

Analysis and thinking of Hongda New Material Financial Fraud Case

-- Based on the Perspective of Business Ethics and Accountant Professional Ethics

Xiaocheng Deng

Business School, Hunan University of Science and Technology, 411201, China

Abstract: With the continuous development of the economy, emerging companies in various industries are also competing for flowers, so information stakeholders in all aspects will pay more attention to the appreciability of profits when using financial statements, and accountants will be more likely to whitewash the statements. However, the occurrence of financial fraud will not only cause huge losses to enterprises, but also expose some shortcomings in various aspects of business ethics and professional ethics. Therefore, this paper analyzes the financial fraud incidents of Hongda New Materials, which then leads to various business ethics and professional ethics thinking problems such as the lack of ethics of financial personnel, the ineffective internal control system of enterprises, and the incomplete construction of industry rule of law, and gives suggestions for feasible measures.

Keywords: Hongda New Material, Financial fraud, Business ethics, Professional ethics.

1. Introduction

Recently, Hongda New Materials has been involved in 4 cases due to private lending disputes and sales contract disputes. The prosecutions included Beijing Changfeng Microelectric Technology Co., Ltd., Shanghai Wujiaochang Branch of Agricultural Bank of China, and Bank of China Shanghai Qingpu Branch, and several bank accounts of the company were frozen. On January 6, Hongda New Materials ushered in a turning point, and the company announced that many bank accounts that had been frozen before had been unfrozen. Then on January 9, the first stock of the New Year's letter fell to Hongda New Materials. This is less than half a year since Hongda New Material New Controller took the helm. Until January 9, Hongda New Materials issued an announcement that it had received the "Notice of Case Registration" from the China Securities Regulatory Commission, and the CSRC decided to file a case for investigation due to suspected violations of laws and regulations. Hongda New Materials said that during the investigation period, it will actively cooperate with the work of the CSRC and strictly fulfill its information disclosure obligations in accordance with regulations. On April 4, 2023, the China Securities Regulatory Commission issued a penalty announcement against Hongda New Materials.

The following is the relevant research on business ethics and financial fraud used in this article:

Ye Chenyi said that the breach of trust and responsibility of accounting practitioners will not only restrict the healthy development of the industry, but also easily cause a negative impact on social order and public values, and should attract the attention and prudent management of the regulatory authorities. [1] Jin Ruiqi and Liu Jing said that enterprises should attach importance to the development of business ethics, and promote the construction of business ethics through various aspects such as employees, internal training and learning, and system assessment and supervision. [2] Mu Dongmin said that the lack of accounting integrity is not only a unilateral problem of accounting actors, but should be analyzed from the perspective of relevant stakeholders of

accounting information, and its root causes should be explored from a social perspective. [3]

2. The basic introduction of the "Hongda New Material Incident"

(1) Hongda New Materials Company Profile

Shanghai Hongda New Materials Co., Ltd. (hereinafter referred to as "Hongda New Materials") was established in 1992 and is one of the earliest enterprises involved in high-temperature silicone rubber in China. In 2008, the company was successfully listed on the small and medium-sized board of the Shenzhen Stock Exchange. In 2019, with the help of the high-quality resources and new technologies of the new controlling shareholder, the company began to explore the strategic transformation of its main business. In February 2019, the company laid out information security and quantum communication technology and established Shanghai Hongyi Information Technology Co., Ltd.; In September of the same year, the company acquired Shanghai Guanfeng Information Technology Co., Ltd., opening up the upstream and downstream industrial chain in the field of private network communication and information security.

As the pioneer of the strategic transformation of the company's main business, Hongyi and Guanfeng have laid a solid foundation for the company in the field of private network communication and information security. The company seizes the opportunity period of rapid development of the private network communication and information security industry, continuously strengthens the company's research and development strength, based on independent innovation, focuses on advanced technology, actively explores the deep combination of cryptography technology and application with a new generation of private network communication, mobile Internet of Things, industrial Internet of Things and other fields, continues to consolidate and enhance the company's market share and brand image in the industry, and actively builds a new industrial development strategy, hoping to create value for customers, create income for shareholders, and create the future for employees.

(2) Analysis of financial fraud incidents of Hongda New Materials

1. Inflated income and profits

By becoming the actual controller of HTC, Sui Tianli introduced the self-circulating private network communication business into HTC. The business is led by Sui Tianli, through product disassembly, assembly, if necessary, patch to supplement losses, and finally enter a new cycle, the product is not actually finally sold, there is no terminal use.

Shanghai Xingditong Communication Technology Co., Ltd. and Jiangsu Xingditong Communication Technology Co., Ltd. are the core companies of self-circulating private network communication business, performing capital pool and product disassembly functions. The new generation of private network communication technology Co., Ltd., Jiangsu Maiku Communication Technology Co., Ltd. and Shenzhen Tiantong Information Technology Co., Ltd. are business channel companies, participating in self-circulating trade in the form of capital posting and contract document circulation, and charging 1.5%-2% channel fees. The above companies are all controlled by Sui Tianli and are related parties of Hongda New Materials, laying the foundation for subsequent companies to form related party transactions with various other companies.

In 2019, Hongda New Materials increased its total inflated revenue and cost by 216.831 million yuan and total inflated profit of 29.7188 million yuan through private network communication business, accounting for 38.93% of the absolute value of the total profit disclosed in Hongda New Material's current annual report; In 2020, Hongda New Materials increased its total inflated revenue by 489.0038 million yuan, cost 385.5563 million yuan, and inflated profit by 103.4475 million yuan through private network communication business, accounting for 146.09% of the total profit disclosed in Hongda New Material's current annual report (accounting for 151.08% of the total profit after correction).

2. Goodwill impairment is not accrued, resulting in inflated profits

In October 2019, when Hongda New Materials acquired Shanghai Guanfeng Information Technology Co., Ltd. (hereinafter referred to as Shanghai Guanfeng), the management's future profit forecast was only based on Shanghai Guanfeng's patch business. Starting from 2020, in order to cover up the obvious impairment of goodwill and complete the VAM performance, Yang Xin proposed and decided by Sui Tianli to carry out a large-scale assembly business in Shanghai Guanfeng. At the end of 2020, when Hongda New Materials conducted the goodwill impairment test, the future cash flow of the relevant asset group included a large number of assembled businesses introduced in addition to the patch business, and the recognized asset group was inconsistent with the asset group recognized at the initial recognition of goodwill (only including the patch business), which violated Article 18 of the "Accounting Standard for Business Enterprises No. 8 - Asset Impairment", resulting in the company not accruing goodwill impairment, inflating profits of 75.8 million yuan, accounting for 107.05% of the total disclosed profit for the current period (110.70% of the total corrected profit).

3. Reflection on Fraud: Based on the Perspective of Business Ethics and Accounting Professional Ethics

(1).The quality of financial personnel is insufficient

In 2019, Hongda New Materials inflated the total profit through private network communication business by 29.7188 million yuan, accounting for 38.93% of the absolute value of the total profit disclosed in Hongda New Material's current annual report; In 2020, Hongda New Materials increased its total inflated profit through private network communication business by 103.4475 million yuan, accounting for 146.09% of the total profit disclosed in Hongda New Material's current annual report (accounting for 151.08% of the total corrected profit).

First of all, the hand of fraud implementation must come from the "grassroots financial personnel", and it can be seen from the relevant penalties that Le Meiyu received, and the accounting personnel must bear their relevant responsibilities. Due to the asymmetry of information, there are some differences in the degree of understanding of various types of information of listed companies by investment personnel, so financial personnel can hide the data obtained through their professional knowledge and rich experience in accounting. For the fraud cases in the CSRC's penalty announcements in recent years, the responsibility of accountants is often ahead, and some accountants are blinded by high-value reports.

In terms of professional quality, taking Kangmei Pharmaceutical in a typical financial fraud incident as an example, some financial personnel did not implement necessary alternative procedures for the audit evidence with obvious discrepancies in the fraud process, and failed to maintain due professional suspicion. [4] In this incident, it is worth mentioning that the audit business of fictitious income in recent years has been hired by notary Tianye accounting firm, and the firm has not only issued a 100% unqualified opinion on internal control, but also responded to the key matters of the audit report, so the accounting firm and its related certified public accountants should also bear relevant responsibilities in the occurrence of fraud cases.

(2).The failure of internal control causes accounting personnel to lose their independence

To a large extent, the occurrence of financial fraud is due to the different purposes of financial statements between investors and business operators, business operators hope that the information disclosed in the financial statements is conducive to the expansion of the company, while investors need to see the real performance information to invest. Like Sui Tianli and Yang Xin in this case, they carried out related party transactions for their own interests, and overconfident management is often overly optimistic about the judgment of affairs, and they may underestimate the probability of deviation from the control objectives caused by the problems in the design or operation of internal control, or underestimate the negative impact on the achievement of the control objectives. [5]

And since a long time ago, Le Meiyu has become the company's accounting head, if the company's financial personnel turnover is in a constant state, in the long run, the relationship between the accountants and the management is likely to become no longer simple, mixed with certain personal emotions, and even reach a profit exchange. This accident is precisely due to the lack of independence of accountants, and the process of accounting is mixed with

various factors that affect accountants, resulting in financial fraud. This also indirectly highlights the huge problems in the company's internal control, and the major flaws in ethics and the relevant values of the company's management. In 2021, the two firms hired by Hongda New Materials issued reservations and could not express opinions on the company respectively, so until after the fraud, the shortcomings of the company's internal control system were gradually revealed.

(3). The awareness of corporate social responsibility is not strong

Hongda New Material is one of the earliest enterprises involved in high-temperature silicone rubber in China, as a pioneer in the industry, it should set a good example for the emerging enterprises behind. However, the business operators of Hongda New Material hope that the information disclosed in the financial statements is conducive to the expansion of the company, and by polishing the company's financial statements, Hongda New Materials shows that in addition to the false information in good operating conditions, coax investors, so as to achieve the purpose of raising the stock price, in order to expand the development space of the enterprise through financing. When the business is not doing well, the company may often choose to use financial fraud to make the company's financial statements look more potential, so as to attract investors. In addition, the audited unit is Hongda New Material's own internal control management system has a problem, when the executives of the listed company choose to commit financial fraud, the fraud is usually very hidden and difficult to be discovered. Therefore, as a pioneer, enterprises do not think about their responsibilities in the entire industry and the financial industry.

(4). The severity of securities penalties is not large

It is difficult to say that the occurrence of Hongda new material fraud incident is not related to the low punishment of the supervision and management department. For example, in 2014, Kangzhi Pharmaceutical in other industries was suspected of financial fraud and information disclosure violations, and the final punishment was only a warning and a fine of 350,000 yuan; From the perspective of cost-effectiveness principle, the huge benefits obtained by listed companies from financial fraud far exceed the cost of violations of laws and regulations, so the punishment for financial fraud is too light, and it will still be repeatedly prohibited. In addition, accounting fraud cases in China's securities market have occurred repeatedly, and the scale and nature of data fraud are getting bigger and bigger, which is essentially inseparable from the imperfect market supervision mechanism. However, fortunately, with the introduction of the new securities law, the problem of insufficient penalties for audit failures of accounting firms and financial fraud of listed companies will be gradually solved, and the nature and degree of punishment will also be related to the judgment before the implementation of the act, so as to provide a sufficient deterrent to potential fraudsters. [6]

4. Countermeasures and Suggestions

(1) Improve the quality of financial personnel

Most of the financial fraud incidents are due to the low moral level of management, hoping to obtain more capital investment or cash out by deceiving investors. Therefore, more attention and supervision should be paid to the comprehensive quality of the company's internal management and more financial staff.

For most accounting firms, factors such as self-interest, self-evaluation, over-promotion, close relationships and external pressure will adversely affect the ethical aspects of auditors, thereby promoting financial fraud. Therefore, financial personnel should adhere to the basic principles of professional ethics, maintain their independence in assurance, maintain integrity and integrity, and maintain objectivity and fairness when providing company information for financial statements. The real situation of the market cannot be concealed, and any financial whitewashing operation is to quench thirst. Certified public accountants should also always pay attention to improving their own professional quality, maintain their audit independence, and always pay attention to improving their business capabilities, maintain audit independence, and consciously avoid the interests of the audited unit to reduce the risk of audit failure.

It is suggested that the Institute of Certified Public Accountants must establish a mandatory professional ethics education system, for example, mandatory professional ethics training for certified public accountants every year. Through the systematic training of professional ethics for current certified public accountants in batches and stages, so that they can always maintain "walking on thin ice" in practice. [7]

(2) Strengthen the internal control system

The internal control system is the measures, methods and procedures established within the unit to make various business activities interrelated and mutually restrictive. The internal control system is also the institutional foundation of corporate governance and the core system of enterprise management.

Lawrence (2009) believes that the effectiveness of internal control operation can test the manager's operating ability, and the more effective the internal control system operates, the higher the ability of enterprise management, the more it can improve the profitability of the enterprise.

With the rapid development of the Internet, the internal management and supervision of enterprises have also undergone essential changes, if enterprises ignore the role of internal control, it is possible to breed internal corruption, so enterprises must eradicate corruption from the source and build an anti-corruption system around the construction of clean government. For example, for the control of the accounting system, enterprises need to strengthen the daily operation and standardized management of accounting personnel and related personnel, reasonably set up posts, clarify the scope of rights and responsibilities, approval procedures and scope of authority of each person in the post, so that each position can form an internal control situation of mutual supervision and constraint, and effectively avoid the occurrence of favoritism. To improve the professional quality of accounting personnel, accounting personnel should exercise their powers and bear risks within the scope of authority, strictly control the operation links, prevent the occurrence of violations, and ensure the safe operation of the system. [8]

Therefore, in the increasingly competitive external environment, in order to enhance their competitiveness, enterprises need to continuously improve internal management, improve work efficiency and improve product quality. In view of the behavior and attitude of the management and internal staff in this incident, Hongda New Materials Future and other companies should implement a strict internal control system to avoid improper operations within the company.

(3) Strengthen awareness of social responsibility

Whether companies should assume social responsibility has always been a topic of debate. From a short-term perspective, assuming social responsibility is likely to reduce the growth rate of corporate efficiency, and the growth rate of word of mouth and goodwill is also slower. Some articles show that the value creation mechanism of corporate social responsibility exists, but there is a lagging effect. From a long-term perspective, companies can create company value by fulfilling their social responsibilities and disclosing social responsibility information (Servaes and Tamayo, 2013), reducing risks (Lee and Faff, 2009), reducing the cost of equity capital (Dan et al., 2012), positively impacting the future performance of the business (Sylvia and Yanivi, 2010), and improving product market awareness (Bardos et al., 2020). Increase corporate revenue and enhance company value (Flam-mer, 2012). Similar conclusions have been drawn by domestic scholars (Jia Xingping, 2016; Huang et al., 2017; Tu Hong and Zheng Wei, 2018; Zhu Qingxiang et al., 2019)

Enterprises should build the concept of fulfilling social responsibility, and at the same time standardize and promote the performance of corporate social responsibility by strengthening the construction of the internal control system of the enterprise, while effectively curbing management opportunism, improving the value creation ability of social responsibility, and forming a virtuous circle between corporate social responsibility and corporate value creation. Enterprises carrying out social responsibility activities help them gain a good reputation and further access to resources, thereby improving the long-term competitiveness of enterprises. [9] Therefore, for enterprises, firmly fulfilling social responsibilities is the right choice for the sustainable development of enterprises. [10]

(4) Improve laws, regulations and industry supervision

When an accounting firm was inspected by the Ministry of Finance for the quality of accounting information, its audit quality in that year was significantly improved, which was reflected in a significant decrease in the degree of earnings management of its audit clients, a significant decrease in the degree of earnings management on the weighted average of clients' total assets at the accounting firm level, and a significant increase in the ratio of non-standard audit opinions. The possible reason may be that the Ministry of Finance's accounting information quality inspection and announcement has a deterrent effect, and accounting firms will strive to improve the quality of audits for reasons of reputation, thereby reducing the degree of earnings management of audit clients. [11] The conclusions are also supported by theory.

Although the Ministry of Finance has organized accounting

information quality checks for decades, there are still many imperfections. Because the domestic punishment system is relatively light, the firm will rely more on the client's ideas to complete the work, which greatly reduces the effectiveness of the inspection work. Therefore, the work on the intensity of punishment and inspection procedures should be further improved, and a corresponding compensation mechanism for fraud liability should be established as soon as possible, so as to increase the cost of fraud violations economically, so as to strengthen the risk awareness of financial personnel from the source. [12]

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