

A Case Study on Financial Fraud of Wisdom Haipai Company in Aerospace Communication Subsidiary

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Abstract: In recent years, performance commitment has increasingly become the "standard" of mergers and acquisitions of listed companies, which is used to alleviate the risk of information asymmetry and safeguard the interests of the acquirer. However, performance commitment has also aggravated the risk of financial fraud, and the acquired party often does not hesitate to sue for financial fraud in order to fulfill its performance commitment and avoid punitive damages for breach of contract. In order to provide suggestions for investors and regulators, this paper takes the aerospace communication Wisdom Haipai Company as an example, analyzes the means of financial fraud from the motivation of listed companies, and discusses how to prevent and supervise financial fraud.

Keywords: Performance commitment, Financial fraud, Fraud identification and fraud prevention.

1. Introduction

Due to the rapid economic development in China, M&A activities of listed companies are becoming more and more active. It has become a common practice to attach performance commitment in high premium mergers and acquisitions, and performance commitment has gradually become a necessary configuration for mergers and acquisitions of listed companies. However, in the process of M&A, due to the problems of asymmetric information and unclear future earnings of the underlying assets, it is easy to generate acquisition risks. In order to reduce acquisition risks, protect investors' rights and interests and protect the overall interests of the company in the process of M&A, signing performance commitment compensation agreements has become an effective preventive measure. Faced with high performance indicators due to performance commitments, many companies must not only bear great performance pressure but also bear the consequences caused by unfinished performance. In order to avoid the loss caused by the failure to achieve performance commitments, companies often use various means to achieve performance goals, which has caused a lot of financial fraud, adversely affected the interests of minority shareholders and seriously affected the healthy development of the capital market.

2. The Case Introduction

(1) Company profile

Aerospace Communication Holding Group Co., Ltd. is located in Hangzhou, Zhejiang Province. Its predecessor was Zhejiang Textile Industry Company, the administrative company in charge of the textile industry in the province. [3] The company's business is to develop manufacturing, textile and international trade. Later, the main business changed, focusing on information and communication services. [4] Wisdom Haipai Company is a subsidiary of Hangtong Communication. At the end of 2015, the company was acquired by Aerospace Communications in the form of mergers and acquisitions. In December 2016, the company's "China Science and Technology Electronic Equipment ODM Center" was completed, and gradually developed into a large-

scale industrial group with intelligent terminals, intelligent security and artificial intelligence as its main businesses. The group has the ability of design, research and development, production, operation and service.

(2) Brief introduction of fraud incidents

On October 14, 2019, the Shanghai Stock Exchange issued an inquiry letter to Aerospace Communication, asking it to reply in writing before October 21 and disclose the related matters of its subsidiary, Wisdom Haipai Company. Aerospace Communication failed to respond within the specified time, and repeatedly issued an announcement to postpone the reply to the Shanghai Stock Exchange's inquiry letter on matters related to the guarantee performance of Wisdom Haipai Company. Finally, on January 21, 2020, it admitted that Wisdom Haipai Company was fraudulent for the first time in its reply to the previous work letter of the Shanghai Stock Exchange. Once the announcement was made, the shares of Aerospace Communications were the first to bear the brunt. In the next three trading days, the stock prices all fell, resulting in a direct loss of about 2 billion yuan. As a state-owned listed company, aerospace communication has been reported by many media after being labeled as financial fraud.

Aerospace Communication Holding Group Co., Ltd. was listed on Shanghai Stock Exchange on September 28th, 1993. With the development of the company, the shareholding has changed many times. By 2019, the largest shareholder of Aerospace Communications is China Aerospace Science and Industry Group Co., Ltd., with a shareholding ratio of 19.2%. The actual controller and the ultimate controller are the State-owned Assets Supervision and Administration Commission of the State Council.

In 2015, Aerospace Communications issued shares at a consideration of 1.065 billion yuan to acquire a 51% stake in Smart Haipai. Intelligent Haipai Technology Co., Ltd. is an international leader in intelligent terminal design and production, intelligent system solution provider and intelligent operation service provider. In October 2019, the Shanghai Stock Exchange suspected that Wisdom Haipai Company had huge overdue debts, financial breakdowns, overdue bank debts, illegal guarantees and even financial forgery. According to the announcement of Aerospace

Communication, by October 15, 2019, the company spent 450 million yuan to provide loan guarantee for its subsidiary, Wisdom Haipai. If Wisdom Haipai fails to repay the loan within the specified time, the repayment responsibility will be fulfilled by Aerospace Communication. In addition, Aerospace Communication also lent Wisdom Haipai an internal loan of 813 million yuan, and there is a trade receivable of 209 million yuan that cannot be recovered. As the existence of financial fraud was confirmed, Aerospace Communications re-invited the accounting firm to audit the business activities of Smart Haipai in 2016-2018 and restate the financial statements. After the restatement, the actual achievements in 2016-2018 were-447 million yuan,-733 million yuan and-2.177 billion yuan respectively, and the performance commitments failed to be fulfilled.^[5] After inspection by Aerospace Communications and Lixin Certified Public Accountants (special general partnership), Wisdom Haipai Company chose to take a "shortcut" to fulfill its performance commitment: engage in financial fraud, adopt false business, false profit increase and other indicators to meet the requirements of the "gambling" agreement. Aerospace Communications restated the consolidated financial statements. After the restatement, in view of the audit finding that the net profit of Aerospace Communications was negative for two consecutive fiscal years, the Shanghai Stock Exchange implemented a special treatment of delisting risk warning (*ST) for the company's shares, and the abbreviation was changed from "Aerospace Communications" to "*ST Hangtong". [1]

3. The Analysis of Financial Fraud Motives of Wisdom Haipai Company

(1) The manager's decision-making failure

The decision-making level of managers affects the development of enterprises. Managers who lack the correct direction of moral values tend to lead the company astray. The decision-makers of Wisdom Haipai Company have made a decision to meet the performance commitment requirements by means of financial fraud. Due to the decline in the performance of major customer Coolpad, Wisdom Haipai Company has been affected by the loss of a large number of orders and may not be able to fulfill its performance commitments. In this inferior situation, managers chose financial fraud to whitewash the company's financial statements. The company's business failure and performance commitment prompted managers to choose financial fraud.

(2) Inadequate internal and external supervision

In 2016, Duty International expressed reservations about the audit report of Wisdom Haipai Company. As its parent company, Aerospace Communications did not pay attention to it and tracked it down, and hastily changed its firm, which was a lack of supervision within the company. There is no abnormality in the audit report after changing the firm, which means that the subsequent firm has not found its fraud, which belongs to the lack of external supervision. Insufficient internal and external supervision has led to the financial fraud of Wisdom Haipai Company for many years.

(3) The penalty cost of fraud is low

From 2003 to 2005, the inflated profits of aerospace communication reached 31.1 million yuan. In 2012, the fixed assets management of Zhangjiagang Xinle Wool Textile Co., Ltd., a subsidiary of aerospace communication, was seriously flawed, and all of them ended up being ordered to rectify.

Kangdexin's financial fraud was 11.9 billion yuan, and the company was fined 600,000 yuan. Observing the punishment of financial fraud of listed companies before, it is found that the cost of making mistakes in financial fraud is negligible, which also encourages the financial fraud of Wisdom Haipai Company in disguise.^[2]

Through fictional business, Wisdom Haipai Company accumulated false income of 6.902 billion yuan and false profit of 2.574 billion yuan from 2016 to 2018. From 2016 to 2018, the income and profit were inflated by 404 million yuan through inflated income and profit. The company was only fined 600,000 yuan.

The low cost of fraud punishment encourages the occurrence of financial fraud in disguise.

4. The Specific Analysis of Financial Fraud of Wisdom Haipai Company

On January 21, 2020, the company issued an accounting error correction announcement, saying that Wisdom Haipai Company had performance fraud, falsely increasing income, cost and profit through specific business processes, and falsely increasing R&D income through fictitious R&D contracts, which led to untrue and inaccurate disclosure of financial information in the early stage.

Cheating means of Wisdom Haipai Company;

First, the Wisdom Haipai Company fictionalized the procurement and sales business, which inflated the income and profits. Smart Shanghai fictional purchasing and sales business, from 2016 to 2018, fictional income was 6.574 billion yuan, forming a false profit of 2.246 billion yuan. Among them, the fictitious sales income in 2016 was 2,120,843,500 yuan, and the fictitious profit was 713,148,000 yuan; In 2017, the fictitious sales revenue was 2,043,605,000 yuan and the fictitious profit was 741,134,600 yuan; In 2018, the fictitious sales revenue was 2,409,981,600 yuan and the fictitious profit was 791,780,300 yuan.

The second is the fictional R&D business of Wisdom Haipai Company, which inflated income and profits. From 2016 to 2018, Smart Haipai and its subsidiaries inflated their R&D income and profits by 328 million yuan, including: inflated R&D income of 9.1686 million yuan in 2016 and inflated profits of 9.1686 million yuan; In 2017, the R&D income was inflated by 145,566,800 yuan, and the profit was inflated by 145,566,800 yuan; In 2018, the R&D income was inflated by 173.273 million yuan, and the profit was inflated by 173.273 million yuan.

Third, Wisdom Haipai Company inflated the income and profit of overseas entrusted processing and sales business. From 2017 to 2018, Smart Haipai and Shenzhen Haipai Communication Technology Co., Ltd. inflated their sales revenue through HEROALLYGROUPLIMITED transfer pricing. From 2017 to 2018, the inflated income and profit were 403,658,400 yuan. Among them, the inflated sales income in 2017 was 180,887,500 yuan, and the inflated profit was 180,887,500 yuan; In 2018, the inflated sales revenue was 222,770,900 yuan and the inflated profit was 222,770,900 yuan.

5. The Influence of Financial Fraud in Wisdom Haipai Company

(1) the impact on investors

Based on the theory of information asymmetry, the most authentic internal information of an enterprise cannot be

accurately grasped by small and medium-sized external investors. Investors can only know its financial situation and operating performance in recent years through the annual reports and related announcements of listed companies every year, so as to make investment decisions. Enterprises that commit financial fraud usually make false disclosure of their financial statements to a certain extent, and attract external investors to invest in order to achieve financing and other purposes by whitewashing the statements. Once the fraud is exposed, it will inevitably have a strong financial impact on small and medium-sized investors, which will greatly damage their investment rights and interests, reduce their investment confidence and enthusiasm, and also lead to the overall sluggishness of China's investment market.

Affected by information asymmetry, investors and users of external financial information are far less familiar with the financial situation of listed companies than managers of listed companies. If the disadvantaged groups cannot obtain real and accurate information in time and effectively, their interests will be difficult to guarantee.

(2) the impact on the listed company itself

After the fraud incident, space communication received a large number of inquiry letters. As can be seen from these inquiry letters, most of them are about the internal control of aerospace communication companies. There are many problems that need to be further understood. The internal management of space communication is not ideal, the internal control consciousness is weak, the system is not perfect enough, the implementation is not strong enough and the effect is not good, there is a lack of supervision and accountability, and the internal control system is a mere formality. Many investors also have doubts about the implementation effect of enterprise internal governance and internal control, thinking that there are problems in enterprise internal management and internal control has long since failed. This will not only bring heavy losses to the corporate image, but also make investors give up their investment decisions. And this major fraud led to the company directly facing the danger of withdrawing from the market.

Table 1. Comparison before and after financial restatement of Wisdom Haipai Company in 2016-2018 (unit: RMB)

	Agreement number	completion number	completion rate	actual completion number	actual completion rate
2016	25000	29134	116%	-44694	-278%
2017	30000	31121	103%	-73292	-344%
2018	32000	35074	109%	-217655	-780%

Source: Juchao Information Network

Before the restatement, Wisdom Haipai Company fulfilled its performance promise "accurately" and "perfectly". After the restatement, the most intuitive consequence of the bubble

bursting was that the operating income of the parent company's aerospace communication plummeted.

Table 2. Changes in Operating Income of Aerospace Communications before Restatement

	2016	2017	2018
Wisdom Haipai Company Income	70.65	65.3	84.78
Main operating income of aerospace communication	105.44	101.96	125.06
The income of Wisdom Haipai Company accounts	67.00%	64.04%	67.79%

Source: Company's annual report

Most of the funds for aerospace communication come from Wisdom Haipai Company. As can be seen from the above figure, its main revenue comes from Wisdom Haipai Company, accounting for more than 50% of its revenue in

2016-2018. When Aerospace Communication disclosed the financial fraud of its subsidiaries, the accounting firm retraced its operating income.

Table 3. ST Hangtong Accounting Error Adjustment Data (Unit: 10,000 yuan)

Time	2016		2017		2018	
	Before adjustment	After adjustment	Before adjustment	After adjustment	Before adjustment	After adjustment
The net profit	24,577	-124,963	24,903	-79,768	37,938	-249,943
Net assets	432,784	288,202	447,008	205,497	482,210	-47,182
Revenue	1,054,398	841,397	1,019,558	782,552	1,250,558	969,563

Source: Company's annual report 1

The company's operating income has fallen sharply, which has seriously affected its subsequent operating conditions and directly led to the risk of delisting of the parent company's aerospace communication.

6. Prevention and Supervision of Financial Fraud Based on The Pressure of Performance Commitment

(1) from the company's own point of view

Improve the internal control system: It is necessary to form a corporate culture that pays attention to internal control within the group. Strengthen the construction of corporate governance structure and internal control system, build effective incentive mechanism and restraint mechanism, and a sound internal control system can be used as the engine of enterprise development to promote the continuous and healthy development of enterprises. The parent company should form the ideology of striving for stability within the group, pay attention to internal control construction and seek economic benefits at the same time, strengthen the guidance of corporate culture in the process of internal control construction, and strengthen the cultivation of internal control awareness of senior executives, especially those of subsidiaries, so that they can have a correct understanding of internal control system. Only by establishing and perfecting internal control and relevant rules and regulations can we better regulate the business behavior of enterprises and guarantee the implementation of M&A performance commitments. At the same time, it is necessary to improve the ownership structure so that the functions of the board of directors and the board of supervisors can be effectively brought into play. Strengthen the independence of the board of directors and the board of supervisors, increase the proportion of external directors and supervisors, and introduce senior managers with strong professional quality, so that the board of directors and the board of supervisors can play an important role in the company's operation. Finally, it is necessary to strengthen the sense of responsibility of enterprise management and reduce the occurrence of related transactions. We should strengthen the cultivation of managers' own quality, actively learn relevant professional knowledge, establish good professional ethics, and establish good professional ethics in our work.

Carefully sign performance commitments: In M&A, performance commitment can protect the acquirer and restrict and encourage the acquired party, so it is very important to conduct a comprehensive investigation before signing performance commitment. Enterprises should not only have a comprehensive understanding of their own situation, but also have a reasonable valuation of the merged company. If the valuation is too low, the merger cannot be completed. If the valuation is too high, it will cost too much, which is not conducive to the future development of the enterprise. Then, an agreement will be signed based on the valuation. In addition, we should have a full understanding of the whole external environment, such as the industry environment and national policies, make a reasonable prediction of the future development of the market and policy changes, and combine it with the enterprise itself to prepare for potential risks and rationally adjust its own decisions. At the same time, the acquired party should set reasonable performance targets. When making performance commitments, it should focus on analyzing the internal strengths and weaknesses, external opportunities and threats, reasonably expect the future performance of the company, and avoid setting performance commitments that are difficult to achieve because of excessive pursuit of short-term interests.

(2) From the perspective of regulatory authorities

Strengthen law enforcement to increase the cost of financial fraud of listed companies: External regulatory agencies should strengthen law enforcement and increase the cost of illegal activities. It is also necessary to further improve the relevant legal systems, such as the Accounting Law and

the Regulations on Certified Public Accountants. Inadequate external supervision is an important factor that leads listed companies in China to take risks to make financial fraud and accounting firms to go along with it. The CSRC should pay more attention to this. Auditors who violate auditing laws and regulations should be punished by revoking their professional qualifications or limiting the time when they are prohibited from serving in related industries to increase the cost of illegal activities. While strengthening the supervision of local governments, we must resolutely stop formalism. At the same time, spot checks of accounting firms are carried out on a regular basis, and relevant punishment decisions are made in time when violations of laws and regulations are found.

Improve the supervision system related to performance commitment: In the daily supervision, the supervision department should carry out multi-node monitoring on the performance commitment and compensation. On the one hand, for the financial fraud under the performance commitment, the regulatory authorities should strengthen the relevant prior supervision, conduct a strict audit of the performance commitment, and curb the high performance commitment from the source. On the other hand, it is necessary for relevant departments to refine the content and form of performance commitment disclosure to reduce the difficulty of obtaining relevant information. At the same time, an accounting firm should be hired to issue a special verification report on the implementation of performance commitments, revealing the implementation of performance commitments and the difference between them and the number of commitments, and explaining the reasons, so that investors can get enough information to make reasonable investment decisions.

Strengthen the regulatory role and independence of accounting firms: It is necessary to further tighten the establishment of certified public accounting firms and professional practice norms. Improve the professional standards of accounting firms and ensure the professionalism of auditors. In addition, CICPA and the financial department should further improve the professional quality of CPA practitioners, strengthen professional training and professional ethics evaluation in the industry, and effectively curb illegal acts caused by "greed" motivation. At the same time, it is necessary to strengthen the supervision of accounting firms, so that they strictly abide by the relevant state laws and regulations and audit work norms, so that the audit industry has a formal and legal development environment.

External regulatory agencies should establish and improve relevant systems and supervision mechanisms to avoid loopholes in laws and regulations that bring "opportunities" for the audited institutions to practice favoritism and malpractice. In particular, the number of years stipulated in the audit rotation system should be clearly defined and cannot be vague. At the same time, we should standardize the behavior of enterprises that have large business dealings with audited units: First, strictly abide by relevant laws and regulations and fully implement relevant regulations of listed companies. Second, increase the supervision of important business partners, so that important partners can carry out corresponding business as required, strengthen the audit coordination responsibility of those who have more business dealings with the audited units, and strengthen the restriction on them, so as to guide the audit market to establish an orderly order, which is also conducive to the promotion of audit work.

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