

Study on the Motivation and Governance of Financial Fraud of Star Technology Corporation

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Abstract: In recent years, China's capital market has been developing rapidly, and at the same time, various problems have emerged one after another. Financial fraud has become a prominent issue in recent years, causing huge losses to the majority of small and medium shareholders. However, in view of the current financial development of Chinese listed companies, financial fraud has not been effectively supervised and controlled, which makes investors lose confidence in the capital market and directly affects the normal operation of the capital market, and also poses an obstacle to the country's economic development. Therefore, fraud prevention and control is a top priority for the development of capital market. Through the fraud risk factor theory, the article analyzes Star Technology Company to understand the means and motives of its financial fraud, and proposes countermeasures for five aspects: fraud motive, moral quality, fraud opportunity, probability of being discovered and the nature of the degree of punishment, aiming to provide reference for the prevention of financial fraud in the future and promote the healthy and benign development of China's capital market.

1. Introduction

China's capital market has maintained rapid development since its formation, but due to its late start and lack of experience compared to foreign capital markets, the relevant laws and regulations are not perfect and there are many problems in management, making financial fraud incidents occur from time to time. According to the relevant data, in 2022, more than 80 listed companies were investigated by the Securities Regulatory Commission, and 23 listed companies were investigated in November alone. Due to the low cost of violation, the frequent occurrence of financial fraud and the lack of concrete implementation of regulatory measures implemented by external regulators, financial fraud by listed companies has undermined the confidence and interests of the market and investors and challenged the law and the system. The financial fraud has been researched by scholars at home and abroad, but many scholars study the causes of financial fraud mainly using the fraud triangle theory and the GONE theory. In this paper, after comparing several commonly used theories of financial fraud motivation, we choose a more perfect theory of fraud risk factor. This theory is proposed by Bologna based on the GONE theory, which divides risk factors into individual risk factors and general risk factors, and the task of financial fraud is caused by the combination of two factors [1]. The former is about individual factors, including moral quality and motivation to commit fraud, while the latter is about factors that are externally influenced, including

the opportunity to commit fraud, the probability of fraud detection, and the nature and extent of fraud penalties. This paper selects the risk factor theory as a framework to conduct an in-depth analysis of the means and motives of financial fraud of Star Technology, and proposes corresponding prevention and governance countermeasures for five fraud motives, aiming to help investors and other stakeholders effectively identify the actual operational risks of listed companies, bring certain insights to other similar enterprises, external auditors and regulators, and promote the smooth development of the capital market to a certain extent.

2. Case Overview

2.1. Company Background

Jiangxi Star Technology Co., LTD. (hereinafter referred to as "Star Technology") was founded in September 2003 and listed on the GEM of Shenzhen Stock Exchange in 2011, becoming the first listed enterprise in the consumer electronics window protection screen industry. Its current focus is on the development, production and manufacture of various precision structural parts and related materials and components around mobile and connected terminal products such as mobile phones and tablet computers.

Until 2010, Star Technology was a supplier of protective glass screens for Nokia, Motorola, Sony Ericsson and other international brands of cell phones. However, entering the era of smart phones, Nokia, Motorola, these old phones failed to keep up with the times, and eventually became a tear of the times. Star Technology's operation also went downhill accordingly and incurred a loss of 149 million yuan in 2013.

Since then, Star Technology has started several asset acquisitions and restructuring, but none of them have been successful, instead, it has suffered huge losses continuously in 2018, 2019, 2020 and 2021: 1.699 billion yuan, 1.281 billion yuan, 2.75 billion yuan and 1.385 billion yuan respectively. The loss amounted to 7.085 billion yuan for four consecutive years, as shown in Figure 1.

On the evening of August 22, 2021, Star Technology, which has dropped 39.90% for 5 trading days in a row, issued an accounting error correction announcement, which showed that 2020 annual net profit from the original 52 million yuan, adjusted to a loss of 2.75 billion yuan. At the same time, the announcement said that the company's shares will be implemented from August 24, 2021 "delisting risk warning" special treatment, renamed *ST star, and subsequently issued a court decision to start the company's pre-restructuring announcement. Since its listing ten years ago, Star Technology has continued to lose money, raising 3.104 billion yuan in total and paying out only 62 million yuan in dividends. The incident will put Star Technology will face unprecedented pressure.

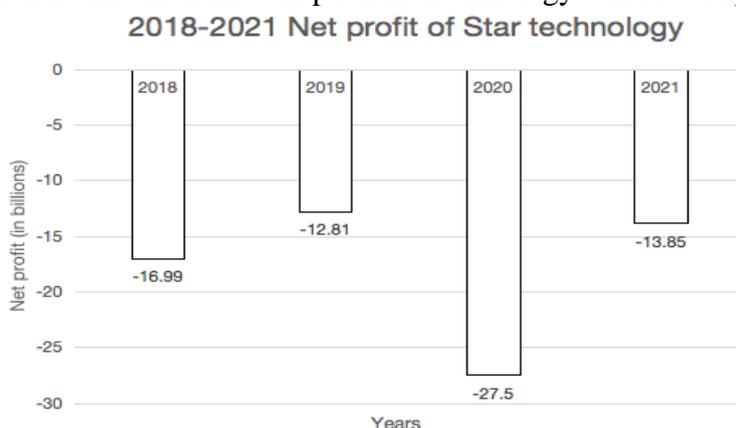


Figure 1: 2018-2021 Net profit of Star Technology Company (in billions)

2.2 Financial Fraud Methods

2.2.1 Inflated Total Operating Revenue and Profit

Through fictitious sales business, Star Technology falsely increased operating revenues by RMB 1,384 million and RMB 3,192 million in 2019 and 2020; through fictitious leasing and processing business, falsely increased operating revenues by RMB 55,193,600 and RMB 65,813,200 in 2019 and 2020; through fictitious procurement business, falsely increased operating costs by RMB 402 million and By agreeing with suppliers on false procurement discounts, Star Technology falsely reduced operating costs by RMB 4,199,100,000 and RMB 1,548,100,000 in 2019 and 2020, respectively.

Through the above illegal acts, Star Technology inflated its operating revenue, operating cost and total profit (excluding tax and period expense adjustments) by RMB 1.439 billion, RMB 265 million and RMB 1.174 billion in 2019, accounting for 22.68% of its disclosed operating revenue, 4.98% of its operating cost and 761.20% of its total profit, respectively; and inflated its operating revenue and operating cost by RMB 3.258 billion and RMB 1.595 billion in 2020. The total operating revenue, operating cost and total profit (without considering the adjustment of tax and period expense) for 2020 are 3.258 billion yuan, 1.595 billion yuan and 1.663 billion yuan, accounting for 39.26% of the operating revenue, 22.22% of the operating cost and 3,799.51% of the total profit disclosed in the period, respectively.

2.2.2 Under-Recording of Impairment Loss on Goodwill

Star Technology completed the acquisition of 100% equity interest in Star Touch and Star Precision in December 2013 and July 2015, respectively. Star Technology's 2019 annual report and 2020 annual report disclosed that the goodwill formed by Star Technology's acquisition of Star Touch and Star Precision was not impaired. However, on December 30, 2021, Star Technology disclosed the announcement of accounting error correction, and after the correction, Star Technology made up a goodwill impairment loss of RMB146, 719, 600 in 2019; and a goodwill impairment loss of RMB729, 028, 000 in 2020. The huge amount of goodwill impairment loss made up the Star Technology's performance in the past two years, and the operating profit which had already turned from positive to negative became more serious loss under the effect of goodwill impairment.

2.2.3 Significantly Increase Other Receivables

Star Technology had capital transactions that were not presented in other accounts payable. In 2020, the transaction amount of \$517.71 million was increased as other accounts receivable and the corresponding bad debt provision was re-provided, resulting in a decrease in the bad debt provision for other accounts receivable by \$320,000, so the ending balance of other accounts receivable in 2020 differed from that before the correction by \$518.03 million.

3. Motivation analysis Based on Risk Factor Theory

3.1. Ethical Factor Analysis

The frequent occurrence of financial fraud in listed companies has an important correlation with the shallowness of managers' own legal awareness [2]. The moral quality of the management will have a great impact on whether a company can develop healthily and permanently in the capital market. In the case of Star Technology's financial fraud, the company's directors, supervisors and

senior management ignored the problems in information disclosure and standardized operation, and organized and implemented Star Technology's information disclosure violations. Company executives also once received a regulatory letter for competition in the same industry. The regulatory letter showed that the company's deputy general manager, Huang Shunchang, held 39.2% of the equity of the peer-to-peer company through a subsidiary under his effective control during his tenure as the company's deputy general manager. At the same time, certain employees of the company lacked proper professional ethical concepts and acted in full accordance with the orders of the company's management, which prevented its financial fraud from being exposed in a timely manner and thus greatly affected the sustainable development of the company.

3.2. Fraud Motivation Factor Analysis

Usually, the motive of corporate fraud has a great relationship with the development needs and economic situation of the company [3]. In the first year of listing, Star Technology had a good performance, but because the company's production capacity was too small and its transformation was too slow to be among the supply chain of emerging cell phone brands such as Apple, it suffered a loss in the third year of listing, and the beneficial owner began to take financing mergers and acquisitions to revitalize its performance. Several consecutive corporate mergers and acquisitions, so that the company is burdened with large-scale debt, Star Technology frequently borrowed from related parties, as of the end of 2020 the cumulative borrowing has exceeded 1.6 billion. Second, Star Technology confessed that the current liabilities have exceeded the total assets, short-term debt service pressure, by the company's 2021 semi-annual report, Star Technology current liabilities amounted to 7.012 billion yuan, more than the total assets of 5.993 billion yuan. In addition, on August 18, 2021, Star Technology was filed for bankruptcy reorganization by the debtor HSBC Investment only because of 50 million arrears. It can be seen that Star Technology needs a large amount of funds to return the arrears, therefore, Star Technology's capital needs are more urgent. The tightening capital chain makes the company unable to cover up the dismal performance, and the error correction leads to a huge loss in short-term performance to cover up the financial fraud.

At the same time, goodwill impairment has always been the hidden "thunder" of the company. Once the acquired company's performance dives, the acquirer has to set aside a high amount of goodwill impairment reserve, which is one of the reasons for the huge loss of Star Technology. Due to unfavourable revenue, the company falsely increased revenue in 2020, and in the loss year, it made more provision for goodwill impairment to avoid the goodwill storm, which dragged down other years and even led to the fate of being delisted for three consecutive years of losses.

3.3. Factor Analysis of Potential Fraud Opportunities

From 2019 to 2021, before the company announced its performance change, Star Technology's management and senior executives changed frequently. The chairman of Star Technology changed for three consecutive years, and the members of the board of directors and senior executives were also adjusted for many times. Such frequent changes at the top lead to multiple changes in the management style of the enterprise, which makes it impossible to implement the established plan of the enterprise and also leads to the chaos of management. A large number of key management personnel changes, on the one hand for the company's financial operation and implementation of improper behavior provided the possibility, on the other hand, also make financial irregularities difficult to be discovered.

3.4. Exposure Factor Analysis

3.4.1. Late Regulation of Market Supervision Mechanism

The management methods of Chinese listed companies are not as advanced as those of developed countries. There is no perfect rating system and regulatory mechanism for listed companies [4]. Listed companies involved in fraudulent practices cannot be detected and stopped by the market as early as possible. The complexity of the fraudulent means of Star Technology is not high, however, under such circumstances, there is no relevant department to reveal the fraudulent behavior of Star Technology, which not only indicates the weakness of the main supervision awareness of the regulator, but also proves the lag of our market mechanism, which gives Star Technology the opportunity to take advantage of it.

3.4.2. Lack of Quality Control of Auditors

Daxin Accounting Firm has been cooperating with Star Technology for 13 years, and even after Star Technology issued an announcement on the material misstatement of the previous period, Daxin Accounting Firm still issued a qualified opinion report. Excessive reliance on the audited entity under continuous audits provided external opportunities for financial fraud. Daxin & Partners did not perform rigorous audit procedures, did not maintain auditors' caution and professional skepticism literacy, did not perform control tests on risk accounts, and did not focus on them. It is evident that Daxin CPA firm is not exercising diligence in the process of auditing Stars Technology.

3.5. The severity and Nature of the Punishment

Enterprise financial fraud, the vast majority are the pursuit of interests, in the fraud of profit and fraud to bear the risk between constantly weighing, if the benefits of financial fraud far more than the risk to bear, then for the idea of financial fraud is bound to be at all costs to obtain the huge profits. In the case of a number of illegal facts, the CSRC gave star technology warning, and imposed a fine of 6 million yuan. A fine ranging from 500,000 yuan to 4 million yuan will be imposed on those responsible. For the company's adjustment of hundreds of millions of yuan, the penalty is not very high, and the loss of small and medium investors has not been recovered, the company and major shareholders have obtained huge benefits from this behavior. The analysis of financial fraud cases in recent years shows that the penalty imposed by the regulatory authorities on fraudulent enterprises is lower than the income earned by fraudulent enterprises. Compared with the strict legal system of the United States, Hong Kong and other places in China, listed companies are afraid of the regulators and dare not take risks easily. However, the punishment of China Securities Regulatory Commission is far from enough to deter the process of listed companies' fraud, which is becoming more serious and the means are becoming more difficult to detect.

4. Suggestions on Measures to Prevent Financial Fraud

4.1. Improving Moral Quality and Professionalism

The personal quality of enterprise management plays a key role in corporate decision-making. Meanwhile, the legal quality of enterprise management also determines that the future development of the enterprise can operate within the legal framework, which is very crucial for the sustainable development of the enterprise. In this case, Star Technology could have used the funds raised and taken effective measures to promote the further development of the company [5]. However, after the company went public, the managers were busy using the existing funds to expand the market

due to their low moral quality level and weak legal awareness, and did not reasonably evaluate whether the current situation of the enterprise was suitable for this development measure. At the same time, when facing the crisis of the company, the manager did not take measures from the root, and was once again used by his own bad psychology, and took the wrong way to cover up, which eventually led to the tragedy.

Therefore, in the process of enterprise development, we should pay attention to the cultivation of the quality of management personnel. In this regard, the media can publicize related deeds and report negative cases to further strengthen the ideological understanding of employees. In addition, the company should pay attention to the moral quality of the candidates when recruiting; In the process of enterprise operation, if it is found that employees have bad behaviors and bad thoughts, they should be criticized and educated in time to make them realize the seriousness of the matter, so as to prevent such situations from happening again. In the company promotion assessment, legal knowledge into the scope of assessment; at the same time, the supervision department should also strengthen the legal education of enterprise employees, especially the management level. Through legal knowledge training, the internal legal literacy of enterprises can be further improved to prevent the occurrence of illegal events [6].

4.2. Reducing the Incentive for Fraud

First, provide diversified financing channels for enterprises. One of the reasons companies are keen to go public is that it is more convenient and non-repayable to raise money after listing. Therefore, from the perspective of the government and society, we can expand a variety of financing routes to alleviate the problem of enterprise capital shortage and curb financial fraud [7]. At the same time, before financing, enterprises need to determine the actual amount of financing needed by enterprises according to the actual operating conditions, repayment ability, market development trend and expected earnings and other factors, and formulate scientific and reasonable financing plan to avoid the subsequent insolvency situation.

Second, improve their profitability. The vast majority of financial fraud listed companies have deviated from the main business to blindly expand the problem. Blind expansion will damage the company's own profitability and cause a large capital gap, which will make the company face liquidity crisis and debt repayment risk. Therefore, in order to reduce the demand for financial fraud of listed companies, enterprises should build a scientific business strategy: first of all, to focus on the main business, the main business is the foundation of its establishment. When looking for the second growth point, listed companies should pay attention not to deviate too much from the main business and be good at making use of the advantages of the original main business. Secondly, listed companies should always pay attention to the turning point of market demand and adjust their own accurate development strategies by tracking market trends.

4.3. Reduce Opportunities for Fraud

Enterprises should improve the internal control management system. Enterprises must attach importance to the construction of internal control system, and constantly improve and optimize the corporate governance structure. In terms of the optimization of the corporate ownership structure, it is necessary to gradually deepen the mixed-ownership reform, adjust the proportion of shares, avoid one dominant company, prevent major shareholders from overriding the internal control and manipulating the interests of enterprises, and safeguard the right of voice of minority shareholders. In improving the internal control of the company, the management and supervision functions of the board of directors and the Board of supervisors should be brought into play. The Board of supervisors, as the supervisory and administrative body of the enterprise, shall ensure the

authenticity of the financial and operating conditions. The relevant management system should be constantly improved and perfected, and supervision should not be a mere formality or lack of power restriction [8].

As an independent third party, the external audit has a relationship with the employer and the employee, so the final report will not be completely impartial and objective. On the basis of relying on third-party firms, an internal audit system should be established to make it clear that the internal audit institution is independent from the management and directly reports the audit results to shareholders or the board of directors. At the same time, the internal audit should also be standardized and institutionalized, the internal audit requirements, responsibilities, rights and methods to make corresponding provisions, and give rewards and punishments, to promote the internal audit staff to improve the enthusiasm, to maintain caution [9].

4.4. Increasing the Likelihood of Fraud Exposure

One is to give play to the regulatory role of the Institute of certified Public Accountants. The institute of certified Public Accountants should strengthen the daily supervision of accounting firms, and take the supervision results as the assessment items of accounting firms, and spot check the audit quality of accounting firms in the enterprise audit work. In addition, the Chinese Institute of Certified Public Accountants should also supervise enterprises to change accounting firms and certified public accountants regularly [10]. Second, we will strengthen supervision over financial institutions. Financial institutions are usually an important link in financial fraud cases. We should strengthen the supervision of financial institutions and increase the punishment of financial institutions as "accomplices", so that financial institutions dare not collude with enterprises. Third, CSRC can improve the existing working system through continuous practice. Strengthen the supervision of enterprises, improve the awareness of self-discipline of enterprises, reduce the possibility of financial fraud from the source, enhance the sensitivity of enterprise financial fraud, timely discover the enterprise financial fraud, and give punishment.

4.5. Increasing the Punishment for Fraud and Violation of Law

China's capital market is still in a state of development, should be in the process of development combined with the current situation of the development of the country and learn from foreign excellent regulatory experience, improve China's relevant laws and regulations. At present, the punishment for financial fraud in China is relatively light, basically based on administrative penalties, and fines are not worth mentioning compared with the proceeds of fraud. The low cost of fraud makes the fraudster unscrupulous and undaunted. In this regard, we can refer to the more mature U.S. market, where financial fraud is punishable by up to 25 years in prison and fines of up to \$25 million for the issuer and \$5 million for the person directly responsible. The high cost of fraud will make the deterrent effect improved, thus reducing the occurrence of fraud [11]. First, the maximum amount of fines and fines for companies and participants of fraud should be reasonably increased as well as the upper limit of prison terms, and perpetrators who seriously disrupt the order of the capital market should be recorded in the breach of trust file and the social credit information network service platform should be fully utilized. Secondly, there is a need to improve the delisting system of listed companies. The current delisting standards in China focus too much on financial indicators, and there is also a need to strengthen the attention to qualitative indicators such as corporate governance, sustained profitability and creditworthiness, and strictly control the quality of listed companies.

Although the newly revised Securities Law and Criminal Law have increased the punishment for securities violators, investors whose real interests have been damaged have not been effectively

compensated, because small and medium-sized investors are on the disadvantaged side of information and mostly file lawsuits only after the acceptors pay fines or penalties, when those involved are basically unable to compensate investors. Therefore, the civil compensation system should be improved and the litigation process should be optimized to save time costs and improve efficiency to protect the legitimate rights and interests of investors. In the event of financial fraud, the amount of illegal proceeds and the necessary civil compensation should be recovered.

5. Conclusion

In this article, we analyze the financial fraud of Star Technology in a systematic and progressive manner, identify the causes of fraud based on the fraud risk factor theory, summarize and identify the fraudulent means, and finally propose relevant countermeasures. There are many reasons why companies commit financial fraud, including the lag of accounting standards, the low moral quality of managers and employees, the lack of internal audit system, the lack of effectiveness of external audit, the lack of resources of government management, and the lack of penalties and the wrong view of performance of government officials. There are many different ways of corporate fraud, so we need to explore the ways to prevent fraud. First of all, improving the construction of the system will reduce the opportunity of fraud; strengthening the supervision and increasing the possibility of exposure. Secondly, increase the penalties to improve the cost of financial fraud; set reasonable goals to eliminate the motivation of fraud. Finally, improve the moral quality level of enterprise managers and form a good enterprise culture.

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