Financial Statement Manipulation of Listed Companies and Prevention

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Abstract: Financial information is what determines the financial condition and results of operations of the firm, Appraisal of management responsibilities, a key source of information for scientific decision-making. It plays an essential role in economic management and economic decision-making. Nowadays, the market economy is so developed that certain companies, because of their own interests, resort to various ways to whitewash their financial statements. Not only does it jeopardize the interests of investors, but it also damages the reputation of the company and brings some negative effects on the functioning of today's market. This paper is mainly based on the financial statements on the statement of the common means of the act of whitewashing to analyze the corresponding countermeasures to deal with the corresponding discussion.

Keywords: listed companies; statement fraud; preventive measures

1. Introduction

Financial statement whitewashing is overwhelmingly an attempt to hide the problems that exist in a public company. However, every enterprise has various problems, and certain problems may seriously affect the rapid development of the company. For example, poor performance of a listed company will prevent the company from going public; losses of the company will affect the bank credit; low revenue of the company will hinder the partnership, and so on. These are all the problems that a company may face, so in order to find a solution, the financial statements are disguised to play an irreplaceable role.

2. Overview of the financial statement cherry-picking practices of listed companies

2.1. Meaning of financial statement manipulation

Financial statement whitewashing is the process by which the relevant management of a listed company, in order to obtain more benefits. Therefore, using various means to change the data in the statement by themselves, the data in the statement will be presented as if the enterprise is in a surplus state. All purposeful communication of false information to users of financial reports not only does it mislead policymakers, investors and creditors into giving false judgments based on false statement information, and deprive the financial statements and audit reports of enterprises of the risk-preventive function they were intended to have. It has also resulted in the failure of governmental supervisory and regulatory authorities to detect and prevent risks in the business of the Company Group in a timely manner, leading to a decline in the ethical standards of the financial industry.

2.2. Essential elements of financial statement embellishment

At present, there are several kinds of accounting statement whitewashing behaviors in China's enterprises, which are specifically included in the following three aspects:

In the course of business development, companies create many different accounting statements in order to gain more and more business credibility and access to loans. In particular, poorly managed companies are generally in a poor position to access bank credit funds. So in order to make the funding problem solved effectively and get more credit, the act of statement whitewashing is carried out.

In order to obtain more economic benefits, enterprises usually carry out tax reduction behaviors mainly through corporate accounting statement whitewashing. However, as things stand now, there
are deviations between our accounting standards and tax laws. The financial statement program used by a business can have a direct impact on the taxes paid. If the tax paid is slightly higher, it will correspondingly increase the cost of the enterprise, which will have a great impact on the economic profit of the enterprise. This will result in the falsification of the financial statements of the enterprise.

2.3. Methods of identifying financial statement misstatements

2.3.1. Non-performing assets elimination method

In the non-performing assets exclusion method, non-performing assets include not only common net losses on pending current assets, such as amortized expenses, virtual assets, net losses on pending current assets, and long-term amortized expenses. Two relative conclusions are prevalent in the method, which are: First, if total non-performing assets are close to or exceed net worth, it suggests that there may be a problem with the ability of the business to continue to operate. Secondly, if the rise in non-performing assets and the rate of increase or decrease in non-performing assets exceeds the increase in total profits and the rate of increase in total profits, then it indicates that the income statement of the enterprise for the current period is suspected of being falsified and needs to be treated with rigor.

2.3.2. Transaction elimination method

The transaction elimination method is one of the methods that can provide a more realistic idea of the actual profitability of a business. The related transaction elimination method means that operating income and total profit from related companies are removed from the company's income statement. Users of financial statements should pay particular attention to the pricing policies of related transactions, and users of accounting information should analyze whether an enterprise is engaging in transactions with related transactions in such a way that the financial statements are not disguised as a quid pro quo. If the financial statements of the enterprise are assessed by comparison with the consolidated financial statements prepared by its parent enterprise. If the total profit of the consolidated financial statements of the parent enterprise (which should be removed from the total profit of the enterprise) is much lower than the total profit of the enterprise, it may indicate that the parent enterprise has engaged in a connected transaction to "package" the profit into the enterprise in a different way.

2.3.3. Industry analysis method

In addition to the two methods of analysis listed above, there is another method, the industry analysis method, which is the most clearly expressed and intuitive of all methods.

The analysis method is mainly than, if and the industry's average data between the difference is large, it is necessary to carry out further investigation and analysis of the company, in determining whether the enterprise has carried out financial fraud.

In fact, the means of determining whether an enterprise has engaged in statement-masking are not limited to the above methods. However, if you use these methods to identify the fraudulent statements, you will be able to confirm the correctness of your judgment more efficiently and quickly. As many companies engage in the practice of cherry-picking due to a multitude of internal factors, it is important not only to further analyze the causes of this practice, but also to understand the various methods and means and to have the ability to quickly identify them in order to quickly and efficiently solve this problem. This will enable the operation of our market economy to continue to show a favorable development trend.

3. The economic consequences of financial statement cherry-picking

3.1. Endangering the market economic order

Enterprise accounting information distortion will cover up the real business situation of enterprises, increase the uncertainty in the operation of the national economy, fraudulent investors and mislead the country's judgment on the current economy.
3.2. *Harming the long-term development of enterprises*

When the top management of an enterprise makes decisions based on the financial statements, the information that does not correctly reflect the situation of the enterprise gives the decision makers a wrong orientation, which leads to the failure of the decision making and causes more losses to the enterprise.

3.3. *Harming the growth of the accountancy profession*

At present, the CPA internal competition is fierce, a few accounting firms in order to attract clients to compete with the price or to reach some kind of agreement with the enterprise. The direct result of this vicious competition is that firms are dependent on their clients and are passive in the professional process.

4. *Analysis of the means of financial statement manipulation.*

4.1. *Adjustment of profits by means of connected transactions*

In our country, most enterprises are generally established by the reorganization of state-owned enterprises. The enterprise generally has multiple relationships and transactions with other subsidiaries managed by the parent enterprise that are inseparable. The main methods of utilizing connected transactions to reconcile profits in corporate financial statements are as follows:

4.1.1. *Fictitious economic transactions*

Purchasing and selling activities, property to regulate profitability, with the aim of demonstrating the excellent business performance of the enterprise, using pricing that is too high or too low compared to the market price.

4.1.2. *Utilization of cooperative investment projects*

Enterprises enter into joint investment contracts with their associated listed companies, with the return on investment determined on the basis of a budgeted profit gap.

4.1.3. *Sources of profit*

In order that the fundamental source of benefit obtained by the listed company is interest income from the flow of funds with associated enterprises, the Company may use high or low interest rates to finance its transactions with its affiliated listed companies, thereby realizing the adjustment of financial expenses; and so on.

4.2. *Use of accounting methods and changes in accounting policies to disguise statements*

China's current accounting policies, accounting standards and accounting methods are susceptible to change, so the accounting policies and standards adopted by different listed companies are also very different points. Although accounting policies generally cannot be changed at will, it does not mean that they cannot be changed completely, so many companies have begun to use this skillfully to achieve the purpose of financial statement revising behavior.

Certain enterprises use changes in depreciation of fixed assets to realize the extension of the useful life of fixed assets, as well as changes in the valuation of inventories and other methods to change accounting policies. Thus, the ultimate goal of financial statement modification is achieved. There are also companies that utilize the fixed cost method to calculate the cost of a product by allocating the fixed cost variance between the product in process and the goods on hand.[3]

So it is not apportioned in the products sold in the period, the cost of goods sold in the period will be reduced by applying this way, change of accounting policy is a common means for enterprises to carry out accounting statement whitewash.
4.3. Use of fraudulent trading devices to inflate statements

In view of the fact that fictitious transactions are one of the most prominent and common methods of financial statement alteration. His main method is to carry out transactions in the form of false certificates negotiated in private between the two parties, when in fact no transaction has taken place. Certain enterprises fabricate false purchase and sales contracts, thereby creating a series of false data bills, such as false goods-in and goods-out bills. Thus, it is common to realize an increase in the assets of the enterprise for the purpose of expanding the income of the listed company, thus contributing to the rise in the total profit. At present, the credibility of financial information has been seriously questioned by the illegal falsification and financial statement whitewashing behavior of listed companies in China. If the enterprise's risk is not timely warning, will greatly increase the audit risk, but also will jeopardize the normal operation of China's capital market, disrupting the normal social and economic order. The following cases illustrate more clearly the seriousness of this phenomenon.

The first case is based on the case of Jinya Science and Technology's information disclosure violations. The company has caused significant damage to the legitimate rights and interests of small and medium-sized investors through a variety of financial counterfeiting, fraud and other acts, which have brought about serious consequences.

This case is a typical example of a series of accounting falsifications and fraudulent practices. GOLDEN ASIA TECHNOLOGY CO., LTD. has falsely obtained approval for its initial public offering (IPO) by inflating its profits through the use of fake customers and businesses, and by creating fake contracts. The company then began to falsely increase its profits by approximately $80.49 million in 2014 and its bank deposits by approximately $218 million. These fraudulent operations, which carried out falsifications, caused unforeseen damage to the interests of other joint venturers. Therefore, in March 2018, the Securities and Futures Commission began to give administrative penalties to the company and the relevant staff in accordance with the law, and in June of that year, the Securities and Futures Commission in accordance with the law will be suspected of counterfeiting and fraud and other criminal acts of the staff referred to the public security organs.

At the present time, the SFC will still be reviewing the above situation. Once irregularities are found in the use of falsified information to manipulate the securities market, they will be dealt with seriously.

4.4. Cash flow manipulation

Cash flow manipulation has been a common method of financial statement manipulation by companies for several years. Because of the high degree of elasticity of the prevailing accounting surplus standard, the public's perception of the quality of accounting surpluses has become highly skeptical. Moreover, a succession of failed enterprises has taught the public that the cash flow situation is far more important than the ability to account for surpluses. In general, quality is unreliable if there is no profit with corresponding net cash flows. Therefore, if the company's net profit is higher than net cash flow for a long period of time, it indicates that the assets corresponding to the profits recognized long ago should be classified as virtual assets that cannot be converted into cash flow, which further indicates that the listed company may be adopting the act of statement revising.

5. Analysis of the drivers of corporate financial statement manipulation

5.1. Access to bank financing

With the rapid development of China's market economy, financing has become one of the most important aspects of the problem, if the listed companies want to continue to effectively increase the speed of development, there is no lack of capital support. In addition, China's current market economic situation is becoming more and more complex, so the banks will apply for loans to enterprises using a variety of ways to implement the survey and evaluation. For example, it will focus on the earning capacity as well as the solvency of the business, etc. Since allotments are subject to time and conditions, bank credit is a little more practical. However, banks and other financial institutions usually do not want to give loans to listed companies with large losses and those that lack business reputation due to risk considerations and self-protection awareness, in order to reduce the banks' own credit risks. Therefore, under such circumstances, certain enterprises with problematic business performance can only obtain the credibility of the bank through the whitewashing of corporate accounting statements,
and in this way enhance the commercial credibility of the enterprises that provide goods to them, and ultimately obtain the needed funds.

5.2. Tax avoidance or minimization

Because corporate income tax prices are derived by adjusting accounting profits to taxable income and multiplying it by the income tax rate, numerous companies will make a series of disciplinary adjustments to the profits on their accounting statements by using. In real life, certain limited liability companies, private enterprises, foreign-invested companies, etc., engage in the whitewashing of financial statements in order to reduce taxes and suppress profits. In order to achieve the purpose of controlling the share price, they even go so far as to falsify and pay more income tax in order to conceal their profitability, so as to lower the income tax payable in the final calculation and achieve the purpose of tax avoidance or tax reduction.

5.3. To qualify for public listing

According to the relevant provisions of the Company Law, a company limited by shares may issue shares publicly only if certain conditions are met. However, the vast majority of enterprises do not meet the listing requirements in terms of financial and operational conditions before listing, and when faced with conditions such as sustained profitability for many years, they may be able to conceal the actual status of their enterprises by manipulating the data in certain accounting statements, thus realizing the purpose. Therefore, many listed companies, in order to raise more funds for listing when they cannot actually realize the qualification conditions necessary for listing, implement the use of corporate accounting statements to conceal the actual performance of the listed company to fabricate a secret corporate accounting statement that appears to be consistently profitable in order to obtain the qualification for listing.

6. Measures for listed companies to prevent financial statements from being falsified.

6.1. Elimination of the use of connected transactions in pricing by enterprises

Pricing by means of connected transactions generally means that the enterprise obtains a corresponding capital occupancy fee on the funds raised that are accounted for by the majority shareholder. So far, China's state-owned enterprises restructuring process there are many related transactions, although China's laws clearly stipulate that between enterprises shall not have the emergence of this type of behavior, but this phenomenon is still unavoidable. As a result, companies should price fairly when doing related transactions, but the whitewashing behavior of numerous accounting employees is not very beneficial to themselves. Accountants do not engage in whitewashing for their own reasons; the accountant is just a small employee of the business. All work arrangements are directed by the leader's orders and the accounting clerk does this because he needs to keep his job and because the supply of accountants in our country now exceeds the demand. So the accounting clerk carries out false behavior.²⁴

In order to reduce the accounting staff to whitewash the accounting statements of the enterprise, the accounting staff should consciously follow their own code of ethics, starting from me, and choose the most correct and standardized method to carry out the work in the future career.

6.2. Beware of the application of improper accounting estimates to reconcile profits

Generally speaking, common accounting estimates contain provisions for bad debts, depreciable lives of fixed assets, and provisions for impairment of intangible assets and assets such as accounts receivable and inventories.

6.2.1. Strengthening professional inspection and management requirements for accounting estimates

Accounting estimates such as the provision for bad debts need to be made by the accounting management based on professional judgment, and the determination of depreciable lives of fixed assets should be assessed by the accounting department, technical department and other departments. Therefore, it is necessary to manage the situation from two perspectives. On the one hand, it is necessary to strengthen the professional inspection of the accuracy of the accounting information of
listed companies from the perspective of the supervisors of the financial management department. In particular, it is important to improve the relevant professional and technical review skills, and it is also possible to establish a professional review committee to strengthen the industry's management control and to accurately correct the violations that may be revealed in the changes in accounting estimates of listed companies.

6.2.2. Improved disclosure of relevant information in corporate financial and audit reports

Because most people's familiarity with financial knowledge is not very high, it leads to the fact that our public's ability to evaluate and judge the financial information of listed companies is often unprofessional. Therefore, it is necessary to strengthen the disclosure requirements related to the annual financial reports and audit reports of enterprises, on the one hand, and on the other hand, to increase the list of information related to the annual financial reports, so as to make the disclosure of accounting information more comprehensive and easier to understand; On the other hand, it is proposed that in the audit report of the annual report, it is also necessary to add a paragraph in the body of the report indicating the relevant significant changes in accounting estimates, so as to facilitate the users of the report to be able to understand the relevant financial information in a more direct manner.

6.3. Preventing excessive misuse of accounting policies and accounting methods

Government departments manage and control the external accounting statements of enterprises through the establishment of a number of accounting policies. The most important thing is to implement such accounting policies, which should be strictly adhered to and implemented in the same way by all enterprises, whether they are private, national or foreign, and without privilege and on an equal footing with each other. Penalties must be imposed for any violation of the relevant guidelines to establish authority. At the same time, any major or minor errors in policies and regulations should be corrected, and policies and regulations that are more conducive to the orderly operation of the market should be prepared as quickly as possible.

The so-called "excessive abuse of accounting policies" refers to the fact that listed companies, when correctly using the accounting policies approved by China's unified accounting system, do not correctly apply them as specified, but change the policies at will. It is therefore not possible to present a reasonable picture of the financial position and results of operations of the enterprise.

7. Conclusions

Currently, the issue of accounting and financial statement fraud is a long-standing and historically internationalized problem. Financial statement manipulation is costly to investors, creditors and relevant policymakers. Studying how to prevent the occurrence of whitewash in accounting statements is a necessary topic for the entire accounting profession. Academics must be in-depth study of China's accounting statement whitewash motives, types and means in a series of measures to solve the problem.

References