

Research on Financial Fraud from the Perspective of Internal Control of Changyuan Group

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Abstract: The rapid development of the capital market has boosted the growth of the national economy, however financial fraud is widespread. These financial fraud instances not only caused enormous economic losses for investors but also raised public concerns about the legitimacy of the capital market. This paper utilizes the financial fraud of Changyuan Group as a case study, employs literature research and case analysis methods, analyzes the reasons for the distortion of corporate accounting information from five elements of internal control, and provides corresponding perfect solutions.

Keywords: Financial Fraud; Changyuan Group; Internal Control

1. Introduction

Domestic and overseas financial fraud cases, such as Anne Stock, Kangmei Pharmaceutical, and Luckin Coffee, have been frequently banned in recent years, causing substantial damage not only to the company's image but also affecting the company's normal functioning.

The China Securities Regulatory Commission confirmed in June 2020, after more than two years of investigation and evidence collection, that Changyuan Group used various financial fraud methods to inflate revenue and profits, resulting in a total of 360 million yuan inflated operating income in 2016 and 2017. Given the amount, means, and consequences, it makes sense to select Changyuan Group to analyze financial fraud and internal control. Using the internal control mechanism as a standard operating mechanism for corporate governance can increase the trustworthiness of financial statements, decrease the possibility of violating laws and regulations, and enhance corporate management efficiency.

2. Case description

Changyuan Group signed a performance commitment guarantee with them in 2016, spending 1.88 billion yuan to purchase 80% equity of Changyuan and Eagle. As a result, in 2016 and 2017, Changyuan Group is expected to generate net profits of 150 million and 200 million yuan respectively. According to the audit by Dahua Certified Public Accountants, Changyuan and Eagle's net profits in 2016 and 2017 were 156 million yuan and 175 million yuan respectively. Although the operating performance had been delivered in 2016, the cumulative performance promise for 2017 and the two years had not. However, in the first half of 2018, the net profit of Changyuan and Eagle was less than 17 million yuan, a decrease of 79% compared with the net profit of 81.72 million yuan in the same period in 2017. At the same time, the company faced a capital gap of up to 1 billion yuan. The operating performance of Changyuan and Eagle decreased by more than 50% year-on-year, which rapidly caught the Shanghai Stock Exchange's notice.

Following an investigation and evidence collection, to fulfill their performance commitment at the time of the acquisition, Changyuan and Eagle used various financial fraud methods to inflate their income and net profit, including early recognition of income, repeated recognition of income, fictitious overseas sales business, signing off "yin and yang contracts," and project accounting that did not comply with accounting standards. Changyuan and Eagle exaggerated their operating income by 149 million yuan and 209

million yuan and their net profits by 123 million yuan and 179 million yuan in 2016 and 2017 respectively, according to the China Securities Regulatory Commission's conclusions of the punishment.

3. Analyzing Changyuan Group's financial fraud from the perspective of the five aspects of internal control

3.1 Defective control environment

Changyuan Group's equity is scattered, even after the agency recognizes it, it believes that the group has no actual controller. The company's management is currently in chaos as a result of the low execution efficiency and competition for group control among all parties. A high executive turnover rate is another issue that Changyuan Group is dealing with as a result of the ongoing stock price decrease and regular losses. The constant departure of directors and senior executives from publicly traded companies is likely a sign that there is significant uncertainty regarding the company's financial condition and operating level, which also sends a bad signal to the outside world and negatively affects the stock price of the company. Undoubtedly, there is a vicious cycle at work when leaders fail to monitor the group's operations with appropriate diligence, internal controls fail, and the situation continues to become worse.

3.2 Weak risk assessment link

Before 2018, Changyuan Group took on a significant amount of debt to finance acquisitions, disregarding the group's viability and actual operational circumstances, and failing to take into account the significant demand for capital from R&D and manufacturing firms. In 2018, an important subsidiary of Changyuan Group was exposed to financial fraud, which inflated the group's income and profits, and the company's reputation plummeted. It will have severe negative chain effects, and the company has a bad credit rating, making it challenging to get bank financing. These factors indicate Changyuan Group's operational issues.

3.3 Insufficient control activities

It is more challenging for the group organization to execute performance evaluation, authority acceptance, information statistics management, and personnel overall arrangement for the subsidiaries as the number of subsidiaries rises. Even in the Changyuan and Eagle fraud case, the company's financial personnel directly participated in the process of financial fraud, not to mention the timely recording and reporting of false information and violations, which also reflects that the group has not properly designed the company's operating process and set up key control points. In the group's inventory management process, there were problems such as random and irregular inventory taking and inventory counting, which also resulted in inconsistencies between actual accounts and inaccurate cost accounting. The accounting firm issued an audit report with a negative opinion after it audited Changyuan Group's internal controls in 2016 and 2017. Serious financial fraud in the corporation was brought on by flaws in its internal control processes.

3.4 Insufficient communication and information

Because of its numerous subsidiaries' complex interrelationships, complicated internal control, and low operational efficiency, Changyuan Group is unable to properly utilize its information system to boost productivity and strengthen its subsidiaries' coordination, management, and control. In addition to the group's quick development, the information system updates too slowly, which makes it difficult to trust important control linkages and prevents the information system from having emergency plans.

3.5 The supervisory role is inadequate

Inadequate monitoring of the financial condition and operational management of Changyuan Group's subsidiaries led to significant financial fraud right after the acquisition of Changyuan and Eagle, which was then followed by significant issues with cost accounting and inventory management. The management of the group quickly accepted the explanation of the company's executives' shirk of responsibility; many affiliated transactions of other subsidiaries did not uphold the obligation of information disclosure, and the group did not become aware of it until it was reported by a competitor and it then started to investigate.

4. Internal control measures to prevent financial fraud of Changyuan Group

4.1 Enhance the internal control environment

The Changyuan Group should establish a set of reasonable organizations, specify the rights and responsibilities of all parties involved, and make clear the particular practices and business principles governing the company's affairs. It should also create a situation where the board of directors and management are independent of one another and serve as a check and balance on one another, as well as control executive and board fraud. As a high-tech corporation, Changyuan Group should begin by considering its nature, commercial characteristics, organizational structure, strategic goals, and other factors before developing a set of corporate values that suit it. It should then use these values to control employee behavior so that the company can function as a whole. Improve the working environment of the company by fostering a more harmonious interaction among the employees.

4.2 Implement comprehensive risk management

To gather comprehensive data on domestic and international macroeconomic policies, market demand, technical development trends, industry competition, and resource reserves, the company must first set up a competent information gathering and analysis system. The Changyuan Group should also pay close attention to the company's financial risks, analyze the company's data from a financial perspective, correct earlier development patterns, and forecast the company's future development course. After organizing the information on enterprise risks, decide which risks may exist, which departments they relate to, and which business processes they affect. Then, determine their possibility of happening and their potential severity. Finally, make decisions based on your personal risk preferences and tolerance.

4.3 Continue to enhance control activities

Before everything else, it's important to define roles and adhere carefully to the system of separating duties that conflict. By separating incompatible positions and strengthening the qualification review, work supervision, and restriction of various departments and personnel, fraud within the company can be prevented, thereby preventing financial information fraud. Second, adhere to accounting standards, carry out accounting in compliance with laws and regulations, and pick pertinent accounting policies as acceptable. To avoid repeating the mistakes made by Changyuan and Eagle and confirming revenue in advance, which would result in significant losses for the company, strictly manage the time, documents, vouchers, as well as the amount, quantity, and measurement method of revenue recognition.

4.4 Build an effective internal control information communication mechanism

First, standardize the communication methods, procedures, and methods between enterprise departments, and establish more efficient communication channels to adapt to the overall development of the enterprise. Then, it's essential to create a full information system, utilize the benefits of contemporary high-tech and Internet technology, create an internal information system that is scientific and standardized, offer businesses a unified information platform, and carry out centralized management of various dispersed information. To prevent other departments from failing to function regularly when the system fails, the management of the information system platform should also have a specific department to create backup plans for various crises.

4.5 Emphasize the internal audit's supervisory role

Internal audit's fairness, reliability, and effectiveness can be used to evaluate the effectiveness and consistency of internal control and identify any flaws. To reduce the possibility that the company would break laws and regulations, Changyuan is developing a system that can recognize and evaluate the current policies and procedures. Other reports are unable to provide the information that internal audit can, and the links and procedures of internal audit are crucial components of internal control.

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