

# *Research on the Identification and Countermeasures of Corporate Financial Fraud Risk: a Case Study of Gansu Huangtai Wine-Marketing Industry Co., Ltd*

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**Abstract:** With the rapid development of China's economy and the improvement of the capital market, the competition among enterprises has intensified. In the context of achieving the goal of maximizing benefits, in order to develop steadily in the market, enterprises have begun to use various means to conduct financial fraud and “whitewash” financial statements. Financial fraud has gradually developed into a common phenomenon of listed companies. This study mainly uses the case analysis method, and mainly conducts research and analysis on the facts of the financial fraud case of Gansu Huangtai Wine-Marketing Industry Co.,Ltd (hereinafter referred to as “HT company”). First of all, the article sorts out the research status of financial fraud in China, and explains its triangular theory, which provides a theoretical basis for future research. Secondly, this study explores the risk identification of financial fraud in general listed companies and discover some clues of HT company's financial fraud behavior from the perspective of financial indicators, more clearly grasp the financial fraud means, and use the financial fraud triangle theory to analyze the fraud motivation. Finally, based on the vertical perspective of the “triangle”, this study summarizes and puts forward measures and suggestions to prevent financial fraud from the perspectives of internal corporate governance and external governance, so as to guide the development of enterprises, reduce the occurrence of financial fraud incidents, and promote the continued stability of the capital market.

## **1. Introduction**

In the capital markets around the world, financial fraud cases often occur, and the impact is very crucial [1]. Under the macro background of the sustainable development of the global economy, the means of corporate financial fraud are becoming more and more diversified and more difficult to detect in advance [2]. Although the relevant regulatory authorities have issued a lot of laws and regulations, in real life, such problems occur from time to time, and it is difficult to stop them. According to the statistical results, in 2020 and 2021, 22 listed companies were imposed administrative punishment by the China Securities Regulatory Commission (hereinafter referred to as the CSRC) for financial fraud, which had a negative impact on investors, the capital market, and

society[3].

Compared with developed countries, China's capital market is relatively new, and the regulatory laws and regulations of the securities market are also not perfect, which means many listed companies have some loopholes in the system, trying to seek greater profits through financial fraud[4-6]. In recent years, China has put forward the “zero tolerance” policy. Under this policy, and under the unified deployment of the CSRC, which investigated many malignant financial fraud cases, from the Roebuck Island scallop “escape” to the history of the largest Kangmei Pharmaceutical Co., Ltd. financial case[7][8]. These bad fraud events have seriously damaged the integrity of the capital market. At a 2020 press conference on dealing with illegal cases, the CSRC announced that the field of financial fraud is expanding, with complex motives and increasingly hidden means[9]. Therefore, this study, through the examination of HT Company's financial fraud event, provides an analysis of why enterprises are willing to take risks on financial fraud, further analysis of its financial fraud, and puts forward the corresponding financial fraud risk prevention measures, perfecting the fraud punishment mechanism[10]. The result of this study will show some significant insights to the regulatory development of China's capital market.

## **2. Overview of the Financial Fraud Case of Ht Company**

HT Company was founded in 1985 and listed on the Shenzhen Stock Exchange in August 2000. The company's business scope includes brewing and selling liquor, wine, etc., is the only listed company famous for its wine in Gansu Province, and is one of the 19 listed companies in the brewing sector in China [11-12]. The company has won the title of famous brand products in Gansu Province for several consecutive years and has won the titles of “National Product Quality Supervision and Inspection Famous Brand Product” and “National Quality Inspection Qualified Product” in China [13-14]. Since 1995, the company has started to develop the wine industry, and now it has 5,000 acres of grape planting area and strictly follows the relevant technical specifications of China. The company has advanced technology and equipment, perfect inspection methods, and a scientific management system. The company mainly produces liquor and red wine, strictly controls the quality of its products, actively expands the market, and becomes a strong, competitive, and dynamic listed company.

## **3. Analysis of the Financial Fraud Case of Ht Company**

### **3.1 Solvency Risk**

This study takes HT company as an example to analyze its debt repayment ability from the medium-to long-term and short-term perspectives. Short-term solvency is the ability to repay short-term debt without selling or handling fixed assets. The long-term liability ability of enterprises is also a very important evaluation index [15-16]. The indicators to measure the solvency of enterprises mainly include: current ratio, quick ratio, asset-liability ratio, and net asset ratio [17].

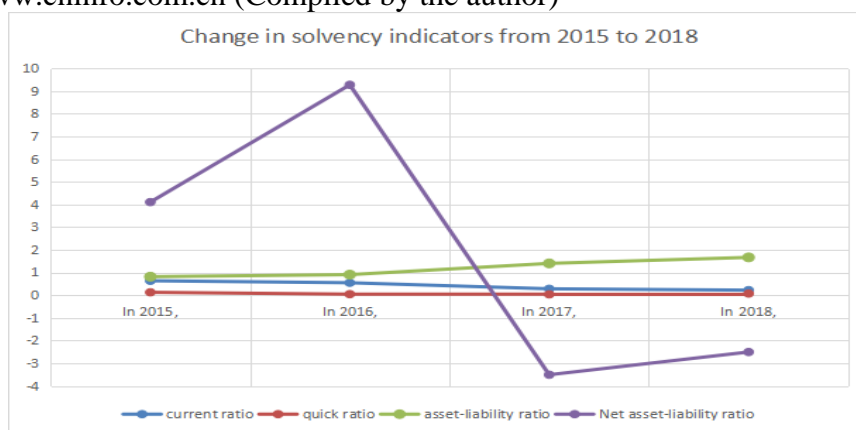
As can be seen from Table 1 and Figure 1, the current ratio and acid-test ratio of HT Company have changed greatly. From 2015 to 2017, the company's current ratio and acid-test ratio have been decreasing year by year, and the short-term solvency has been significantly reduced. Overall, companies with a current ratio of less than 1 have relatively weak short-term solvency. Secondly, as the debt asset ratio of the company increases year by year, the company may have a capital shortage and therefore needs to pay more attention to its debt risks. Under normal circumstances, the company's debt asset ratio is more reasonable in the range of 60%–70%, and when it exceeds 85%, it can be considered a warning. The company must pay full attention to this, indicating that there

may be the possibility of short-term support due to poor capital supply, and we should pay special attention to the debt repayment risk.

Table 1: Analysis of the Solvency during the Fraud Period of 2015-2018

Ratio name	explain	In 2015,	In 2016,	In 2017,	In 2018,
<b>Current Ratio</b>	Current assets and current liabilities	0.63	0.54	0.28	0.22
<b>Acid-test Ratio</b>	(Current assets-Inventory) Current liabilities	0.12	0.04	0.03	0.07
<b>Debt Asset Ratio</b>	Total liabilities Total assets	0.81	0.90	1.40	1.66
<b>Net Debt Asset Ratio</b>	Total liabilities, owners' equity	4.10	9.27	-3.51	-2.51

Data source: www.cninfo.com.cn (Compiled by the author)



Data source: www.cninfo.com.cn (Compiled by the author)

Figure 1: Changes in Solvency Indicators from 2015 to 2018

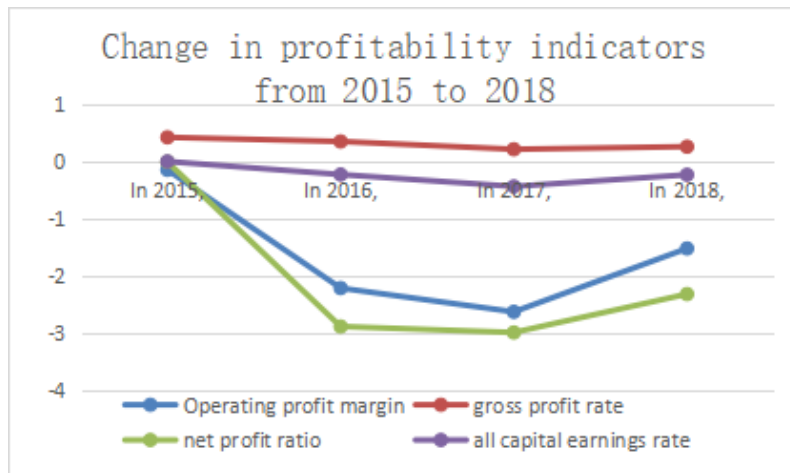
### 3.2 Weak Profitability

The survival of the enterprise is dependent on profit. Its most direct embodiment is asset appreciation [18]. As a result, this paper derives its empirical analysis from the operating profit margin, gross profit margin, net interest rate, return on total assets, and other four aspects. Due to the false records in HT's 2015–2016 accounting statements, according to the announcement data of H T's annual report from 2015–2018, this paper found that the false error reports in 2015 and 2016. Table 2 and Figure 2 show the changes in the data. By comparing the trend of profit-related indicators before and after the adjustment, we can see that in 2016, the four profit indicators of HT companies all declined significantly, and all were low, indicating that the profitability of the whole enterprise is weak.

Table 2: Profitability Analysis during the Fraud Period from 2015 to 2018

Ratio name	explain	In 2015,	In 2016,	In 2017,	In 2018,
<b>Operating Profit Ratio</b>	Operating profit Operating income	-14.73%	-221.09%	-262.55%	-151.94%
<b>Gross Profit Ratio</b>	(Operating income-operating cost) Operating income	42.05%	34.81%	21.21%	25.76%
<b>Net Profit Rate</b>	Net profit operating income	-0.90%	-288.11%	-298.57%	-231.54%
<b>Return on Assets</b>	Net profit on average of total assets	-0.11%	-22.86%	-43.67%	-23.29%

Data source: www.cninfo.com.cn (Compiled by the author)



Data source: www.cninfo.com.cn (Compiled by the author)

Figure 2: Changes in Profitability Indicators from 2015 to 2018

### 3.3 Declining Growth Ability

Enterprises, to maintain competitiveness, must continue to develop. That is, the enterprise's resource transformation and value-added ability improvement, the article from the enterprise's sales development and asset appreciation perspective [19]. Using statistical methods, the operating revenue growth rate, operating profit growth rate, and asset growth rate are selected and analyzed. This is shown in Table 3. The results show that HT company's operating income and operating profit growth rate are not very stable. During 2015–2017, operating profit and total asset growth rate have a significant decline, and during this period, three fees (financial expenses, management expenses, and sales expenses) did not rise significantly but have a trend of decreasing. This means that operating income and expenses have problems and there are potential risks.

Table 3: Analysis of Growth Ability during 2015-2018

Ratio name	Explanation	In 2015,	In 2016,	In 2017,	In 2018,
Operating Income Growth Rate	(Current operating income-previous operating income) / Previous operating income	82.51%	70.14%	-73.23%	-46.47%
Operating Profit Growth Rate	(Operating profit of the current period-Previous operating profit) / Previous operating profit	--	-6026.72%	0.67%	-0.69%
Total Asset Growth Rate	(Total assets of current period-total assets of previous period) / Total assets of previous period	9.18%	-26.81%	-35.74%	-9.40%

Data source: www.cninfo.com.cn (Compiled by the author)

### 3.4 Low Operating Capacity

The efficiency of enterprises in using various assets directly affects their ability to operate their assets. Therefore, the article chooses the turnover ratio of accounts receivable and the turnover rate of total assets, and these indicators are analyzed [20-21]. The details are shown in Table 4 and Figure 3. It can be seen that the receivables of HT company increased significantly between 2015

and 2016 and declined sharply in 2017. Decreased significantly during this period, indicating that the company has adopted relatively strict credit policies and noted the risks brought by the sharp changes in accounts receivable. Usually, a high accounts receivable turnover rate indicates that a company has a higher payment collection rate, a relatively short collection period, low bad debts, rapid asset flow, and good solvency. But during its leave, the asset-liability ratio has increased. The turnover index of accounts receivable is high or low, which is both bad. If there is a large amount of receivables, it will cause bad debts, thus affecting the company's sales scale and profits. During the fraud period, the inventory turnover rate and the total asset turnover rate were also unstable, and they showed a downward trend in 2017, indicating that the same operating revenue consumed more of the company's resources. In general, HT management uses its assets inefficiently and weakly to use its assets.

Table 4: Analysis of Operating Capacity during the 2015-2018 Fraud Period

Ratio name	Explanation	In 2015,	In 2016,	In 2017,	In 2018,
<b>Turnover of Account Receivable</b>	Average operating revenue and accounts receivable	23.94	26.31	14.88	26.43
<b>Turnover of Inventory</b>	Average inventory of operating cost balance	0.22	0.80	0.24	0.27
<b>Turnover of Fixed Asset</b>	Operating income fixed net assets	0.90	2.00	0.62	0.40
<b>Turnover of Total Assets</b>	Average total assets of operating income	0.20	0.38	0.15	0.11

Data source: Cninfo Website: [www.cninfo.com.cn](http://www.cninfo.com.cn) (Compiled by the author)

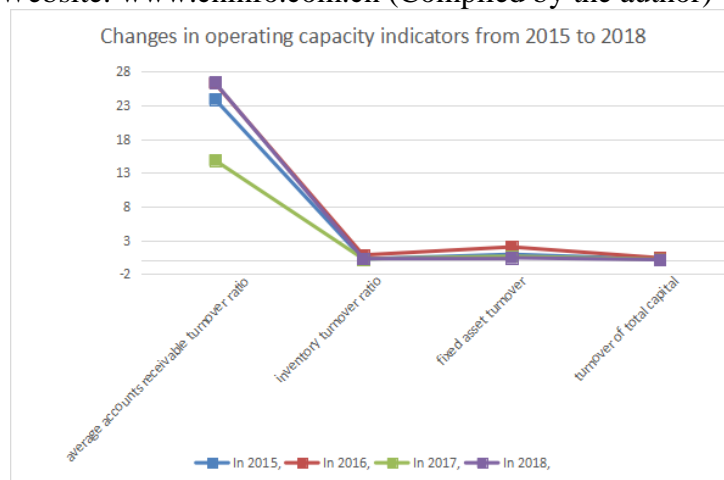


Figure 3: Changes in Operating Capacity Indicators from 2015 to 2018

## 4. Analysis of Financial Fraud Means

### 4.1 The Use of Special Subsidy Funds to Falsely Increase the Income

In 2015, HT company raised a special subsidy of 5 million yuan and transferred it from an investment company to a trading company, then to a winery, and finally allocated it to H T company. As shown in Table 5, the company recognized the government subsidy funds as non-operating income in the 2015 annual report, which constituted an inflated increase in assets. Therefore, the company's total profit reached RMB 5 million[22]. The Company corrected its 2015 annual report in November 2016, including \$5 million in non-operating income and other receivables in 2015 as adjustments, as shown in Table 6.

Table 5: Government Subsidy Adjustment in 2015

Account	Balance for 2015	
	Before Adjustment	After Adjustment
Other Receivables (Government Subsidies)	5,000,000.00	0.00
<b>Non Operating Income</b>	<b>5,000,000.00</b>	<b>0.00</b>

Unit: RMB Yuan

Data source: 2015 HT Company's Annual Report Adjustment (Compiled by the author)

Table 6: Total Assets Adjustment in 2015

Account	In 2015,		In 2016,	
	Before Adjustment	After Adjustment	After Adjustment	Differences from the previous year
Total Assets	541,294,989.85	536,294,989.85	353,553,166.21	-34.07%
Net Assets Attributable to Listed Company	128,471,114.10	123,471,114.10	5,990,246.39	-95.15%
Operating Income	104,519,918.05	104,519,918.05	177,828,067.36	70.14%
Net Profit Attributable to Listed Company	6,344,144.47	1,344,144.47	-165,619,649.31	-12421.57%

Unit: RMB Yuan

Data source: 2015 and 2016 HT Company's Annual Report Adjustment (Compiled by the author)

## 4.2 Inflated Inventory

The company ran a deficit in its inventory in late 2016. In the 2016 annual report, the book balance of inventory was RMB 131.35 million, of which the inventory book balance of the parent company was RMB 130.85 million. However, at the end of 2016, the inventory of the parent company totaled RMB 44.55 million, and the company inflated the book balance of the inventory of goods by RMB 86.30 million, resulting in an increase in total assets and finally inflated profits [23-24].

After verification, the company has a deficit problem in the inventory of goods at the end of 2016. The company controlled by the former chairman, Mr. Lu, still has RMB 30.25 million debt. The reason is due to Mr. Lu's position encroachment, and the company should compensate the company for its losses. At the end of 2016, the company lost RMB 69.19 million in finished wine production. After deducting the recognizable responsible person's compensation of RMB 30.25 million, there is still RMB 38.94 million of compensation that cannot be estimated, so it is all deducted from the current profit and loss [25-26].

## 5. Conclusion

This study starts with the financial indicators of HT company and compares the solvency, profitability, growth ability, and operation ability of HT company, so as to help us better understand the possibility of its fraud behavior. The results show that HT company's financial situation in 2015-2018 is poor, with internal governance problems and poor capital use ability, which belongs to enterprises with low profitability and low turnover rate. Investors should pay special attention to their investment risks. After analysis and research, it is found that the main means of financial fraud of the HT company is to falsely increase the inventory and use the special subsidy funds to confirm the income in multiple amounts. Secondly, HT company's financial fraud motivation is analyzed



from three aspects, which reflects the short-sighted and thoughtlessness of the company's development strategy; it does not consider the long-term development and excessively pursues short-term interests, resulting in irreversible consequences. Through the study and analysis of this case, it is believed that the HT company's fraud is mainly due to the company's own defects and the poor supervision of the external market. First of all, because HT companies do not realize the importance of corporate internal governance mechanisms, the current securities law has ineffective supervision of listed companies and their related intermediaries, and the lack of an information disclosure system and investor protection system of listed companies in China eventually leads to the phenomenon of financial fraud of HT companies. This paper, through the analysis of HT company's financial fraud cases, summarizes its ways and methods of fraud, and discusses how to strengthen the internal control of the company and how to prevent and control the problem, hoping to learn from the experience, enhance the company's internal control, and ensure the quality of accounting information.

Honest management is always one of the social responsibilities that enterprises must fulfill. The financial fraud behavior of the HT companies analyzed in this paper has had a great negative impact on investors, enterprises themselves, and the whole industry and society. Therefore, it is urgent to improve the relevant laws and regulations, strengthen the understanding of the audit work and audit risks of China's listed companies, ensure the quality of the accounting information of China's listed companies, and reduce the company's financial fraud. At the same time, in their business activities, enterprises should pay attention to the company's cultural construction and constantly improve their own quality and ability. Only in this way can we attract investors or be eliminated by the market.

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