

# *Research on Financial Fraud of Listed Companies from the Perspective of Corporate Governance*

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**Abstract:** Listed companies are important participants in China's capital market, it is of great significance to promote the vigorous development of Chinese market economy and capital market. The fraudulent behavior of financial statements seriously strikes the confidence of market participants in financial statements and seriously affects the healthy and stable development of enterprises. Corporate governance is the distribution system of power and responsibility of different parties in the company formed by the checks and balances of internal mechanism and external mechanism. This paper analyzes the causes of financial fraud of listed companies from the perspective of internal governance and external governance, aiming to raise people's vigilance against financial fraud, and put forward feasible suggestions and measures to prevent financial fraud, improve supervision and further standardize the market to reduce the occurrence of illegal and irregular acts such as financial fraud. It is hoped that the occurrence of similar incidents can be effectively reduced and the healthy and stable development of the Chinese market can be promoted.

## 1. Introduction

With the development of the capital market for more than 30 years, the number of A-share listed companies in China has increased from 13 in 1991 to more than 5000, and the market size has steadily ranked second in the world. As the "power source" of China's economic growth, listed companies have far-reaching significance to the long-term development of China's overall economy. However, with the increasingly rapid development of the capital market, the phenomenon of financial fraud of listed companies has become increasingly fierce, from 2013 to 2021, there are 131 companies that have been punished by the China Securities Regulatory Commission for financial statements fraud. The financial fraud of listed companies not only involves a large number of cases, strong concealment and complex forms, but also causes the unreasonable allocation of social resources and brings serious economic losses to enterprises and their stakeholders. Therefore, it is necessary to conduct in-depth research on financial fraud of listed companies from the theoretical and practical levels.

We see corporate governance as referring to the formal structures, informal structures, and processes that exist in oversight roles and responsibilities in the corporate context [1]. The perfect corporate governance structure can effectively curb the incidence of fraud, and the defective

corporate governance will also become the incentive to encourage fraud. Therefore, it is crucial to prevent the root causes. Based on the core elements of corporate governance, this paper analyzes the causes of fraud from internal governance perspectives such as equity structure, board of directors, board of supervisors and management, combined with external governance perspectives such as industry regulations and audit departments, and puts forward corresponding countermeasures in order to improve corporate governance structure and promote listed companies to achieve long-term development.

## **2. Analysis of Causes of Financial Fraud from the Perspective of Corporate Governance**

Corporate governance is divided into two parts: internal governance and external governance. Internal governance mainly focuses on the distribution and checks and balances between rights and obligations among corporate stakeholders. The board of directors sits at the top of the pyramid of the company's internal control system and determines the appointment and removal of personnel, remuneration and incentives of the management. The management is specifically responsible for the company's operation. Creditors and shareholders, as the providers of the company's capital, have the right to influence the decisions of the company's board of directors and management on the one hand, and are the owners of the company's income or the undertakers of its losses on the other hand. In addition, corporate governance is influenced by legal, political, market, cultural and community influences.

Fraud can be carried out smoothly, not a single department or individual can be completed, which is largely due to the problems in the field of corporate governance. From the perspective of internal governance structure and external governance mechanism, this paper analyzes the motivation of financial fraud of listed companies.

### **2.1 Cause Analysis from the Perspective of Internal Governance**

The occurrence of financial fraud cases leads to the distortion of corporate financial information, and the imperfect corporate governance is usually considered as one of the important reasons. The problems existing in the field of internal governance of listed companies are mainly manifested in the following four aspects.

#### **2.1.1 Imbalance of ownership structure**

In the shareholding structure of listed companies in China, the proportion of major shareholders is too high, the share is highly concentrated, and the proportion of untradable shares is too high, which leads to a series of problems in corporate governance practice, such as serious "insider control", "one share is dominant", and the major shareholders plunder the interests of minority shareholders. Due to the small shareholding share of minority shareholders, they also get less dividends from the company. Under the combined effect of information asymmetry and the high cost of participating in the company's management, it is easy for minority shareholders to not participate in the shareholders' meeting or reduce their enthusiasm, and it is difficult for minority shareholders to play the role of supervision and balance. In this way, large shareholders can control the right to speak at the annual general meeting of shareholders, and the general meeting of shareholders has become a form of "going through the motions". Therefore, this will induce the occurrence of financial fraud.

#### **2.1.2 There is malfeasance on the part of independent directors**

Some independent directors did not play the role of supervision and restriction preset by the

system and did not fulfill their duties. According to the purpose of the independent director system and the current situation of market practice, the focus of compacting the responsibility of independent directors is to seriously investigate the civil liability of major non-performance behaviors such as catering to fraud and serious violation of the duty of care, while eliminating the worries of diligent and conscientious people to avoid the "chilling effect". Not surprisingly, shareholder advocates and business groups have long been proponents of independent board structures [2]. Although some listed companies have independent directors, they fail to maintain an independent and sober attitude in the relevant resolutions, and the supervision effect of independent directors in a virtual form is not good, which will also encourage the wind of fraud.

### **2.1.3 The supervisory board and the internal audit committee fail to supervise**

The supervision effect of the Board of Supervisors and the internal audit Committee is directly related to the level of the internal governance of the company. The current Company Law stipulates the composition of supervisors, which makes supervisors not independent and difficult to exercise their rights. Some listed companies have not established financial risk early warning mechanism, and the internal board of supervisors and audit committee have weak awareness of risk management. The voting situation of the board of supervisors of some listed companies in the resolution documents is similar to the flow of work, and they do not deeply investigate the company's financial status, production and operation, merger and reorganization, connected transactions, and performance of senior executives, etc., and it is difficult to expose the behavior of financial personnel who fabricate business, income and profit. The internal audit committee of many listed companies is only a formal audit, consistently approving all the company's resolutions, and purposeful and planned fraud is difficult to find. It can be seen that the internal control of enterprises does not play a role in supervision and prevention, which provides opportunities for the financial fraud of enterprises.

### **2.1.4 Management did not adhere to corporate ethics**

Corporate culture is an indispensable part of the enterprise, excellent corporate culture can create a good corporate environment, improve the cultural quality and moral standards of employees. The core executives of many listed companies violate ethics and ethics and lack the guidance of excellent corporate culture. As a leader of a listed company, its moral level and legal consciousness will directly affect the overall value orientation of the company's employees, so the core executives should play an exemplary role and set a good example for all the employees of the company. In order to satisfy the purpose of using the funds of listed companies to achieve their own interests, some chairmen and general managers of listed companies take the lead and financial directors and other departments take advantage of the loopholes in the information disclosure system, conceal related parties and related transactions, premeditated financial fraud, swindle the majority of investors and harm the interests of the people, with extremely bad social impact.

## **2.2 Cause Analysis from the Perspective of External Governance**

After more than 20 years of development, China's capital market still needs to be further optimized and improved, and the supervision and regulations of listed companies also need to be further improved, which also provides opportunities for some listed companies to commit fraud. Good corporate governance can slash the impact of systematic risk, and state-owned enterprises (SOEs) are more resistant to systematic risk [3]. From the perspective of external governance, the causes of fraud in listed companies mainly include the following four aspects.

### **2.2.1 Industry regulations are weak**

In the more than 30 years since the establishment of the capital market, the problem of financial fraud has gradually become prominent, and the number of enterprises found and investigated for financial fraud has been increasing, and the means of fraud are various. China's existing relevant laws and regulations lack a reward mechanism for reporting financial fraud. The current laws and regulations on financial fraud punishment is not enough to effectively deter listed companies from financial fraud impulse. Compared with the huge benefits brought by financial fraud, the illegal cost of listed companies is very low, which leads to some listed companies taking risks to commit fraud.

### **2.2.2 External regulators are not doing enough**

External regulatory bodies are not in place. Effective external supervision can promote managers to operate according to law and is an important barrier to protect investors' rights and interests. The CSRC's supervision of listed companies has been questioned by all walks of life, and it is often after all walks of life have paid attention to this case that the CSRC has attracted the attention of. In the lack of supervision environment, it will also cause enterprises to "sword edge", thus embarking on the road of fraud.

### **2.2.3 The external audit department is not diligent**

External auditors failed to do their job. Failure to maintain due professional skepticism and to perform further audit procedures to dispel doubts, resulting in insufficient and appropriate audit evidence. Eventually, the accounting firm issued a false audit report. When providing audit services to listed companies, audit departments shall strictly follow the audit procedures, require listed companies to provide sufficient audit evidence and materials, and issue objective and true audit opinions on this basis.

### **2.2.4 The economic situation is facing serious difficulties**

After the epidemic was brought under control, enterprises restarted production, but the preparation time and production costs increased, resulting in a slow recovery of production capacity. Secondly, as the epidemic is raging around the world, many countries have adopted lockdown measures and entry and exit restrictions, and tourism, aviation and other industries have been hit hard, reducing tourism income and foreign exchange inflow.

The good and bad business performance of a company is directly related to the good and bad market evaluation. Under the influence of national policies and the background of global economic slowdown, many enterprises have poor operating conditions, the main business income has decreased, and some listed companies have always had negative net profit and are in a state of loss. In accordance with relevant laws and regulations of listed companies, their trading may be suspended. In order to continue to survive and develop to achieve the evaluation index of listed companies, some listed companies began to make an article from financial statements.

## **3. Countermeasures and Suggestions to Prevent Financial Fraud of Listed Companies**

### **3.1 Improve the Internal Governance Structure of Listed Companies**

According to the characteristics of the company, improving the internal governance structure and strengthening the construction of internal control and risk management system can effectively improve the level of internal governance. Listed companies can improve their internal governance

capacity from the following four aspects.

### **3.1.1 Optimize ownership structure**

Reasonable ownership structure is the basis for the stability of an enterprise, and the management style of a dominant company tends to be too biased to that of major shareholders. For shareholders who are too extreme, the operation of enterprises is easy to rush to success; Too conservative shareholders will make the business too backward. For example, Lu Zhengyao, the largest shareholder of Luckin Coffee, has a holding of 26%, and other individual shareholders have close nepotism with the largest shareholder, showing the characteristics of a dominant share. Meanwhile, Luckin Coffee's top management has the problem of cross-serving between management and governance.

The wide shareholding ratio among shareholders is more likely to cause financial fraud in enterprises. Therefore, enterprises should set up reasonable shareholding structure, disperse the power of shareholders, prevent one dominant share, and restrain major shareholders from damaging the interests of the company and other shareholders due to personal gain, which is conducive to reducing the fraud caused by senior executives of enterprises to a certain extent. By attracting the participation of social capital to achieve equity diversification of private enterprises, the problem of "one share dominance" can be fundamentally improved.

### **3.1.2 Strengthen the sense of responsibility of independent directors**

The establishment of independent directors in listed companies can make use of the professionalism and independence of independent directors to play the supervisory role of independent directors, check and balance the monopoly and insider control, safeguard the interests of minority shareholders, and improve corporate governance. It suffices for them to share the realization that an external shock to the institutional order will impair their position, or, conversely, improve it vis-à-vis other interest groups [4]. Listed companies fully mobilize the enthusiasm of independent directors to participate in corporate governance, and change the existing independent director selection and exit mechanism by setting a reasonable salary distribution mechanism. From the perspective of regulatory bodies, listed companies increase the punishment of independent directors' malfeasance. For independent directors who have malfeasance, they should be dismissed from their positions, and criminal and civil liabilities should be investigated in accordance with the law, so as to promote independent directors to be diligent and responsible. Second, from the perspective of listed companies, independent directors can be introduced in the form of public recruitment, and professional and professional independent directors can be attracted and hired by market-oriented compensation mechanism. Independent director candidates who participate in the application should be voted by minority shareholders, which can reduce the risk of fraud.

### **3.1.3 Optimize the selection mechanism of members of the supervisory board**

The supervisory Board is a supervisory body independent of management and shareholders, and is mainly responsible for overseeing the company's financial reporting, internal control and audit. If the functions of the board of supervisors are fully developed, accounting fraud can be discovered and corrected in time, so as to ensure the financial security of the company.

First, Select supervisors with financial background. The board of supervisors not only supervises the operation and financial activities of the listed company to safeguard the interests of all shareholders, but also supervises the performance of the board of directors and management. Objectively, the members of the board of supervisors should have strong professional ability, especially should have a certain financial background, so that it is possible to find the problems of the company through the analysis of financial statements. Therefore, when selecting members of the supervisory Board, priority should be given to selecting supervisors with financial background.

Second, ensure the independence of the members of the Supervisory Board. As the supervisory authority of listed companies, the independence of the Board of supervisors is very important. The members of the supervisory board should be composed of management and employee representatives, and the management usually concurrently holds other positions in the company, which makes the members of the supervisory board unable to concentrate on discovering the loopholes of the company's financial fraud. The proportion of employee representatives among the members of the board of supervisors is very low. Therefore, the proportion of employee representatives can be appropriately increased. At the same time, the management should be avoided as far as possible to make the members of the board of supervisors more focused on their work.

### **3.1.4 Improve the selection and appointment mechanism of core executives**

For core executive positions, third-party human resources agencies can be relied on to recruit professionals from the society through market-based compensation mechanisms, so as to achieve a fair, efficient and transparent executive selection process. Similar to Yili's use of restricted stock incentives, the performance of the company is linked to the compensation of the executives, so as to motivate the executives of the company. Under the incentive of market-oriented compensation mechanism, core executives will try their best to improve the business performance of the enterprise. At the same time, the market-oriented selection mechanism can break the "iron rice bowl" color of core executives and make them more susceptible to supervision, so as to urge them to abide by professional ethics when performing their duties and avoid the motivation of financial fraud.

## **3.2 Create a Sound External Governance Environment**

To a certain extent, a good external governance environment can urge managers to abide by business ethics and conduct business activities within the scope of legal constraints. Suggestions on improving external governance are put forward from the perspectives of external regulators and industry regulations.

### **3.2.1 Increase the illegal cost of financial fraud**

We will make good use of the new Securities Law to strengthen the convergence of administrative, civil and criminal responsibilities. The revision of the new Securities Law has greatly increased the penalties for securities violations. At the same time, the Criminal Law of the People's Republic of China has also made corresponding joint amendments, and the crime of "illegal disclosure and non-disclosure of important information" has been severely punished. Therefore, the most important task at present is to effectively link the functions of administrative punishment, civil compensation and criminal punishment, accelerate the strengthening of sanctions against enterprises and individuals who violate the law, and promote the healthy development of the capital market.

### **3.2.2 Increase the illegal cost of financial fraud**

Certified public accountants shall strictly abide by the relevant provisions of the auditing standards, adhere to professional ethics, avoid close contact with the audited entity outside of business, resist the temptation of improper interests, and maintain an objective and independent state. The financial fraud of many listed companies is also more conventional, mainly through fictitious customer and supplier transactions, to create business income, to achieve the purpose of fictitious profits. However, the accounting firm did not find the problem. If it is not the lack of professional standards of the certified public accountants, then there is sufficient reason to suspect that there is a lack of independence and a blind eye in the audit process of the audited entity.

In addition, certified public accountants should obtain sufficient evidence of possible related party transactions, operating cash flow statements and book deposits and other doubts, carry out appropriate further audit procedures, and make corresponding records on audit papers to avoid the loss of audit independence. Certified public accountants should pay attention to the explanation of matters after the audit period, the preparation of audit reports, audit drafts and other contents, especially in the audit of the existence of financial assets, monetary funds misstatement and other behaviors to make an effective judgment.

### **3.2.3 Establish a reasonable market evaluation system**

The relevant departments of the company should pay attention to the problems encountered by the current private economy and effectively introduce targeted policies. For example, during the epidemic period, policies such as tax reduction and rent reduction for private enterprises can be continued, and management should listen to the voice of the market and consider medium - and long-term issues after solving short-term problems. In view of this situation, refinancing standards can be reasonably formulated and evaluated according to local conditions in combination with the actual situation, so as to reduce the pressure of listed companies to continue to survive and develop to reach the evaluation indicators of listed companies and avoid financial fraud.

### **3.2.4 We will strengthen the supervisory role of society and the media**

Due to the asymmetry of information, it is difficult for minority shareholders to grasp the real information of the company. In order to solve this problem, strengthening the supervision role of the society and the media can play a key role. Many of the fraud cases were first raised by netizens and the media, which then led to the involvement of regulators and were eventually verified. Regulators and market investors should encourage society and the media to participate in the external supervision of listed companies and give them appropriate protection, so as to play an important role in the external governance structure of society and the media, and encourage enterprises to abide by the law, so as to create an external environment to curb the breeding of fraud.

## **4. Conclusions**

Based on the perspective of internal and external corporate governance, this paper comprehensively analyzes the causes of financial fraud and draws the following conclusions and Revelations: Financial fraud of listed companies is relatively common in the capital market. Based on the perspective of corporate governance, this paper discusses the financial fraud of listed companies, analyzes the purpose of financial fraud of listed companies, and puts forward corresponding countermeasures and suggestions according to the causes, in order to provide effective reference for standardizing the behavior of listed companies and promoting the high-quality development of enterprises.

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