

# Accounting Fraud and Prevention In Listed Companies In China

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**ABSTRACT.** *Accounting fraud would seriously damage the interests of investors and would bring severely damage to the development of capital market. Therefore, preventions should be strengthened. This paper attempts to systematically summarize the former research, analyzes the definition of accounting fraud, and the causes of accounting fraud in listed companies in China. And try to come up with a specifically solution for accounting fraud. Expecting to regulate the financial activities of listed companies in China and prevent the occurrence of accounting fraud.*

**KEYWORDS:** *listed companies, accounting fraud, prevention of accounting fraud*

## 1. Introduction

The authenticity and effectiveness of accounting information of listed companies is an important measure to protect the operation of capital markets, and accounting fraud often tampers and distort these information. After 2000, accounting fraud cases of listed companies in China have been constantly exposed. The accounting fraud cases that have been investigated and punished reflect that the characteristics of Chinese accounting frauds are high fraud amount, long fraud time and the severe losses of the society. The frequent occurrence of accounting fraud also reduce the investors' faith to the accounting information of listed company and the stock market. Such violations seriously undermined the normal market order and were resisted by the investors. And every participant in the capital market agreed that such violations should be eliminated. However, due to the diversity and complexity of influencing factors, it is still very difficult to prevent and control accounting fraud.

This paper attempts to systematically summarize the former research, analyzes the definition of accounting fraud, and the causes of accounting fraud in listed companies in China. And try to come up with a specifically solution for accounting fraud. Expecting to regulate the financial activities of listed companies in China and prevent the occurrence of accounting fraud.

## **2. The Damage of Accounting Fraud**

### **2.1 Conception**

*International Standards on Auditing No. 240* defines accounting fraud as: "Intentional acts that result in the misrepresentation of accounting statements by one or some of the managers, employees or third parties".

In China, the *Certified Public Accountant Auditing Standards No. 1141* defines accounting fraud as: "Deliberate acts of the audited entity's management, governance, employees or third parties using fraudulent means to obtain improper or illegal interests."

What needs to be emphasized here is that: accounting fraud is mostly fraudulent corporate management, or operating fraud, or accounting fraud under pressure. Therefore, the experts suggest that "accounting fraud" should be named "corporate fraud" or "management fraud". The essence of accounting fraud is that such fraud is illegal, deliberate and harmful.

### **2.2 Damage**

#### *2.2.1 Accounting Fraud Harms the Survival and Development of Enterprises*

Accounting information is a reflection of the financial status of a company at a certain point in time or the operating results and cash flow of a certain period of time. It is the basis for the managers to judge the achievements and potential problems of enterprises, and also the basis for planning and decision making for the future. Meanwhile, accounting information also linked all sections of a company's production and operation, it could effectively guide and supervise the economic activities of the company. Therefore, accounting information is very important to the development of enterprises. In the short run, corporate management authorities may implement accounting fraud for immediate interests, but in the long run, it is difficult to ensure the company's healthy development in the future, and the guidance and supervision of accounting information in enterprise development cannot be reflected. For a long run, the lack of basic management will damage the enterprises' long term survive and development.

#### *2.2.2 Accounting Fraud Harms Interests of All Parties*

The users of accounting information include investors, creditors, employees, governments, and customers etc. The investors are most concerned about the company's operations. They want to evaluate the past and predict the future. Investors or potential investors use the general information reflected in accounting information to obtain the company's dividend payment and stock price change expectations, and to make investment decisions or whether to invest. Creditors are

very concerned about the company's reputation, solvency, and the future development. As the accounting information is an important judgement basis, creditors can assess whether the debtor can pay the loan principal and interest on time, or can pay arrears of goods as scheduled. Enterprise employees can make judgments and plans on their own rights, personal development and career prospects based on accounting information.

Government departments need relevant information to formulate macro-control policies or supervise enterprises. For example, based on accounting information, the taxation department formulates taxation policies, conducts tax collection and management; the social security department checks the social security funds paid by the enterprises, and the government may also need relevant information to supervise the company's operation. Customers are the most important external interest groups of a company. They may need to understand the company's reputation, product quality, quality, cost performance, quality assurance and other relevant information; the public may concern about the company's social responsibility, public welfare and so on. Therefore, false accounting information will seriously affect all aspects of the social economy, which would seriously damage the interests of all parties.

#### *2.2.3 Accounting Fraud Affects the Development of Capital Markets*

The capital market is an essential part of the market economy and plays a very important role in the development of the Chinese national economy. It is the link between listed companies and investors, and plays a role in market financing, optimizing resource allocation, and price discovery. The listed company falsifies the accounting data to implement accounting fraud by forging accounting documents, applying inappropriate accounting methods or maliciously changing accounting policies. This will undermine the principles of "fair", "open" and "justice" in the capital market, and will seriously shake the confidence and expectations of participants in the capital market, which is not conducive to the long-term healthy development of the capital market.

#### *2.2.4 Accounting Fraud Can Lead To Industry-Wide Credit Crisis*

Former State Council Premier Zhu Rongji's inscription on the Shanghai National Accounting Institute: "Integrity-based, ethical, adhere to the guidelines, do not make false accounts", which fully reflects the importance of accounting integrity. However, accounting fraud has occurred from time to time. In the United States, where financial supervision is relatively perfect, there have been sensational "Enron" and "WorldCom" financial fraud cases at the beginning of the 21st century. And the accounting fraud cases such as "Ya Baite", "Jinya Technology" and "Xintai Electric" which have occurred in China in recent years have once again triggered the doubts of regulators and investors on the accounting information of listed companies, even for the entire accounting industry had been questioned.

### **3. Reasons**

#### ***3.1 Asymmetric information***

Information asymmetry is the main reason for accounting fraud. When one party has mastered most of the information related to the transaction, and the other party has to pay a huge cost to verify the authenticity of the information provided by the former, this will lead to information asymmetry between the two parties. In practice, investors and regulators are unable to accurately, fully and timely grasp the production and operation of listed companies, and in addition, accounting fraud is often very concealed and complicated. Therefore, the asymmetry of information often causes the accounting fraud.

#### ***3.2 Financial pressure***

When companies face severe financial pressures, managers often take the risk of financial fraud. Some companies want to catering to profit expectations, some want to cover up their problems, some companies try to maintain sustained growth, while some want to prevent performance decline. In summary, the motives for listed companies to implement accounting fraud are related to their financial distress. Therefore, some scholars believe that the occurrence of financial fraud is positively related to corporate financial pressure.

#### ***3.3 Imperfect Structure***

A good corporate structure can reasonably guarantee the benign operation of listed companies and effectively protect the rights and interests of shareholders. Many accounting fraud cases that have occurred in recent years are related to the weak corporate governance structures. In terms of statistics, in recent years, cases involving corporate governance and shareholder rights disputes have increased year by year, accounting for more than 60% of corporate disputes. In some companies, large shareholders use their own advantages to infringe the rights of minority shareholders to know and share the same rights.

At present, China's shareholding structure is highly concentrated, and the shareholding structure is unreasonable. More than 90% of investors are small and medium-sized investors. Large shareholders have infringed the interests of small and medium shareholders by whitewashing the company statements for their own benefit. The controlling shareholder may also control the company's general meeting of shareholders, the board of directors and the board of supervisors, damage the function of the board of directors, affect the operation of the board of directors, and prevent supervisors from conducting effective supervision. These will lead to information asymmetry, which triggers accounting fraud.

### ***3.4 Lack of Internal Control System***

The internal control system of listed companies is weak and not valued. Although most companies have established their own internal controls, the internal control system still could not form a complete system. Even some entrepreneurs have the misunderstandings about internal control: strengthening internal control will only increase cumbersome procedures and reduce efficiency. Meanwhile, the lack of an evaluation system also reduces the effectiveness of internal controls. In short, due to the imperfect internal control, it is impossible to effectively regulate accounting information, which is another reasons for the increasing accounting fraud.

### ***3.5 Moral Factors of Managers***

According to a survey, 88.8% of accounting practitioners in accounting fraud are instructed and forced by management. Another survey found that the degree of education of managers is often inversely proportional to the occurrence of accounting fraud cases, the higher the degree of education, the more inclined it is to induce others to conduct accounting fraud. If not instructed, accountants themselves will not actively create false accounting information. Although 50.34% of accountants are forced to participate in fraud, this data also shows that there are problems with the professional quality of accountants. In addition, corporate managers with greater power lack of moral conscience, social ethics declines and the lack of strong ethics have also led to accounting fraud.

### ***3.6 Lack of government supervision***

The government supervision department paid insufficient attention to accounting supervision and the accounting supervision was weak. Specifically, accounting supervision lacks specific practices; some government staff believe that accounting supervision has a large workload, a wide range of policies, strong policy requirements, high requirements, and heavy tasks, so they are worried and perfunctory. These facts have also led to the occurrence of accounting fraud.

### ***3.7 Inappropriate legal system***

The law is an important guarantee for protecting the interests of investors. In China, because of the lack of relevant laws, it is much higher than those in the United Kingdom and the United States that the major shareholders of listed companies infringe on the interests of minority shareholders. Strong legal protection can limit the falsification of corporate performance within the company. For example, the current securities law is not strict enough to manipulate the market and other violations of laws and regulations, resulting in insufficient legal shock. Therefore, the realization of damage compensation for small and medium-sized investors depends on the continuous improvement of the rights and obligations of

the market participants and the basic legal system. From this point of view, it is necessary to formulate more perfect laws and regulations and increase the punishment for accounting fraud in order to better protect the rights of small and medium investors.

#### **4. Solutions**

##### ***4.1 Improve the Company's Operating Mechanism***

First of all, in order to prevent abuse of power, the proportion of independent directors should be increased among the board of directors. In order to ensure the fairness and effectiveness of decision-making, the selection of independent directors should try to select employee representatives or minority shareholders to ensure that supervision is in place.

Secondly, optimize the ownership structure and governance institutions, ensure the independence of the board of directors and the board of supervisors, play the supervisory role of the board of supervisors, and promote the fair disclosure of accounting information.

Third, we should also strengthen the construction of corporate culture and improve the professional ethics and professional conduct of accountants. Finally, it is necessary to establish incentive and restraint mechanisms with clear rewards and punishments.

##### ***4.2 Improve Laws and Regulations, promote the revision of Accounting Standards***

The *Accounting Law of the People's Republic of China*, which came into effect on November 5, 2017, is the second revision of the *Accounting Law* promulgated by China in 1985, and is an important task of China's accounting reform and development during the *13th Five-Year Plan* period. This revision serves as the legal basis for standardizing and adjusting accounting behavior, and solidifies the legal basis for establishing a unified market rule and a fair market environment.

In recent years, China has formed a legal system including securities law, company law, securities investment fund law, criminal law and a large number of administrative regulations and departmental regulations, and issued the *Opinions on Further Strengthening the Protection of the Legal Rights and Interests of Small and Medium-sized Investors in the Capital Market* and *Measures for the Appropriateness of Securities and Futures Investors* etc. However, it should not be denied that compared with the small and medium-sized investors who account for more than 90% of the entire securities market, the legal content of investor protection in China is still very limited, and a special investor protection law is still missing.

In the same time, the formulation or revision of the accounting standards that meet the needs of the development of China's enterprises and capital markets and the

continual convergence of IFRS will further clarify accounting responsibilities and improve the effectiveness of accounting fraud prevention.

#### ***4.3 Establish and improve Internal Control System***

Whether the internal control of a listed company is perfect reflects the level of enterprise management, and the construction of an internal control system is also an effective means to improve the management level. To achieve scientific management, enterprises must strengthen internal control to ensure the normal operation of enterprises and the preservation and appreciation of assets.

From the reality, with the development of the enterprise, its capital, personnel, and market have reached a certain level. The organization, financial management level and human resources allocation of the enterprise may not be able to adapt to the further development of the enterprise. There have been phenomena such as corporate funds, loss of control of personnel, and falsification of financial data. These phenomena may lead to the collapse of enterprises.

Therefore, strengthening internal control can reasonably ensure that enterprises provide real and effective information, especially accounting information, thus reducing the occurrence of accounting fraud from the perspective of internal control.

#### ***4.4 Enhance the Independence of Accounting Supervision***

Strengthening the independent status and role of internal audit institutions and the board of supervisors, and giving them more supervisory power is the basis for enterprises to strengthen internal supervision. Internal supervision is the basis of accounting supervision, and is an important measure to ensure the authenticity and integrity of accounting materials and prevent accounting fraud. Maintaining the independence that it deserves is the key to its effective exercise of supervisory power and the guarantee of ensuring the independence of accounting supervision.

#### ***4.5 Strengthen the supervision of CPA***

In the "13th Five-Year Plan" period, China strengthened the construction of accounting professional ethics, clarified the ethical requirements, professional norms, and disciplinary standards of accounting personnel, and regulated them through legislation.

The policies released will effectively reduce the CPA's disregard of professional ethics, deviate from the principle of practice, cooperate with the audited units to commit fraud or false practice, and truly improve the quality of CPA audit supervision. These policies released include establishing an accounting integrity file system and an accounting "blacklist" system, incorporating the accounting records of accountants and certified public accountants and the illegal and illegal accounting

units into the national credit information sharing platform, and strengthening the binding and deterrent of professional integrity discipline.

#### ***4.6 Increase Penalties for Accounting Fraud***

From the perspective of accounting fraud, corporate managers are the dominant and the beneficiaries of accounting fraud. Therefore, management should also be the responsible bearer of accounting fraud. Some listed companies falsify balance sheets, income statements, and cash flow statements by inflating assets, concealing liabilities, inflating income and underpricing costs, and issuing false financial reports to disrupt market economic order.

Therefore, once a company is found to have accounting fraud, it should severely investigate and deal with the responsible person, and impose administrative sanctions on it, even requiring it to bear criminal responsibility and conduct economic punishment. In the face of huge punishment, relevant responsible persons will weigh the pros and cons and strictly supervise the quality of corporate accounting information, thus achieving the effect of reducing accounting fraud.

### **5. Conclusion**

The main means of accounting fraud in listed companies in China is to inflated profits and assets. The fundamental motivation for accounting fraud is to pursue their own interests. The neglect of the regulatory authorities and the inadequacy of the regulatory system provide opportunities for the breeding of accounting fraud, and the flaws in corporate governance mechanisms create conditions for accounting fraud.

Therefore, the prevention of accounting fraud should be implemented through the improvement of laws and regulations, the enhancement of the independence of accounting supervision, the increase of penalties for accounting fraud, and the improvement of the quality of auditing supervision of certified public accountants. On the other hand, the conditions for the breeding of accounting fraud are eliminated by improving the corporate governance mechanism and establishing a sound internal control system.

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