

A Case Study of Financial Falsification behind the "Face Turning" Performance: Zhengzhou Huajing Diamond Co., Ltd. as an Example

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Abstract: With the development and improvement of the securities market, the high-speed dissemination and high transparency of market information have become the characteristics of the time. As a result, more and more investors pay attention to the financial reports of listed companies in order to obtain their financial status and make investment decisions. At the same time, the revelation of financial falsification of listed companies is also common. Financial falsification not only threatens the healthy development of securities market, but also touches the personal interests of investors. The typical case of Zhengzhou Huajing Diamond Co., Ltd. (Yu Diamond)'s "face-turning" performance has aroused great concern from the society. The continuous falsification of its financial statements has exposed many problems and the authenticity of financial information is worth repeated consideration.

1. Introduction to the Case of Financial Falsification of Yu Diamond

Zhengzhou Huajing Diamond Co., Ltd. (Yu Diamond) disclosed on January 18th, 2020, in "the Annual Results Announcement of 2019" that the net profit attributable to shareholders of the listed company for the year 2019 is expected to be RMB 67,438,000 to RMB 96,340,000. The earnings release disclosed on February 29th also estimated the net profit for 2019 will be about RMB 80,434,000. And on April 3rd, Yu Diamond, which had never incurred any loss since 2007, issued the "Announcement of Revision of 2019 Annual Results Forecast and Results Express", disclosing that the company had incurred a huge loss and the net profit for 2019 was revised from profit to loss of RMB 5,151,497,000.

Yu Diamond's 2019 annual financial data changed dramatically in amount and even direction in just over a month, raising questions from the society. Immediately afterwards, it received the Notice of Investigation from the China Securities Regulatory Commission (CSRC), while a warning letter was issued to the company and relevant responsible personnel. On the last day of 2020, the CSRC informed the investigation of the illegal information disclosure case of Yu Diamond, pointing out that it was suspected of major financial falsification. On August 13th, 2021, the Letter of Prior Notice of Administrative Punishment and Market Prohibition was issued. Yu Diamond abused the principle of prudence and some of the amounts accrued were not adequately and appropriately justified. It pointed out that the financial information disclosure was grossly inaccurate from 2016 to 2019, and the amount of falsification was significant and the impact was widespread, which was a long-term systematic falsification of a serious nature and became a typical case in the securities market.

2. Analysis of Yu Diamond's Financial Fraudulent Approach Based on Financial Statements

2.1 False Entries in the Income Statement - Inflated Operating Income and Total Profit

2.1.1 Income Statement Falsification Approach

Yu Diamond inflated its operating income and total profit by fictitious sales transactions of ornaments and non-ornaments. Among them, the fraudulent sales transactions included false bills and low-value merchandise offsetting, the subject matter of the contract and offsetting merchandise

without actual acceptance and other unusual circumstances. They did not have commercial substance and authenticity, and the economic benefits did not flow into Yu Diamond and should not be recognized as revenue. The above actions resulted in the misstatement of the income statement for the current period, and its inflated amount and proportion are as Table 1 and Table 2 shows.

Yu Diamond also inflated its total profit in 2018 through equity transfer transactions, both of which were the relevant transactions between its subsidiaries, which should not be recognized as investment income. It resulted in false entries in its 2018 annual statements, inflating total profit by RMB 31,766,251.80, accounting for 24.48% of the total profit disclosed in the consolidated income statement for the year.

Table 1 Amount and Percentage of Inflated Operating Income of Yu Diamond from 2017 to 2019
(Amount in RMB)

Annual	Operating Income of Statements Disclosure	Inflated Operating Income through Fictitious Non-Accessory Sales Transactions	Inflated Operating Income through Fictitious Accessory Sales Transactions	Total Inflated Operating Income	Percentage of Inflated Income in the Disclosure of Current Statements(%)
2017	1,532,773,223.28	88,164,327.44	225,550,914.58	313,715,242.02	20.47%
2018	1,240,180,825.52	104,136,405.98	108,258,472.02	212,394,878.00	17.13%
2019	955,446,218.14	27,173,302.51	12,549,075.31	39,722,377.82	4.16%

Table 2 Amount and Percentage of Total Inflated Profit of Yu Diamond in 2017 to 2019 (Amount in RMB)

Annual	Operating Profits of Statements Disclosure	Inflated Operating Profits through Fictitious Non-Accessory Sales Transactions	Inflated Operating Profits through Fictitious Accessory Sales Transactions	Total Inflated Operating Profits	Percentage of Inflated Profits in the Disclosure of Current Statements (Absolute Value)
2017	261,555,738.73	28,274,284.77	26,589,088.12	54,863,372.89	20.98%
2018	129,751,500.98	24,391,944.18	32,712,310.56	57,104,254.74	44.01%
2019	5,169,420,437.45	2,944,127.29	4,058,121.74	7,002,249.03	0.14%

2.1.2 Analysis of Income Statement Falsification Accounts

From Tables 1 and 2, it can be seen that Yu Diamond falsified relatively large amounts of operating income and total profit in 2017 and 2018, and even though the performance level was re-revised in 2019, the falsification could not be eliminated. Reviewing the financial falsification cases revealed by the SEC in previous years, based on the special nature of operating income and profit accounting accounts, management's preference for this falsification was high. The company might make its financial statements present high income and high profit for reasons such as completing its budget, meeting performance assessment requirements, winning the trust of outside financial institutions, attracting more market investors, and stabilizing its share price. Yu Diamond involved a wide variety of transactions. Firstly, it fictitiously made a number of transactions, and then confused the public with the help of diversification of collection methods, so that the transaction activities formed a closed loop and thus whitewash the income statement.

The transfer of shareholding, as a special matter of the enterprise, often involves a large amount of money, which should comply with laws and regulations, satisfy the commercial substance, involve the articles of association, shareholders' meeting recordings, and the related relationship between the counterparties. Yu Diamond took the transfer of equity interest in the subsidiary, in the form of a transfer of money but the actual transfer of control did not occur. Obviously, the listed company might use this fictitious investment income to inflate a large amount of profit.

2.2 False Records in the Balance Sheets - Inflated Inventories, Fixed Assets and Non-Current Assets

2.2.1 Balance Sheet Falsification Approach

First, Yu Diamond fictitiously created inventories through a number of unreasonable purchase transactions, such as lack of invoices, not actually handling acceptance procedures, and unfair transaction consideration, which did not satisfy the conditions for inventory recognition because they did not have commercial substance and authenticity. Second, fictitious equipment renovation business to inflate fixed assets, but the corresponding consideration was not actually paid for this purpose. Third, other non-current assets were inflated by borrowing purchase transactions and engineering construction operations for which payments were made but no equipment or services were received. Fourth, construction in progress was inflated. The above actions resulted in the misstatement of the balance sheet in the corresponding accounting period and the cumulative inflated assets of RMB 1,856,001,384.03 in 2019. Some of the inflated data accounted for a significant proportion of the data disclosed in the actual statements, which had a significant and extensive impact.

Table 3 Amount and Percentage of Inflated Inventory of Yu Diamond in 2019 (Amount in Yuan)

Annual	Inventory of Statements Disclosure	Inflated Inventories	Percentage of Inflated Inventories in the Disclosure of Current Statements (%)
2019	1,152,102,641.37	628,133,252.58	54.52%

Table 4 Amount and Percentage of Inflated Fixed Assets of Yu Diamond in 2019 (Amount in Yuan)

Annual	Fixed Assets of Statements Disclosure	Inflated Fixed Assets	Percentage of Inflated Fixed Assets in the Disclosure of Current Statements (%)
2019	2,801,634,902.62	406,450,000.00	14.51%

Table 5 Amount and Percentage of Inflated other Non-Current Assets of Yu Diamond from 2016 to 2019(Amount in RMB)

Annual	Other Non-Current Assets of Statements Disclosure	Inflated other Non-Current Assets through Purchasing Operations	Inflated other Non-Current Assets through Engineering and Construction Business	Total Inflated other Non-Current Assets	Percentage of Inflated other Non-Current Assets in the Disclosure of Current Statements (%)
2016	665,495,468.89	118,381,400.00	No data	118,381,400.00	17.79%
2017	495,382,680.81	138,381,400.00	No data	138,381,400.00	27.93%
2018	1,206,693,646.55	116,122,691.42	No data	116,122,691.42	9.62%
2019	879,400,028.31	789,872,047.90	31,546,083.55	821,418,131.45	93.41%

Table 6 Amount and Percentage of Inflated Construction in Progress of Yu Diamond in 2018 (Amount in RMB)

Annual	Inflated Construction in Progress of Statements Disclosure	Inflated Construction in Progress	Percentage of Inflated Construction in Progress in the Disclosure of Current Statements (%)
2018	1,128,573,145.11	155,517,241.38	13.78%

Table 7 Amount and Percentage of Total Accumulated Inflated Assets of Yu Diamond in 2019 (Amount in RMB)

Annual	Total Assets of Statements Disclosure	Total Accumulated Inflated Assets	Percentage of Total Inflated Assets in the Disclosure of Current Statements (%)
2019	7,378,844,290.90	1,856,001,384.03	25.15%

2.2.2 Analysis of Balance Sheet Falsification Accounts

Inventory, as a current asset that accounts for a large portion of an enterprise, is usually costly to verify its accuracy and has a higher risk of misstatement compared to other accounts. As a high-tech manufacturing enterprise integrating professional research, production and sales, Yu Diamond had a large scale, complicated business and a large number of transactions. It had complex cost basis, with diversification of non-accessory semi-finished products and accessory finished products. And it is difficult in accurately assessing the net realizable value of inventories. All these factors increase the possibility of falsification with the help of inventory accounts. From Table 3, we can see that the amount of inventory inflated by Yu Diamond in 2019 accounted for more than half of the inventory disclosed in the current statements, which is a serious situation.

For high-tech manufacturing enterprises, it is difficult to assess the accurate value of fixed assets such as major machinery and equipment. Yu Diamond made a lot of technical upgrades to its machinery and equipment, which made the audit evidence insufficient to judge the reasonableness of the value of its machinery and equipment and the appropriateness of the provision for impairment, and took the opportunity to fictitiously make subsequent expenditures on fixed assets. For a portion of the expenses transferred to the beneficial owner, Yu Diamond recorded as an increase in other non-current assets and construction in progress. This resulted in the proportion of the fictitious increase in other non-current assets in 2019 to the current period's report. A series of falsifications resulted in an inflated final total asset value of more than \$1.8 billion for fiscal 2019, a staggeringly realistic figure.

2.3 Other False Statements and Material Omissions in the Annual Report

Yu Diamond also had non-operating appropriation of funds of up to RMB2.3 billion by the controlling shareholder and its related parties. It failed to comply with the required disclosure of affiliated guarantees and external guarantees totaling more than 4 billion, and failed to disclose projected liabilities and contingent liabilities as required. The disclosure of the "2019 Annual Results Forecast" and "2019 Annual Results Update" are suspected of false record.

All the above-mentioned issues are sensitive issues that have been widely concerned by the community. Failure to disclose the non-operating appropriation of funds by the controlling shareholder as required is undoubtedly a violation of the law, and one's own gratuitous appropriation of funds is detrimental to the interests of other shareholders. In order to deceive financial information stakeholders, some enterprises make use of unreasonable related party relationships and create the illusion of profitability to whitewash financial statements and provide false information. Undisclosed external commitments and guarantees involve the issue of business risks of enterprises and the higher risk of assuming joint and several guarantee responsibilities, which undoubtedly have an impact on the company's continuous operation and thus influence the decision of financial statement users. Yu Diamond's annual report disclosed false records and material omissions due to the loans, guarantees and other significant commitments involving 74 lawsuits, while the amount of lawsuits involved and the amount of accrued estimated liabilities are large.

3. Revelations and Suggestions of Financial Falsification of Yu Diamond

3.1 Strengthen the Ethical Construction of Enterprise Management and Accounting Practitioners

The first article in the creed of the corporate culture of Zhengzhou Huajing Diamond Co., Ltd. is "A carat of loyalty is greater than infinity". Now that the performance has slumped greatly, and we cannot help asking: "what is loyalty? "

Since 2016, Yu Diamond has started financial falsification. Guo LiuXi, as the actual controller, chairman and secretary of the board of directors of the company, organized, planned and participated in the illegal acts involved, controlled and made decisions on the large amount of capital flow of Yu Diamond, and occupied the funds of the listed company with non-operating items. Through fictitious purchase transactions and other ways to falsify assets and performance, it aimed to form a closed loop of funds, while most of the funds eventually returned to Guo Liuxi, the actual controller. At the same

time, Guo Liuxi led the board of directors' resolutions on the guarantees involved, provided guarantees and external guarantees for the actual controller and its related parties, and did not disclose them in accordance with the law. In the whole long-term, organized and premeditated fraudulent activities, the top managers who knew and concealed it should not be few, which can't help but make people jaw-dropping.

Strengthening the ethical construction of corporate personnel is a matter of internal environment cultivation, which is the basis of corporate operation. As directors and senior management of a company should have high moral quality, dedication, professional ethics and social responsibility. They should abide by the company's articles of association, stand at the social level for the sake of the majority of investors and set a good example. The moral quality of the company's top management will influence whether a company can develop healthily and permanently in the capital market. In addition, the grassroots accounting practitioners should also establish the correct concept of professional ethics and enhance the basic ability to distinguish right from wrong. They should not be easily swayed in the face of temptation and act in full accordance with the company management's orders. Moreover, they should promptly expose the illegal acts instead of pushing the public trust.

3.2 Improving the Company's Internal Control System

Yu Diamond had a concentration of power and the decision power of subordinate departments is limited. When the chairman was leading the case, no one raised a denial. Supervisors and independent directors did not play their supervisory roles and had stated in their work reports that they did not find that the company, its directors and senior management had violated the law or that there were special circumstances. It is evident that the internal control is like a void, and the internal control at the grassroots level is not functioning, and the internal management system is seriously failing.

The existence of internal control is to ensure the legal compliance of business management and the reliability of accounting information, and to improve the efficiency and effectiveness of business management. Most of the enterprises in China only focus on the establishment of the system but not the implementation, resulting in generally weak internal control. Therefore, it is suggested that they should strengthen the implementation, based on the establishment of the internal control system. Internal control should not be a pavilion in the air, but should be deeply rooted in the daily operation and management. The corporate governance structure should be improved to prevent the lack of checks and balances by a small number of major shareholders who control the staffs seriously. The internal audit organization should be improved to follow the principles of independence and authority so that internal auditors can perform their duties fruitfully.

3.3 Strengthening External Supervision of the Company

From 2016 to 2018, the Company's external auditor has issued an unqualified audit report. The problem was not discovered until after the "face-turning" of the performance in 2019, which led to a high degree of social concern, and the audit reports with qualified opinion and unavailable opinion were issued thereafter. The fraudulent approaches of Yu Diamond mostly utilized the common ways of manufacturing companies, such as inflating income, profits and fictitious transactions to increase assets. The circumstance of the concealment also is considered as a more sensitive issue for listed companies, such as non-operational appropriation of funds, providing external guarantees for the actual controller and related parties, etc. It can be seen that the quality of review by external supervisory bodies needs to be further improved.

Nowadays, market environment places higher requirements on certified public accountants, and they are facing greater challenges. They should raise their risk awareness, improve their professional competence, enhance their independence and strengthen their prudence. For items with higher risk of misstatement such as income, inventory and accounts receivable, audit procedures should be improved. CPA practice standards should be strictly observed, risk assessment procedures should be implemented, materiality levels should be reduced, audit evidence should be increased and audit quality should be improved. Financial falsification should be made public in a timely manner to protect the healthy development of the securities market as soon as possible.

4. Conclusion

This paper analyzes the approaches of financial falsification and the problems exposed by listed companies through the case of financial falsification arising from the "face-turning" of Yu Diamond's performance. Under the warning of the typical case, it is necessary to further improve the market mechanism and increase the supervision of external auditors to prevent the financial falsification of listed companies. Listed companies should also strengthen self-regulation, pay attention to the cultivation of corporate ethics, eliminate financial falsification, and create a healthy market environment.

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