteristics have made it extremely complicated for the accounting firms to audit. With the exception of some material that can be obtained from the third party, the bases for auditing by the accounting firms are the material supplied by the customers. If the clients to be
audited are complicit in counterfeiting the first-hand material, the difficulty in auditing would be huge for the accounting firms. Besides, some listed companies are engaged in very special business and their means of fraud are even more difficult to be discovered. For example in the real estate industry, the project period extends quite long to span several accounting years, and the cost corresponding to the project progress requires on-site auditing. So there is relatively large controlling space in the carry-over of the cost income. This kind of financial fraud means is more hidden than the direct false profits, and more likely to cause accounting firm audit failure.

Suggestions on Preventing Finance Fraud by Listed Companies

**Strengthening the Independence of Auditing**

The first, the status between non-auditing service and the auditing service must be clearly differentiating to avoid overlapping of the two during service providing. When the “Enron Scandal” was exposed, the SEC (Securities and Exchange Commission) demanded that the auditing and the consultancy of the same listed company must be respectively handled by two accounting firms, which has well prevented the auditing failure that could be caused by over-concentration of business. The second, auditing alternation system must be implemented. Due to that the cooperation between the auditing firms and the enterprises to be audited is long-term, and the cost occurred during the auditing process is decided by the two sides through discussions, so, in order to secure the long-term cooperation with the enterprises to be audited, the auditing firms usually provide some convenience to their partners. However, the auditing alternation system can cut the intimacy between the two developed through their long-term cooperation, which is beneficial to guaranteeing the fair, just and objective attitude of the certified public accountants in auditing. And the third, to purify the competition environment of the industry, the industrial credit archive should be made full use of, timely the dishonesty record of the auditing institutes and employees should be released, and penalty intensity should be increased.

**Uplifting the Violation Cost and Exploring New Civil Compensation Mechanism**

On the basis of the analysis to the current status of the finance fraud domestically and abroad, the market environment abroad is better controlled than that domestically, which is after all contributed to the daunting violation cost abroad. Taking the America as an example, not only shall the listed company involved in finance fraud face to penalty and criminal punishment, but also the accountants, auditors and company managers take corresponding civil and criminal responsibilities. In accordance with the relevant American accounting law provisions, the people concerned shall be sentenced to a penalty of 5 to 25 million dollars, or an imprisonment of 25 years maximally. Skilling, the CEO of Enron Corporation was sentenced to an imprisonment of 24 years and 4 months. But domestically, in contrast, the accountants violating rules shall just be sentenced to an imprisonment of maximally less than 5 years or detention on the basis of the penalty measurement for fraudulent issuance of stocks and bonds. The root cause of the finance fraud in enterprises is that the violation cost is lower than the profit they gained therefrom. So, it is important to increase the criminal punishment on the foundation of the existing administrative punishment, which shall play a deterrence role to others. For the civil compensation, the judicial department should handle it in time and give rapid verdict, trying to introduce the mechanism of group action. When the listed company realizes that the violation cost is far above the personal profit gained, and once the violation is exposed, huge loss will occur to the company, the intention of fraud by the listed company should be possibly restrained.

**Improving Internal Auditing System**

Among so many cases of finance fraud by listed companies, the function of the internal auditing is nearly invisible. And it could be even said that the internal auditing exists in name only in almost all the listed companies involved in finance fraud. In fact, internal auditing is the first gate to prevent finance fraud in the company, and meanwhile, effective internal auditing can guarantee to a great
extent the objectivity and justice of external auditing. The effective internal auditing system can be built from below aspects: The first, the ratio of the shares of the major shareholders’ should be reduced to avoid that the major shareholder “covers the sun” alone, or decides at his/her free will, or assertively plays tricks with certain auditing firm behind all backs, interfering with the auditing independence. 2. The second, board of directors takes direct lead of the internal auditing department, uplifting the level and authority of the internal auditing. The third, it is necessary to clearly define the responsibilities and post settings of the internal auditing, and hire those qualified for post requirement for internal auditing. And the fourth, the real-time supervising and feedback system should be established. Accordingly, appropriate rewards and punishment measures must be introduced to ensure the effective operation of internal audit.

Summary

There are many reasons for financial fraud of listed companies. The internal motivation is to whitewash financial data, win the favor of investors, and avoid the risk of delisting and stopping listing. The external reasons are lack of independence, lack of ability and low cost of violation. In order to effectively curb the financial fraud of listed companies, externally, it is necessary to strengthen the independence of audit, improve the quality of CPA audit, and improve the cost of violation. From the internal point of view of the enterprise, it is necessary to establish a complete internal audit system and really make it play a role.

References