Research on Financial Statement Fraud in Listed Companies and Countermeasures

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Abstract

Against China's rapid economic and social development, the problem of fraudulent financial statements of listed companies has become increasingly severe. Therefore, it is imperative to take appropriate audit countermeasures against financial statement fraud to minimise the negative impact of unlawful acts on the economic development of enterprises and to strengthen supervision to eliminate fraud problems. As China's economic environment is still in transition, many historical and social factors limit the strength of the accounting system and the corresponding regulatory system reform so that the current phenomenon of fraudulent financial statements of companies still exists. This paper discusses the common fraudulent practices that exist and the audit strategies adopted in response to fraud, with the aim of providing some references and suggestions to eliminate fraud in the financial statements of enterprises and companies to draw the attention of the community and the government to such issues, while calling on relevant practitioners to abide by their own professional ethics and help enterprises to contribute to the economic development of China.

Keywords

Listed Companies, Financial Fraud

1. Introduction

Against the backdrop of China's rapid economic and social development, the problem of fraudulent financial statements of listed companies has become increasingly serious. Therefore, it is particularly important to take appropriate audit countermeasures against financial statement fraud to minimise the negative impact of unlawful acts on the economic development of enterprises, and to strengthen supervision to eliminate fraud problems.

2. The main causes of fraudulent financial statements of listed companies in China

2.1. Economic environment

Although the country's economic development has been high and steady in recent years, the fact that our economy is
still in a transitional phase; although, on the whole, the systems and legal regulations relating to the economy are gradually being improved, there are still varying degrees of oversight concerning certain aspects of regulation and restraint. In the case of accounting reform, while efforts are being made to establish convergence with international systems, some of the limitations of the current situation in China have to be taken into account, especially concerning the management of economic entities, which appears to be inadequate, leaving opportunities for fraud and forgery by unscrupulous enterprises or unscrupulous elements. In addition, there is also a lag in the construction of relevant laws. The pressure of the legal responsibilities of the CPA profession is increasing day by day, but in terms of the regulation of the appropriate conduct, the designation is not clear, so there are more difficulties in the implementation of the law, the enforcement of the law is relatively weak, and some personnel are not strict in the enforcement of the law, and other phenomena have provided opportunities for fraudulent financial statements (Ozcelik, 2020).

2.2. Internal institutional factors

The main regulations and laws involved in the arrangement of the accounting information system in China are the Accounting Law, the Accounting Standards and the Financial Reporting Regulations. Through the analysis of cases of fraudulent reporting by Chinese enterprises, it is easy to see that the current accounting system is inherently more resistant to high-quality accounting information in its arrangement. In other words, even though there is a code of conduct for accounting that can be relied upon, the enforcement and supervision of the code of conduct is inadequate, and the targets of punishment are not specific enough, resulting in the odd phenomenon that the enforcers need to be punished while the relevant managers who authorise the enforcement are exempted from blame.

The government is the main force in market regulation, but China's capital market development is still immature, and laws and regulations need to be improved. Most of the violations are punished by the regulatory authorities 1-2 years after they occur, and in the longest cases, more than 3 years. This shows that the capital market is not sufficiently regulated. On the other hand, the regulatory authorities impose small penalties for breaches of the law, mostly in the form of notifications and criticisms, regulatory concerns and requests for rectification. The low level of penalties may encourage further fraudulent behavior (Li & Yang, 2019).

2.3. External institutional factors

Due to the imperfection of the external market supervision and management system, the imperfection of the relevant legal system and the special nature of the industry, etc., enterprise financial fraud has the opportunity to take advantage of. There are still many problems in the regulation of accounting information in China, and these problems have reduced the efficiency of the regulation to a certain extent, and some unscrupulous enterprises still have illusions about financial fraud. Listed companies often receive strong support from local governments and are also subject to enormous pressure from the government, which becomes an external factor for the emergence of fraudulent and fraudulent practices in the investment market. In the case of disorganised internal controls, audit units have issued audit opinions that internal controls are adequate. The fact that some companies have incurred audit fees of a million dollars, more than twice their previous fees, in the face of continuous losses and that internal control fee never fall below several hundred thousand dollars does not inspire confidence in the validity of external audits (Bala et al., 2018).

3. The harm of financial fraud in listed companies

Financial fraud will create an illusion of good corporate development, but a fake is a fake, not a real one, and will be uncovered. When the false veneer of financial fraud is discovered, all the beauty of the Company will be shattered like a bubble, many shareholders will sell their shares in large numbers, investors may lose everything or even lose all their money, and the image of the Company will be lost and hit the lowest point. Therefore, fraudulent financial statements can be fatal to listed companies, and the risks are extremely high.

3.1. Influencing the government's macro-control

In the formulation of national macroeconomic policies, the main basis is the publicly disclosed information of listed companies, such as financial statement data, etc. Based on the large amount of information, combined with the market situation, the correct decision can be made. Once the accounting information is not true, it will lead to distortion of national economic statistics, macroeconomic policies do not match with the actual phenomenon, and cannot truly express the needs and status of economic entities, which will lead to uncontrolled macro-control and damage the development of the national economy (Yiu et al., 2019).

3.2. Misleading investors' economic decisions

Currently, China is in a market economy environment, and whether the financial information is true and effective di-
rectly affects the development of the market economic system. As the core embodiment of financial information, market information now reflects that investors can correctly and accurately understand the Company's business performance and financial situation. Whether a personal or institutional investment, it is necessary to analyse the development of a listed company in detail and carefully before making an investment decision. As the main financial data of a company, financial statements are of great significance for a detailed understanding of the Company's operating conditions. If the financial statements are falsified, it is likely that investors will be misled and will not be able to analyse the actual operation accurately and future profitability of the Company, ultimately causing them to suffer financial losses.

3.3. Jeopardising the stability of the securities market

As the main source of corporate funds, the securities market is of great significance in expanding the scale of enterprises and enhancing production capacity. However, at this stage, China's securities market system is still not sound, the system construction is still in the early stage, a large number of the emergence of financial fraud is constantly impacting China's fragile securities market, which is not conducive to the stable and healthy development of the securities market, and may even have a serious impact on the credibility of the securities market, shaking the very foundation of the market.

3.4. Affect the healthy development of listed companies

Financial statement fraud is a double-edged sword, on the one hand, on the surface will bring certain benefits to the enterprise, cleverly disguise the various financial defects of the enterprise; but at the same time will be detrimental to the long-term development of the enterprise, once exposed, it will push the enterprise to the abyss of ruin, in short, more harm than good. According to the status quo of China's corporate governance structure, a company's operating and ownership rights are separate and cannot be merged into one. Listed companies have the responsibility to disclose accurate and true financial information promptly, which can provide investors with a basis for proper decision-making. Suppose a listed company violates this provision and provides false financial information to investors. In that case, it is likely to violate the "three fairmesses" (fairness, impartiality and openness) principle of the securities market and may even threaten the credit of the Company and expose it to the risk of bankruptcy (Luo, 2020).

4. Common Fraudulent Practices in Financial Statements of Listed Companies

4.1. Revenue falsification

At the end of a period, some unscrupulous enterprises establish a sales relationship by entering into a sales contract by agreement with the purchaser, followed by the return of the sale by the agreed purchaser at the beginning of the next period, by which means the sales amount is offset. Some companies also try to collaborate with multiple parties by issuing false VAT invoices to each other with related or unrelated parties, fictitious purchases and sales to obtain more export tax refunds, or using fictitious purchases and sales to create the illusion of high sales. This type of revenue falsification is one of the common financial statement frauds.

4.2. Inappropriate use of funds

According to the relevant laws and regulations in China, the mutual borrowing of funds between enterprises is explicitly prohibited. Some unscrupulous enterprises often raise a large number of funds and then lend them directly to related parties for use. Instead of investing this part of the funds in projects with higher returns, they charge high capital occupation fees to inflate the Company's profits. This can easily lead to a shortfall in the Company's profits due to the personal use of a certain portion of the Company. This is one of the phenomena that is extremely likely to occur in cash fraud (Yao et al., 2019).

4.3. Fraud in the form of inflated inventory values

Companies and businesses conduct regular inventory counts, and sometimes the inventory is actually in the red, but the value of the inventory is still there in the financial books. Through this device, companies can reduce the cost of goods sold on their books, achieving a false increase in the Company's total profit and increasing the product's value at the end of the period. The fraudulent way to inflate accounts receivable and prepaid accounts market surveillance, for example, Company A inflated prepaid accounts by RMB 24,078.82 million in 2017, accounting for 3.11% of the Company's disclosed total assets and 3.68% of its net assets; and inflated accounts receivable by RMB 4.71 million in 2018, accounting for 0.05% of the Company's disclosed total assets and 0.06% of its net assets, and inflated prepaid accounts by RMB 281,239.9 million This represents 2.99% of the Company's disclosed total assets and 3.59% of its net assets.
As at 31 December 2018, $404,363,700 in accounts receivable, $79,972,300 in other current assets and $106,238,000 in prepayments were occupied by other companies.

4.4. Fraud in the timing of revenue recognition

Early or late recording of revenue recognition is also a common ploy in financial statement fraud. In many cases, the financial records are made to recognise sales revenue in advance when no goods or services have been provided to the customer and the corresponding documents have not been received. The opposite is the delayed lag in recognising sales revenue, which often delays the recognition of sales in the current period to the next period when the Company is unable to meet its expected targets, thus balancing the level of operations.

4.5. Related party related fraud

This refers to collusive fraud in which a company or business uses related parties of the Company. For example, related party transaction fraud, where a company uses its own related parties and both parties agree to engage in fraudulent purchase and sale practices or delegated operations, where a listed company places non-performing assets in its name under the management of an associated company.

It should be noted that conventional means of financial processing may also result in distortion of financial statements, thus providing a breeding ground for financial statement fraud. For example, Kang Hong Pharmaceuticals capitalised on large-scale research and development expenditure in FY2019, resulting in an inflated profit income in the financial statements, followed by an unexpected termination of the research and development project, resulting in a plunge in the books, leaving a lot of room for manipulation between one rise and one fall for fraudulent behaviour.

Therefore, it is important to adopt appropriate forms and methods to deal with and record changes in the structure of various expenses or assets of an enterprise in an effort to avoid distortion of financial statements.

5. Measures to be taken to avoid fraud in financial statements

Currently, China does not have an audit function dedicated to dealing with financial statement fraud, but foreign theoretical research on fraud has some reference value for handling and studying this aspect of the problem in China.

5.1. Building an excellent internal control environment

In order to effectively curb financial statement fraud, building a good internal control environment is the most important tool. Therefore, to improve the internal control system of listed companies, it is necessary to work on the internal control environment, ensuring the reasonableness of the shareholding structure and not having the situation of "one share is too big". It is also required to establish a sound corporate governance mechanism and clarify each department's authority to influence and control each other. At the same time, the effectiveness of internal control evaluation should be improved. What is internal control evaluation? The author believes that internal control evaluation refers to the audit activities carried out by the Company so as to continuously eliminate a large number of risks and hidden dangers in internal control, to improve the internal control system further and achieve the purpose of controlling fraudulent financial statements. The audit strategy should be developed with due regard to the effectiveness of internal controls by the relevant management and with a firm understanding of the extent to which fraud impacts the financial statements themselves. If the impact is material, a relatively detailed audit process needs to be developed to adequately gather relevant evidence to confirm or eliminate suspicions of fraud and avoid wrongful or missed audits. At the same time, the audit plan should be executed and implemented with due regard to the likelihood of fraud and the corresponding risk of fraud in causing a material misstatement of the financial statements. If there are indications of fraud, the audit strategy should be adjusted in a timely manner, and more targeted measures and audit procedures should be adopted. It is worth noting that a sceptical and evidence-based approach to the profession of a CPA is key to detecting and exposing fraud in financial statements by examining the risk factors for fraud in financial statements and scientifically assessing the risk of possible fraud in financial statements.

5.2. Targeted audit strategies

In the development of a company's operations, risks are everywhere and once financial statement fraud occurs, it will certainly have a serious impact on the Company's sustainability and stability. Internal control is a key measure to ensure that the Company successfully completes its target plan, but it can also be adversely affected by risk. For this reason, it is important to strengthen the Company's risk awareness, establish a risk control system and use a series of measures such as risk warning, risk identification and risk assessment to minimise the Company's financial risks. At the same
time, it is necessary to enhance the risk warning awareness of relevant departments and company personnel, organise relevant personnel to study financial statement knowledge and legal knowledge on a regular or irregular basis, enhance legal awareness, standardise operational behaviour and effectively inhibit the occurrence of financial statement fraud from an ideological and psychological point of view. Through the above analysis of several common fraudulent techniques, it is easy to see that although there are commonalities between the various fraudulent techniques, there are also considerable differences.

The CPA should consider the risk factors for fraud in the financial statements while the audit plan is still in the development stage. Assess the risk of material misstatement or distortion of the financial statements due to fraud and respond accordingly, document this response in the audit working papers, and actively communicate with the relevant management.

5.3. Improve regulation

The reason for the occurrence of fraudulent financial statements is inaccurate information disclosure. To effectively reduce and curb fraudulent financial statements of listed companies, the law is guaranteed. First of all, on the basis of the existing legal provisions, the gaps and omissions must be added to clarify the legal scope of information disclosure of listed companies. Secondly, the law should be enforced more vigorously to make the disclosure of information by listed companies a legal obligation and improve financial information transparency. At the same time, all those involved in financial statement fraud should also be severely punished, and enforcement should be stepped up so that in the event of fraud, severe punishment will be meted out. Lack of supervision is a direct cause of financial fraud. In order to effectively curb financial statement fraud, leadership and management must be increased, and a sound regulatory mechanism must be established.

5.4. Strengthening the ethics of grassroots financial staff

In numerous cases of financial fraud, the relevant grassroots financial management staff have broken their professional commitment and failed to regulate their behaviour with ethics due to the temptation of different means by their supervisors, and various pressures exerted on them by their supervisors. In turn, the grassroots finance staff are the direct operators of the Company when it comes to financial fraud. Therefore, it is necessary to strengthen the professional ethics of the grassroots finance staff. The Company should not neglect to improve the integrity and ethical standards of its grassroots finance staff by focusing on developing their business skills. Only when grassroots finance staff have the right moral values of integrity can they hold on to their professional bottom line and firm up their professional ethics. The Company should establish a reward and punishment incentive mechanism to motivate the grassroots financial staff to adhere to professional ethics, not yield to the management's threats to force, and resist the various temptations of senior management. If they are hit and retaliated against, they should dare to use legal weapons reasonably to defend their legitimate rights and interests. Regardless of the approach taken by the enterprise, it is necessary to raise the moral and legal awareness of financial management workers so that they can apply good professional ethics to restrain their own behaviour.

6. Conclusion

In China's modern economic environment, fraudulent financial statements of listed companies not only affect the trust of the society in the enterprises and make the actual profits of the enterprises suffer a certain degree of loss, which further affects the development of the enterprises and slows down the development of the enterprises; at the same time, it is also not conducive to the sustainable development of China's economy. At present, China's capital market is in a new stage of transformation. As the law continues to improve, the environment of China's capital market is also improving, and even though fraudulent behaviour is changing, the market regulators are also making progress in developing a "keen eye" for it. In the future, listed companies should strictly abide by the rules and regulations of the capital market, comply with relevant laws and regulations, and achieve sustainable development with the joint efforts of the management and relevant government departments.

References


