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Research on Legal Issues of Financial Fraud in Listed Companies

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Abstract

In the rapidly developing economy, with the increasing frequency of socio-economic activities, the number of listed companies is also growing. As an important part of China's non-state-owned economy, the information disclosure of listed companies is particularly important and serves as a crucial indicator for small and medium investors. However, in the prosperous market economy, some listed companies, in order to attract more investors, resort to financial fraud, such as issuing false invoices, creating fictitious transactions or related party transactions, and other means to inflate profits and deceive investors' funds. This undoubtedly undermines China's socio-economic order and reduces the public's trust in the securities market. Due to the imperfect market economy rules, inadequate legal system, and incomplete internal control systems in China, financial fraud occurs very frequently. Financial fraud not only harms the interests of small and medium investors but also disrupts the social and economic order. Next, this paper will explore the means and motivations of financial fraud to delve into the essence of financial fraud.

Keywords

Listed Companies, Fraud Governance, Accounts Receivable

1. Introduction

Financial fraud is the act of altering financial statements to conceal or distort the true operating conditions of a company, colluding with external auditors or government inspectors, and using false financial statements to deceive users of the statements and the trust and funds of small and medium investors. Compared with companies that have not committed financial fraud, companies that have committed financial fraud will have significant differences in some financial ratio data.

The sales growth index is a very important symbolic data. When a company's profitability declines, to avoid the risk of delisting, listed companies often engage in financial fraud. That is to say, when a company's profits are decreasing, with high debt and slow profit growth, the company is more likely to engage in financial fraud. In today's various entertainment companies, due to the rapid development of ACG and fan culture in previous years, the market has become overheated, and many large and small entertainment companies have been established in recent years, resulting in fierce market competition and a significant decline in profitability.

To win the trust of creditors, sometimes to make the accounts look good, they will reduce the quality of assets to increase the amount of assets on the books. That is to say, companies with high leverage risk and low asset quality are more likely to have financial fraud. For example, many entertainment companies nowadays, due to the generalization of entertainment, have expanded the scope of their main business operations, and their current ratio and quick ratio are far from excellent. In this case, to win the favor of capital, to achieve the purpose of listing or not being delisted, these entertainment companies are at risk of financial fraud.

The accounts receivable turnover rate is a key data point. If a listed company's assets are mostly composed of accounts receivable, it is necessary to consider whether these accounts receivable are related to related party transactions. That is to say, when a listed company has too many accounts receivable, the possibility of financial fraud is greater. Many entertainment companies have the business of selling some figures or toys, and in the entire animation industry chain, the production and sales of figures and toys are the main source of profit for domestic entertainment companies. The sale of figures has uncertainty. When the animation characters are not popular or are boycotted, it is possible to commit fraud by increasing accounts receivable to increase revenue and profits.

In summary, there are many traces to follow when judging whether a company has financial fraud. When conducting external audits, it is necessary to pay attention not only to the data on the financial statements but also to the financial ratios related to profitability, solvency, and asset operation. Comparing these ratios with those of companies in the same industry or of the same size, if there is a significant gap, it is necessary to pay more attention to whether the listed company has engaged in financial fraud.

2. Means of Financial Fraud by Listed Companies

2.1 Fraud through Fictitious Business

By fabricating sales business, fictitious sales contracts, and issuing false invoices to commit fraud. By fabricating sales business, listed companies can inflate sales revenue, thereby achieving the purpose of fabricating revenue. Since the net profit obtained by an enterprise can be reflected through the net profit margin of operating income, when the net profit is low or the operating income is relatively high, there is a possibility of inflating sales revenue. However, after fabricating sales business, the corresponding bank deposits or accounts receivable should also change. When recording bank deposits, in fact, this money has not been received. In order to make the accounts look normal, it is also necessary to increase some expenditure items, such as procurement business. In addition, in manufacturing enterprises, the subject of inventory should also change accordingly. When the enterprise's inventory cannot form a counter price with the payment of fictitious sales business, production costs should also change. In some media industries, film and television industries, and other light asset industries, due to the different nature of the industry, a project can bring a lot of profit to the company. At this time, in order to avoid taxes, enterprises are very likely to commit financial fraud to evade taxes.

2.2 Fraud by Inflating Fixed Assets

In accounting, the interest on liabilities formed for the purchase or construction of fixed assets should be included in the cost of fixed assets. By capitalizing expenses that should be expensed, the company's profit for the year is increased, and the expenses that should be expensed in the current year are deferred through depreciation to the following years.

2.3 Confirming Revenue in Advance and Deferring the Recognition of Expenses

The transaction is considered complete only when the ownership of the goods is completely transferred. Sometimes some listed companies will confirm revenue in advance, even if the ownership of the inventory has not been completely transferred, so as to increase profits by increasing income. They will also defer the recognition of some expenses that should be recognized in the current period, thereby increasing profits by reducing expenses.

2.4 Under-provision or Non-provision of Bad Debt Provisions

According to the requirements of accounting, the bad debt provisions made in this year should be directly offset against profits. Some listed companies, in order not to make profits negative, will under-provision or even not provide bad debt provisions, which will make profits artificially high, thereby achieving the company's goals.

2.5 Related Party Transactions

Most listed companies will sign fictitious contracts with their related companies. These contracts are usually not signed at market prices, in order to transfer profits to the places they want to transfer, by under-recording or concealing accounts payable to increase profits. At the same time, related parties will also cooperate to implement this non-existent transaction. This method is often highly covert and not easy to be discovered.

3. Analysis of the Motivation for Financial Fraud by Listed Companies

3.1 Analysis based on the Inner Heart of the Person in Power

In the audit process, attention should be paid to the company's equity structure. Sometimes the executives hold shares, and since the executives are related to the company's interests, they will restrain financial fraud to a certain extent. However, if the equity is too concentrated in a few people, especially in family businesses, it may breed financial fraud for personal or family interests. The management, as the core of financial fraud, is generally a conspiracy of management personnel. The management, as the core of the company's internal, to a certain extent, their power has not been effectively constrained. Although it is the financial personnel who carry out some financial fraud operations, it is generally impossible to carry out without the authorization or permission of the management. As the saying goes: "The higher the official, the more oppressive". Due to the management's excessive authority, the integrity of the accounting personnel's professional ethics sometimes cannot be maintained. The CFO is the executor of the management's collective will. Financial fraud is not only the personal behavior of the CFO but also the collective behavior of the company. The financial fraud of listed companies is a collective crime.

3.2 Analysis from the Perspective of the External Market

In the capital market, there are all kinds of financial frauds. In fact, in a market where bad money drives out good, it is difficult for listed companies to ensure their own purity. On the books, the financial statements of companies that have committed financial fraud are often more perfect than those of companies that have not committed financial fraud. Moreover, the investment market is now very hot, and we, as leeks, rush to the capital market like moths to a flame. At this time, listed companies with a perfect financial statement can win the favor of a large number of investors. In such a market where bad money drives out good, the listed companies that can survive better are usually not those that are serious about industry, but those that are good at swimming in the financial market. In this situation, financial fraud seems to have become a wealth password, in order to deceive the funds of small and medium investors, or to deceive the national subsidies, etc. Marx once said: "Capitalists are afraid of having no profit or too little profit, just as nature is afraid of a vacuum. Once there is an appropriate profit, capital becomes bold. If there is a 10% profit, capital will be used everywhere; with a 20% profit, capital can become active; with a 50% profit, capital will take risks; for a 100% profit, capital dares to trample on all human laws; with a profit of more than 300%, capital dares to commit any crime, even to risk hanging". Undersuch temptation of interests, coupled with the failure of internal control systems and the imperfection of legal supervision systems, and the shareholders' inability to effectively supervise the management due to information asymmetry and free-riding after the separation of property rights, are all reasons for financial fraud.

3.3 Analysis from the Regulatory Level

Financial fraud is usually an administrative penalty, and there is little involvement in criminal law. Because most financial frauds are fakes at various levels and do not involve the scope of "crime of disrupting the socialist market economic order" controlled by criminal law, even if financial fraud is discovered, compared with the benefits obtained by listed companies over the years, the cost of fraud is quite low, and low cost often stimulates the birth of financial fraud. For example, the financial inspection rate of IPO is only 5%, and the proportion of financial fraud found is very low. Even if it is discovered, it will not bring serious consequences. The current cases of profit manipulation found by regulators show that they only give orders to correct and give warning letters, without warning penalties and fines. This has almost no major impact on the refinancing of the company after the fraud, nor does it have a great negative impact. Such a low cost can be exchanged for fraudulent listing, and can be exchanged for huge benefits in stock reduction, employee equity incentive costs, and other aspects. Even if the regulatory side gives the highest penalty, I believe there will still be many companies that choose to continue profit manipulation and financial fraud.

3.4 Lack of Independence of External Audits

The main work of accounting firms is to be responsible for the annual inspection of enterprises, financial statement audit, and capital verification. In the audit process, it may be because of the company's obstruction, or because the project leader and the company's executives have a close connection (audit collusion), which may lead to the audit report issued by the accounting firm lacking independence. For example, Zhengzhong Pearl River Accounting Firm has been issuing unqualified opinions for many years, and as a professional institution, and has been auditing Kangmei Pharmaceutical for so many years, it is impossible to have not found a clue, so it can be seen that Zhengzhong Pearl River Accounting Firm lacks professional ethics and independence in this business.

Therefore, financial fraud not only brings huge economic losses to investors but also damages the reputation of securities regulatory departments and accounting firms, and the confidence of investors in investment is frustrated, and the normal market competition order is disrupted, resulting in a bad social impact.

4. Strategies to Prevent Financial Fraud

4.1 Building the Ideological and Moral Character and Legal Awareness of Accounting Personnel

Most accounting personnel have to follow the arrangements of their leaders when working, whether for a living or for promotion. Accounting personnel often turn a blind eye to some illegal behaviors within the company, and even encourage the momentum of illegal behaviors. Cultivating the legal awareness of accounting personnel is to enable them to detect some illegal behaviors in their work, which can help relevant authorities to quickly discover and crack down on existing illegal crimes. For example, in the "Crime of Issuing Fake VAT Invoices for the Purpose of Defrauding Export Tax Rebates or Tax Deductions" in the criminal law, whether it is for oneself, for others, or letting others do it for oneself, accounting personnel are indispensable in the process of committing the crime. As the main responsible person, they play a role in making false accounts and signing and stamping on invoices, and as the main responsible person, they should bear the corresponding criminal responsibility. If there is enough legal awareness training for accountants, there may be accountants who dare to report such existing crimes, which can avoid national losses and disrupt the social and economic order.

4.2 Maintain the Independence of External Inspectors

In the process of discovering financial fraud in listed companies, external inspectors will play a significant role. An auditor or inspection agency that does not collude with listed companies is very important. It is necessary to maintain the independence of the audit and the purity of the inspection agency, to strictly implement the avoidance system, and to prevent auditors or inspectors from colluding with listed companies to commit fraud together. Moreover, in the listed companies that commit fraud, it is also necessary to pay more attention to whether the company itself is involved in money laundering. After all, a large amount of liquid funds are needed in the process of committing fraud. In the process of financial fraud, money laundering may be involved. A lot of black money from the seven major upstream crimes of money laundering may be laundered through some companies and enterprises through false transactions, etc. It is necessary to strictly inspect the legality of the listed companies' capital sources and the rationality of suspicious funds flowing through various related enterprises, whether it is simply for fraud or involving money laundering. At this time, whether the auditors, institutions, and inspectors can maintain their independence in the face of huge interests is crucial for maintaining the social and economic order. To maintain this independence, it is necessary to further improve the internal authority separation system of the audit institution or inspection agency, so that the personnel of each position can form effective checks and balances, and achieve complete and effective procedures.

4.3 Improve the Legal System

4.3.1 Update Laws and Regulations in a Timely Manner

With the implementation of the new "Securities Law" in 2020, the new securities law has added a new Chapter 5, which is the new requirements for information disclosure, and added requirements for the quality of information disclosure, which requires truthfulness, accuracy, completeness, simplicity, clarity, and easy to understand, without false records, misleading statements, or significant omissions. The new requirements for information disclosure are higher for listed companies, not only to be true and effective but also to be easy to understand, which is a good thing for small and medium investors. The reports are easier to understand for them, which is a good thing, because the financial statements that were originally difficult to understand have become easier to understand. Article 80 of the new securities law also expands the scope of information disclosure, from the original five to the current twelve, and the matters that listed companies must disclose have increased, the quality of accounting information is higher, and the disclosure of accounting information is more transparent and timely, which is more helpful for ordinary investors to protect their rights and interests.

4.3.2 Increase the Punishment for Financial Fraud

The new securities law has also increased the fines for financial fraud behavior, from the original 600,000 yuan to 10 million yuan. In China's judicial practice, the chances of top-level cases are relatively small. From the original 600,000 yuan to the current 10 million yuan, this amount is a cost that listed companies that have obtained more benefits from financial fraud do not care about at all. Compared with the punishment for financial fraud in American law, China's legal punishment for financial fraud is far from enough. For listed companies, even the punishment after the implementation of the new securities law is still a drop in the bucket. In my view, financial fraud is a very serious mistake, which seriously disrupts the social and economic order. The punishment for financial fraud should also play a deterrent role. After all, one of the many functions of the law is to educate, to warn and warn ordinary people or violators themselves. Both the original securities law and the new securities law do not pose a great threat to listed companies. In addition, for such unit crime behavior, not only should the double penalty system be implemented, but restrictions should also be imposed on these companies that have been found to have financial fraud in the securities market through laws or administrative regulations, rather than just issuing warning letters or orders to correct.

4.3.3 Accelerate the Application of Big Data in the Daily Business of Listed Companies

With the advancement of the accounting computerization process, more and more companies choose to use financial software to replace manual accounting. The top ten IT information technologies that affected Chinese accounting practitioners in 2020 include financial cloud, electronic invoices, accounting big data technology, electronic archives, RPA, new generation ERP, etc. The application of big data has also reduced the work pressure of accounting personnel and made traditional financial fraud behavior face the impact of big data. In the daily management of enterprises, the use of financial software can make the company's transactions controllable, thereby reducing financial fraud behavior. With the development of big data, the popularization of specific valuation methods can make each inventory have a basis for inquiry. Nowadays, most of the goods' transportation depends on logistics, and combining with logistics information can eliminate some fictitious businesses from the source and reduce financial fraud.

5. Discussion

The prevalence of financial fraud within listed companies poses a significant threat to the integrity of China's securities market and undermines investor confidence. The paper has thoroughly examined the various methods of financial fraud, highlighting the need for a robust approach to identify and combat these unethical practices. To address this issue, it is essential to enhance the ethical and legal awareness among accounting personnel, ensure the independence of external auditors, and continuously update and enforce regulations to increase the penalties for financial misconduct. The integration of big data into the daily operations of listed companies can also serve as a powerful tool to prevent financial fraud by improving transaction traceability and oversight. Ultimately, the paper calls for a concerted effort at both the corporate and national levels to foster a market environment that is transparent, regulated, and resistant to the corrupting influence of financial fraud.

6. Conclusion

Although financial fraud is common in listed companies, the behavior of financial fraud seriously damages China's securities market and frustrates the confidence of investors. The methods of financial fraud are various, and exploring the methods of financial fraud by listed companies helps to rectify the current economic market atmosphere and make the operation of the economic market tend to be standardized. This paper believes that in order to rectify financial fraud behavior, it is necessary to strengthen the construction of the ideological and moral character of accounting personnel, the cultivation of legal awareness; to maintain the independence of external audits and inspectors; to update laws and regulations in a timely manner, and to increase the punishment for financial fraud; to accelerate the application of big data in the daily business of listed companies. At the same time, at the national macro level, correct guidance should be carried out to minimize the disturbance of financial fraud behavior to China’s social and economic order.

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