

# *Financial Fraud Prevention and Monitoring from the Perspective of Internal Control*

**Tianying He**

*Zhanjiang University of Science and Technology, Zhanjiang, Guangdong, China  
13428593676@163.com*

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**Abstract:** Financial fraud has become a critical concern for corporate management as the global economy has grown in complexity and enterprise scale. Financial fraud not only directly threatens the economic interests of businesses, but it also harms market trust, shareholders' rights and interests, and has a detrimental influence on the overall health of the economy. This paper is dedicated to exploring the multifaceted domain of financial fraud prevention and monitoring through the strategic lens of internal control. Functioning as a linchpin within an organization's internal framework, internal control assumes a paramount role in thwarting and vigilantly overseeing instances of financial malfeasance. A meticulous analysis of the intricate concepts, principles, and frameworks inherent in internal control forms the crux of this study, aiming to unravel the specific applications that bolster its efficacy in preventing and monitoring financial fraud within the organizational milieu. By shedding light on these intricacies, the paper contributes to a deeper understanding of how internal control serves as a proactive safeguard against the intricate challenges posed by financial fraud.

## **1. Introduction**

With the increasing complexity of the global economy and the expansion of enterprise scale, financial fraud has become a serious challenge for enterprise management. Financial fraud not only directly threatens the economic interests of enterprises, but also damages the market trust, shareholders' rights and interests, and has a negative impact on the healthy operation of the entire economic system [1]. The variety of financial fraud involves a wide range of areas, which makes enterprises face great difficulties in prevention and monitoring. As the cornerstone of enterprise management, internal control plays an important role in maintaining the economic order of enterprises and preventing risks. In financial management, the internal control system provides a powerful means for enterprises to prevent and monitor financial fraud by standardizing behavior and supervising information flow. Therefore, introducing the perspective of internal control into the study of financial fraud will help to understand the nature of financial fraud, improve the effectiveness of financial management, and promote enterprises to take a steadier step in risk management.

Through in-depth study of financial fraud prevention and monitoring under the perspective of internal control, this paper aims to provide a series of practical suggestions for enterprises to help

enterprises establish a more complete internal control system and improve the efficiency of financial management [2]. At the same time, for the academic community, the in-depth analysis of the relationship between internal control and financial fraud will provide new perspectives and research ideas for the research in this field.

## **2. The Role of Internal Control in the Prevention of Financial Fraud**

### **2.1 The Design and Implementation of Internal Control**

#### **(1) Internal control framework**

The internal control framework is the basis for the construction and implementation of internal control, which is crucial for the prevention of financial fraud. Enterprises should choose the internal control framework suitable for their own business characteristics and scale. Such as the COSO (Committee of Sponsoring Organizations of the Treadway Commission) framework or COBIT (Control Objectives for Information and Related Technologies) framework [3]. This framework clarifies the components of internal control, including control environment, risk assessment, control activities, information and communication, supervision activities, etc., and provides comprehensive and systematic guidance for enterprises on internal control.

#### **(2) Draw and optimize the internal control flow chart**

The internal control flow chart is a tool to present the internal control activities in detail. Through the clear flow chart, the enterprise can identify and understand the key control points. When designing and implementing the internal control flow chart, enterprises should fully consider each link of the business process, clarify the relevant control measures, and ensure the coherence of the process [4]. With the changes of the business environment, the internal control flow chart also needs to be optimized regularly to ensure its consistency with the actual business Activities.

### **2.2 The Influence Mechanism of Internal Control on Financial Fraud Prevention**

#### **(1) Internal control of employee behavior norms**

Internal control reduces the risk of financial fraud by regulating employee behavior. A clear internal control system can clarify the responsibility and authority of employees in the business process, and prevent employees from using their authority for improper operations.

Enterprises should establish a perfect system of job responsibilities and authority, implement the principle of separation of duties, and ensure that each link in the financial process has the corresponding internal control measures to supervise [5]. In addition, internal control can also improve employees' awareness of internal control and enhance their consciousness of complying with internal regulations through regular training and communication.

#### **(2) Internal control management and supervision of information systems**

With the development of information technology, the storage and processing of financial data of enterprises mainly rely on information systems. Therefore, internal control is very important for the management and supervision of information systems. Enterprises should establish a perfect information system security control mechanism, including the control of system access management, data backup and recovery mechanism, network security and other aspects [6]. Regular information system audit is an important means to ensure the effectiveness of internal control. Abnormal behaviors and potential risks can be found in time through monitoring and analyzing system logs. In addition, enterprises should also pay attention to the development of new technologies and update and optimize the internal control measures of information systems in a timely manner to adapt to the constantly changing information environment [7-8].

### **3. The Influence of Internal Control on the Monitoring Effect of Financial Fraud**

#### **3.1 The Relationship between the Perfection of Internal Control and the Monitoring Effect**

The perfect degree of internal control directly affects the effect of financial fraud monitoring. A sound internal control system can provide a clear audit track, accurate financial information and effective risk management mechanism, so as to improve the monitoring effect of the internal audit team. The lack of internal control system may lead to incomplete and inaccurate information in the audit process, and then affect the monitoring effect of financial fraud. Therefore, enterprises should constantly optimize the internal control system to ensure that it matches the needs of financial fraud monitoring, so as to improve the accuracy and timeliness of the monitoring effect.

#### **3.2 Synergy between Internal Control and Financial Fraud Monitoring**

Internal control and financial fraud detection should form a synergistic effect and strengthen each other. The construction of internal control system needs to fully consider the risk points of financial fraud, to ensure that the internal control measures can cover all aspects of financial fraud. At the same time, the results of financial fraud monitoring should also provide feedback for the optimization of internal control, and encourage enterprises to adjust and improve internal control measures. By establishing a close connection between internal control and financial fraud monitoring, enterprises can more comprehensively prevent the risk of financial fraud and improve the overall level of financial management [9-10].

In the whole monitoring process, the internal control team needs to work closely with the information technology, audit team and other departments to form a multidisciplinary collaborative work pattern, so as to deal with the challenge of financial fraud more comprehensively and deeply.

### **4. Case Study: Xintai Electric Financial Fraud**

#### **4.1 Background Introduction**

Xintai Electric is one of the first listed companies in China's capital market to be delisted due to financial fraud. At the beginning of its establishment, Xintai Electric, as a manufacturing enterprise focusing on power grid equipment, was committed to providing various power services by obtaining funds through listing. However, in the course of its operation after the listing, the company was involved in a wave of financial fraud.

#### **4.2 Description of the Incident**

In 2015, the Liaoning Securities Regulatory Bureau conducted an on-site inspection of Xintai Electric, which revealed the problem that the company's financial data were untrue. Subsequent investigations revealed serious problems in the company's financial management, internal control and other aspects, including major shareholders misappropriating the company's deposits and falsifying means of recovering accounts receivable. Xintai Electric Company was found to have the illegal fact of financial fraud, and was eventually forced to delist by the securities Regulatory Bureau, and made severe administrative penalties to the relevant person in charge.

#### **4.3 The Main Means Adopted By Xintai Electric for Financial Fraud**

- (1) Major shareholders misappropriate the company's deposits  
Wende B, the major shareholder of the company, deliberately misappropriated the company's

deposits and made the company's assets untrue. This behavior not only caused the company to face a tight situation of funds, but also had a substantial impact on the company's financial statements and harmed the interests of investors. Falsifying the collection of accounts receivable, Its fund diagram show in Figure 1.

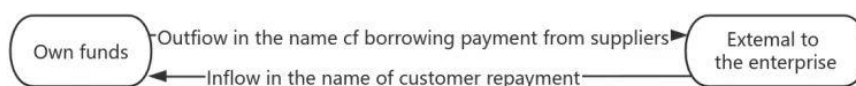


Figure 1: A diagram of the closed-loop flow of funds

The company's top management conspired to increase the company's profits by fictitious collection of accounts receivable. This technique involved the use of borrowers as customers to deceive the company's financial statements in a fictitious manner, concealing the actual state of the business. These show in Table 1 and Figure 2

Table 1: Comparison of accounts receivable balance

Year	Before adjustment	Number of adjustments	After adjustment/ten
2011	16364.50	10156.00	24520.50
2012	17965.12	11792.22	29757.34
2013	22094.22	18377.53	40471.75
2014	41438.60	7262.36	48700.96



Figure 2: Comparison of accounts receivable balance

(2) Failure to follow the approval procedures

The company did not timely disclose related party transactions and did not go through the approval procedures, so that some key information was not disclosed transparently. This led to the inadequacy of the company's internal control and capital supervision, and increased the opportunities for financial fraud.

## 5. Analysis of Financial Fraud Motivation of Xintai Electric

### 5.1 Excuse Analysis

Driven by interests, senior managers such as Wen Deyi have lost their morals and failed to effectively practice the company's culture. Even though Wendeyi tried to make excuses for his

actions after the financial fraud was exposed, the company had already gone down the road of financial fraud the further it went [11].

## 5.2 Stress Analysis

After Xintai Electric went public, the company's top brass faced great pressure from the market and the government due to its poor performance [12-13]. Investors' doubts about the company's profitability and the attention of local governments have put the company under pressure for financial fraud (Table 2).

Table 2: Financial Risk indicators

Financial Risk Indicators	2016-3	2015-12	2015-9	2015-6	2015-3	2014-12	2014-9	2014-6
Asset-liability ratio	48.85	46.24	42.55	46.1	41.11	37.01	35.33	35.34
Current liabilities/total liabilities	97.42	97.01	97.11	97.43	96.75	96.04	96.36	86.81
Current ratio	1.69	1.77	1.94	1.88	2.08	2.30	2.39	2.64
Quick ratio	1.56	1.55	1.67	1.71	1.89	2.08	2.17	2.45

## 5.3 Opportunity Analysis

The internal structure problems of Xintai Electric, including the imbalance of equity structure, the failure of checks and balances on shareholders' rights, and the multiple positions of actual controllers, provided a space for financial fraud to be used. An atmosphere of corruption within the company also encouraged the practice.

## 6. Conclusions

Through a comprehensive exploration of the pivotal role internal control plays in financial management, this paper elucidates its significance in preventing financial fraud. An effective internal control system not only standardizes employee behavior and optimizes business processes but also serves as a proactive measure to prevent potential financial fraud. The establishment and implementation of internal control are imperative not just for regulatory compliance but also form the cornerstone for the stable operation and maintenance of the enterprise's reputation. Delving further, the paper delves into the practical application of internal control in financial fraud monitoring, encompassing aspects such as data analysis and internal audits. By employing data analysis and mining in tandem with internal audit methods, internal control actively identifies abnormal circumstances, facilitating the timely detection of potential financial fraud and enhancing overall monitoring effectiveness.

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