

Study of Financial Fraud in Guangzhou Longkey Based on Fraud Risk Factors

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Abstract: With the development of the economy and society, China's capital market has become more open and transparent. In recent years, listed companies have gone to great lengths to whitewash statements and convey false information in order to raise funds, improve performance and boost share prices, which has led to frequent instances of financial fraud such as Ruixing Coffee and Wanfushengke. Despite increased supervision by regulators, a series of punitive measures and regular training for executives and finance staff to improve their professional ethics, the huge benefits of financial fraud still drive practitioners to commit fraud on their own initiative. This paper analyses the causes of fraud at Guangzhou Longkey based on the more established fraud risk factor theory and proposes effective countermeasures to address the causes.

Keywords: Guangzhou Longkey; Financial fraud; Fraud governance; Fraud risk factor theory.

1. Introduction

1.1. Research Background

In recent years, financial fraud has occurred repeatedly, causing extremely serious damage to the market order and investors' interests. Financial fraud, as an important part of enterprise risk management, has also received increasing attention from scholars and the industry. However, in practice, the detection and prevention of financial fraud still faces many problems. Guangzhou Longkey, a company in the consumer goods industry, is suspected to have committed a large number of financial frauds by inflating its inventory. Therefore, this study will focus on the financial fraud of Guangzhou Longkey Company Limited to explore the risk factors behind the fraud. By analysing the financial data of Guangzhou Longkey in the past few years, the risk factors that have been overlooked will be identified, thus providing practical guidance and assistance for future financial risk management in the consumer goods industry.

1.2. Research significance

The analysis of financial fraud cases allows accounting

researchers to relate theory to practice. When the number of cases analysed reaches a certain level, common features of financial fraud can be identified, and then typical cases can be analysed. The common causes of financial fraud in listed companies can be identified, which can lead to the establishment of a better financial system, improve the governance structure of companies and create a safer and more secure capital market. At the same time, it can provide suggestions for strengthening corporate governance and preventing financial fraud. And to a certain extent, it can help investors to identify companies with fraud risks.

2. Fraud Risk Factor Theory

Boogna et al. added their own ideas to the GONE theory and came up with the risk factor theory of financial fraud. The risk factor theory divides the motivation for listed companies to engage in financial fraud into two broad areas, namely individual risk factors and general risk factors(as shown in Figure 1) [1].

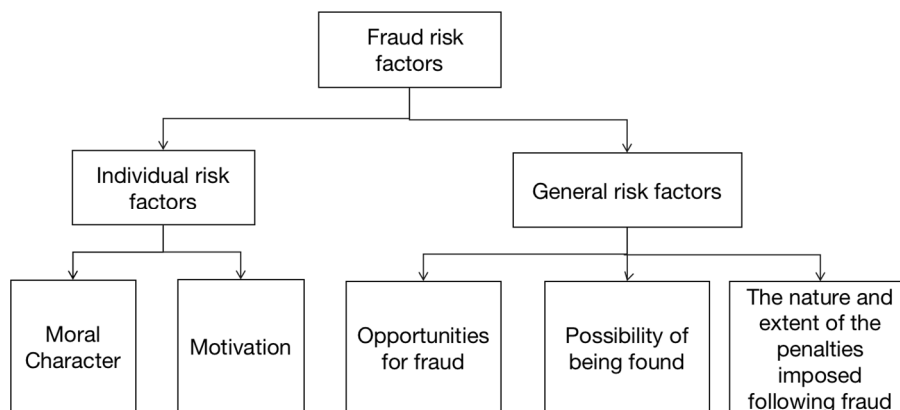


Figure 1.

The individual risk factors are subdivided into the motives for counterfeiting and moral character. Motives for falsification often include the motivation to save a shell, to issue additional shares, to go public and to pay off debts, etc. Moral character mainly includes the perpetrator's own values, outlook on life, world view and emotional state.

The general risk factor mainly includes the probability of financial fraud being discovered [2], potential opportunities for financial fraud and the penalties for financial fraud being discovered. Potential opportunities for financial fraud are mainly caused by the internal governance structure of the hand, the design and operational effectiveness of the internal control system and the existence of defects or unsoundness in the shareholding structure: giving the financial fraudster a loophole to exploit: the probability of financial fraud being discovered is also the probability of carrying out financial fraud. If the probability of financial fraud being uncovered is low, the perpetrators of financial fraud will often take a chance and risk implementing financial fraud, mainly due to the following reasons: internal audit is not in place, internal auditors lack independence, and there is a greater chance of cooperation with the managers of listed companies: external

supervision is also unsound, such as the lack of independence of accounting firms and the lack of supervision by government departments.

3. A Case Study of Fraudulent Financial Information of Listed Companies Based on Fraud Risk Factor Theory

3.1. Guangzhou Longkey Company Profile

Guangzhou Longkey is one of the oldest detergent manufacturers in South China and one of the oldest listed companies in the daily chemical industry in Guangdong Province. The company was listed on the Shenzhen Stock Exchange in 1993 and in 2005, the Guangzhou State-owned Assets Management Office transferred its state-owned shares to Guangzhou Light Industry and Trade Group Company Limited without any compensation. The actual controller is the State-owned Assets Supervision and Administration Commission of the Guangzhou Municipal People's Government (as shown in Figure 2).

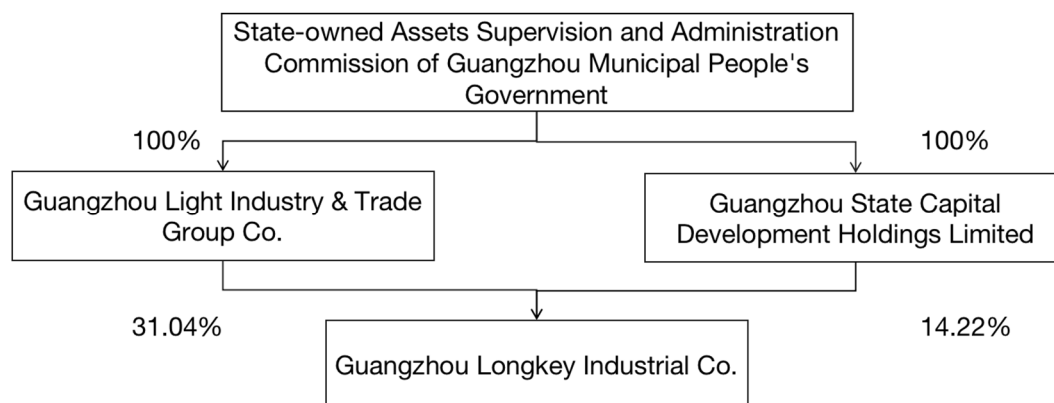


Figure 2.

3.2. Guangzhou Longkey's financial fraudulent means

3.2.1. Inflated operating revenues, operating costs and profits - fictitious economic operations

(1) Fictitious commodity trading business

In 2019, three of the top five suppliers of the Company's trading business were also customers of the Company, while three of the top five customers were also suppliers of the Company. As banks usually tend to accept commercial

acceptances issued by state-owned enterprises, Baohua and CMT attempted to obtain commercial bills of Longkey approved by banks and other funders through fictitious trade backgrounds, and then take the commercial bills of Longkey to raise funds, and later return the money to Longkey through associated From 2018 to 2019, Longkey used this method to write off false inventories and increase its operating income. In essence, it is a sham trade for financing purposes, with only funds flowing and no goods flowing.

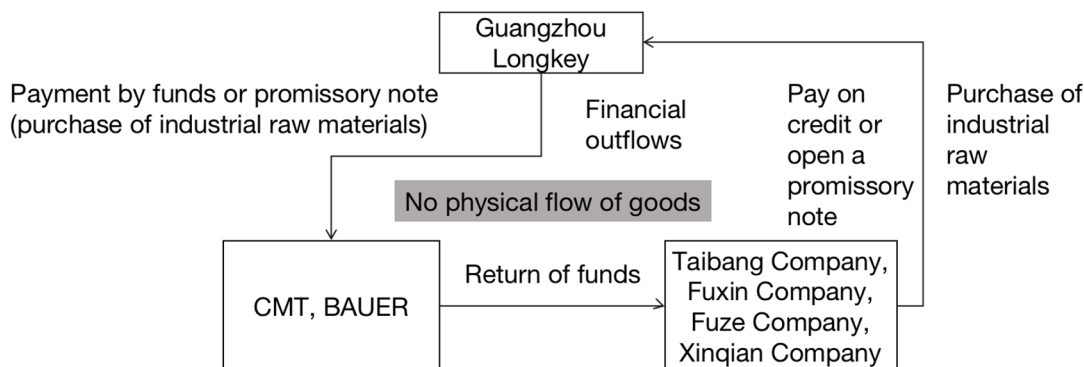


Figure 3.

(2) Revolving trading of glycol warehouse receipts

Longkey sold warehouse receipts for the chemical raw material ethylene glycol to a customer and then to other customers, and the warehouse receipts are the right of delivery, the goods themselves do not need to be handled by the company, but the accounts need to have inventory purchases and carry forward costs into the accounts. Longkey increased its operating revenue and operating costs through fictitious

results to increase profits, while the large accounts receivable formed were all impaired in 2020.

3.2.2. Inflated inventories

Longkey inflated its inventory amount by RMB956 million and RMB1,082 million in 2018 and 2019 respectively, accounting for 75.84% and 78.58% of the disclosed inventory amount for the period (as shown in Figure 4)

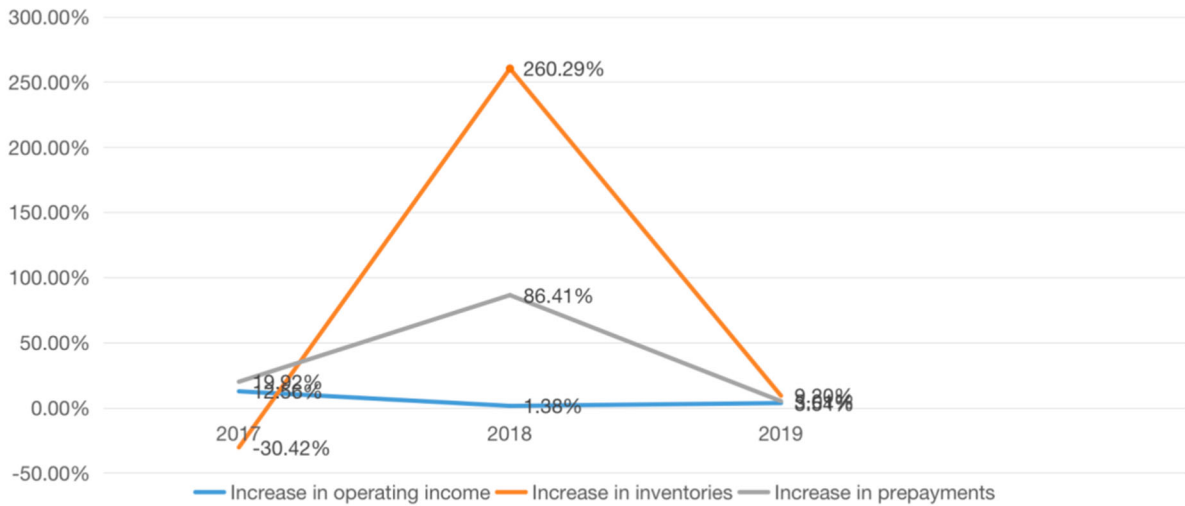


Figure 4.

3.2.3. Failure to disclose related party non-operating fund transactions and related transactions as required

During the period from 2018 to 2019, Guangzhou Longkey had connected transactions with related method person Fa Niu amounting to RMB300 million and RMB31 million, accounting for 16.59% and 1.65% of the latest audited net asset value respectively; Guangzhou Longkey transferred funds to related parties in the name of external purchases through the transition of multi-layer companies, amounting to RMB3.7 billion in aggregate. Guangzhou Longkey did not disclose the connected transactions and fund transactions of related parties in its 2018 annual report and 2019 annual report.

planned financial fraud in order to achieve its own performance and to stabilise the share price, which adversely affected the reputation of the company and brought significant losses to investors and put the company on the verge of delisting while the management of Longkey deliberately increased the amount of inventories and inflated profits in order to turn losses into profits. This fraudulent behaviour, which was not exposed and resisted by the rest of the management and the independent directors in pursuit of short-term performance at the expense of long-term development, reflected the general lack of proper professional ethics among the management of Guangzhou Longkey, a bad corporate culture that could influence the financial work of the company and affect its business performance, ultimately leading to the financial fraud of Guangzhou Longkey for five years.

4. Analysis of Financial Fraud in Guangzhou Longkey Based on Fraud Risk Factor Theory

4.1. Moral character analysis

The higher the moral quality of the managers, the more they can take risks for the development of the company. However, the management of Guangzhou Longkey, with the objective of maximising its own interests, deliberately

4.2. Analysis of the motives for falsification

4.2.1. Slow growth rate of Longkey's gross margin

The gross profit margin of Longkey has been declining year by year, and has been negative since 2015, which shows that Longkey's products are not very competitive in the market. Therefore, when the company faces the financial difficulties of declining performance, the top management of the company. The chance of fraudulent action is higher.

project	2014	2015	2016	2017
Gross margin	7.76%	3.72%	3.07%	2.82%
Gross margin growth rate	23.17%	-52.06%	-17.47%	-8.29%

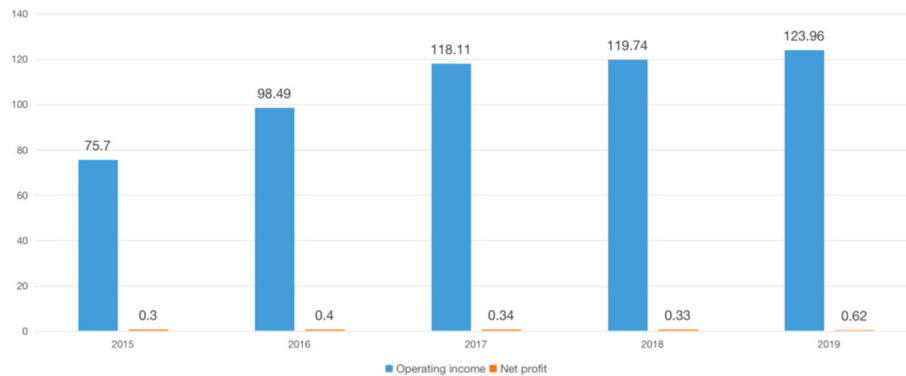


Figure 5.

4.2.2. Weak solvency and high financing pressure of Longkey

For many years, Longkey's net cash flow from operations was lower than net profit after extraordinary gains and losses, and the cash flow ratio was very low and had been negative for many years. When cash flow from operating activities cannot meet production and operation and debt servicing needs, the company needs to expand external financing. In 2018, Longkey increased its original short-term borrowings of RMB661 million to RMB1.11 billion, and the following year to RMB1.88 billion, while accounts and notes payable also increased from RMB1.51 billion to RMB2.16 billion, an increase of 43% year-on-year, which invariably increased Longkey's debt pressure, and this This was one of the major causes of the financial fraud committed by the management of Longkey. (as shown in Table 1)

Table 1.

project	2015	2016	2017	2018	2019
Net cash flow from operations	-0.42	-6.95	-1.6	-4.76	-5.57
Net profit after extraordinary gains and losses	0.25	0.29	0.13	0.22	0.12
Cash flow ratio	-1.72%	-29.69%	-5.47%	-9.29%	-8.37%

4.3. Analysis of potential forgery opportunities

4.3.1. Internal opportunities:

The corporate governance structure is not perfect. Longkey is a typical state-owned restructured enterprise with excessive management power and serious "insider control". [3] Firstly, in terms of executive directors, the then chairman, Fu Yongguo, had been working at Longkey for 38 years and had accumulated a lot of resources and contacts over his long career, giving him a considerable voice within the company, while the remaining three directors were also directors of a number of companies in addition to their management positions, making it difficult for them to perform their supervisory duties. Secondly, the independence of the Supervisory Board is inevitably questioned as the management is responsible for the salary of Longche's Supervisory Board. As a result, the unreasonable staffing of the Board of Directors resulted in a breakdown of internal controls, which ultimately led to the Board of Directors

becoming the domain of Fu Yongguo, with management overriding internal controls and fraud being perpetrated.

4.3.2. External opportunities:

Firstly, the inventory monitoring procedures were not in place. Only correspondence procedures were implemented for third party warehouse inventories. In addition, the proportion of auditors' correspondence on inventory was low. Secondly, the correspondence procedures were not effectively implemented. A low percentage of letters were received in response to accounts receivable and prepayments, which are accounts with a high risk of fraud. On 15 January 2019, Long Qi suddenly replaced Lixin CPA, with whom it had worked for 26 years, yet the replacement, Zhongqi Zhonghuan, did not include it as a key audit matter in the audit of inventories, which was clearly not in line with the audit practice experience.

4.4. Analysis of the probability of counterfeiting being detected

First, the government system is not strictly regulated. Guangzhou Longkey's financial fraud lasted for five years, but the SFC only intervened to investigate in 2020, which shows that the SFC's regulatory role is relatively lagging behind. Although the capital market has improved its regulatory system and increased penalties, incidents such as financial fraud are still occurring all the time. In summary, the regulatory system still needs to be improved. Secondly, there is a serious failure of intermediaries. According to the administrative penalty decision announced by the SFC on 12 November 2021, the audit report issued by China Auditing Zhonghuan for Guangzhou Longkey was falsely documented, the inventory monitoring procedures were not designed and implemented in accordance with the auditing standards, and the raw material audit procedures were not properly implemented.

5. Conclusions and Recommendations

The study found that poor financial stability, poor corporate structure and external audit failure were the main reasons for financial fraud in Longkey. In view of this, this paper makes the following recommendations from the perspective of enterprises and regulators: (1) improve the ethical level of managers. (2) strengthen internal control and improve operational capability. (3) improve supervision by regulators.

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