

Analysis of Reasons for Financial Fraud of TY Shares

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Abstract: China's capital market lags behind that of western countries. The Shanghai Stock Exchange, the first stock exchange after China's reform and opening up, was formally established on November 26, 1990, and the Shenzhen Stock Exchange began its trial operation on December 1, 1990. The overall market has great potential for development. So far, there has been a fairly good market scale. No matter from the number of listed companies, the amount of financing and investment, or the number of shareholders involved, we can see the vigorous development of securities in China. However, in recent years, financial frauds of listed companies in China have frequently occurred, such as the inflated huge amount of money of Kangmei Pharmaceutical, the illegal disclosure of information by Wanfu Shengke, and the fraudulent issuance of shares by Green Land, such as the falsification of documents and fabricated statements by Yinguangxia, etc. From a macro point of view, financial fraud disturbs the order of China's capital market, reduces China's ability to allocate resources in the market and hinders the sound development of the capital market. Due to the various financial fraud methods of TY shares, the inflated operating profit amount is huge, the personnel involved are numerous, and the fraud case is serious, which was given the top punishment by the CSRC and 2019. Therefore, it is necessary to analyze the financial fraud cases of TY shares, which can be used as a reference for subsequent financial fraud of other companies and also as a warning for other companies.

Keywords: Financial fraud, TY Group, Internal control

1. Introduction

With the continuous progress of science and technology and the rapid development of economy, the scale of the capital market in the world is also growing, and each enterprise realizes that listing brings convenience to its operation and fund raising. As a result, the number of listed companies is gradually increasing, which leads to the gradual improvement of the standard of listed companies in the securities market. Some of these enterprises are unable to maintain a good corporate profitability, which makes it impossible to maintain their listing qualification. Therefore, if you want to protect your listing qualification by using financial fraud, or if some listed companies want to obtain a huge amount of liquidity, you may beautify the financial statements by using financial fraud, and attract investors to invest in them by using false earnings. ^[1]This is one of the main reasons for the endless cases of financial fraud. However, nowadays, some ways and means of fraud are relatively hidden, with various means, not to mention the fact that these enterprises have invested a certain amount of time, cost and resources. Under such circumstances, it is often difficult for certified public accountants to detect such long-term and deliberate financial fraud by enterprises. Such behavior has a serious impact on the sound development of capital market, causing a certain degree of lack of market confidence and a negative impact on the normal order of capital operation. ^[2]

2. Relevant Theories

2.1. Iceberg Theory

In 1895, the iceberg theory was put forward by psychologist Freud in his research, and was introduced into the study of financial fraud by Bologna of the United States and Lindquist of Canada, thus being well known by people. The theory compares fraud to an iceberg at sea level. What is exposed at sea level is only the tip of a small part of the iceberg. Above and below sea level are two components of fraud. What is exposed at sea level is the structural part of financial fraud, while what is hidden below sea level is the behavioral part of financial fraud. ^[3]The reason why the iceberg can be

exposed to the sea level is because the iceberg above is an objective fact that is exposed to everyone's eyes, such as the unreasonable internal control system of the company, the unreasonable equity structure of the company, the unreasonable cross-check relationship between the profit statement and the balance sheet in the financial statements, and the company's organizational goals, etc.; The part of the iceberg hidden in the sea water that is not easy to detect is the behavior part, while the behavior part is bigger and more dangerous. More performance is invisible and cannot be quantified, including the feelings of the internal management personnel of the company, the personal values embodied, education level and education environment, etc.

2.2. GONE Theory

GONE's theory is gradually derived from the iceberg theory and was put forward by Bologua in 1993. GONE is the first letter of four English words. G stands for greed, which means greed. O represents an opportunity, which is an opportunity; N stands for needed and refers to need; E stands for exposure. The four factors of GONE constitute the motivation of financial fraud and are also the most widely used fraud motivation theory.

2.3. Information Asymmetry Theory

With the continuous development of modern enterprises, the internal functions of the enterprises are gradually separated, and different authorities such as the board of directors, the board of supervisors, etc. are formed. These authorities, after a reasonable division of responsibilities, manage the daily production and operation activities of the enterprises to meet various management needs of the enterprises. Therefore, the information users in the internal environment of the enterprise have a unique position advantage. Compared with the external information users, the information they have access to is more convenient and accurate. External information users mainly include investors, creditors, regulators, the public and so on. ^[4] The enterprise information obtained by these external information users is also different due to the different location and environment. This results in the personnel participating in the management inside the enterprise being able to obtain more relevant information of the enterprise by virtue of their own position advantages. There is a difference in the information users' ability to obtain information between inside and outside the enterprise, which in turn results in asymmetric information obtained inside and outside the enterprise. Then for financial fraud, internal personnel of the enterprise commit financial fraud to conceal relevant financial information and whitewash financial data from external information users in order to meet specific purposes or seek personal gain. It is also based on the gap between the internal and external environment of the enterprise, which cannot be bridged, and based on the asymmetry of information obtained inside and outside the enterprise, that financial fraud occurs.

3. Case Presentations

3.1. Theory Introduction of Company

TY shares, formerly known as Shandong Jinan Department Stores, was founded in 1955 and is subordinate to Jinan No.1 Commercial Bureau. In 2010, TY Group became the first controlling shareholder of TY Shares. The principal businesses of TY Shares include ore mining, real estate development and sales, and financial services, etc. The main business of the mining industry is the exploration and development of precious metals mainly including gold, and also includes the processing, mining and sales of ores; The Company carries out the real estate business with the concept of independent development and sales. The main business of real estate includes the construction and sales of residential and commercial houses, and the major links involved in the real estate development process, such as land acquisition, site selection planning, construction commencement, follow-up house sales and operation, etc.; financial business mainly includes small loan business, finance lease business and commercial factoring business. ^[5]

3.2. TY review of financial fraud cases

In 2017, during the equity transfer transaction with China Youth Equity Investment Co., Ltd., TY Company recognized the investment income as current income when the actual control right was not transferred, resulting in the inflated operating profit of approximately RMB145.97 million in 2017. ^[5]

In addition, during the period from January 2016 to June 2018, TY shares concealed significant related party transactions with TY Group and its subsidiaries for personal gain, with transactions between related parties amounting to RMB1.9 billion; From 2016 to 2018, TY shares not only provided huge amount of guarantee to related parties in violation of relevant regulations, but also failed to disclose truthfully to the public to protect shareholders' right to know; From September 2017 to the end of 2018, in order to stabilize the external investors, TY Shares did not disclose the default of the unsatisfied debts truthfully, and did not disclose the major lawsuits and arbitrations occurred during this period in a timely manner.

4. Defects in Corporate Governance

4.1. Equity interests are relatively concentrated

In GONE's theory, the opportunity factor is the fraudulent means and ways adopted by fraudsters when they commit financial fraud. Internal opportunity factors are related to the internal environment of the company, including the internal governance structure, equity structure, internal control system, etc. In the risk factor theory, it also shows the effect and influence of opportunity factor on financial fraud. In the financial fraud case of TY shares, it can be seen that the main "opportunity" is caused by the loopholes in the company's equity structure.^[6]

If an enterprise wants to continue to operate effectively, it needs to maintain its own good internal organizational environment, including the internal equity structure of the company, corporate governance institutions, etc. The internal equity structure of the enterprise is especially important. The general meeting of shareholders is the highest authority within the company. It is composed of all shareholders. All members of the general meeting vote on the company's next major development strategies and decisions through the convening of a general meeting. The voting result adopts the principle that the minority is subordinate to the majority. Therefore, if the ownership structure of the company is unreasonable and the ownership concentration is too high, the voting rights will be concentrated in the hands of the majority shareholders, which will enable the majority shareholders to control the company's major development strategies and decisions. At the same time, because the minority shareholders have less equity, even if they express their opinions on a certain strategy and decision, the final voting result of the shareholders' meeting may only be consistent with the majority shareholders' idea, but deviate from the minority shareholders' idea.^[7] Therefore, excessive concentration of equity may damage the voice of minority shareholders and suppress the enthusiasm of minority shareholders. Such excessive concentration of equity may also cause the majority shareholders to disregard the interests of the company and the minority shareholders in order to obtain personal interests. And the power in the hands of the majority shareholders enables them to have the conditions and capital to force the relevant management personnel or financial personnel to commit financial fraud. Therefore, the unreasonable ownership structure also provides opportunities for financial fraud and increases the possibility of financial fraud.

4.2. Directors, supervisors and senior management are controlled

According to GONE's theory, the opportunity factor includes the failure of corporate internal governance structure. Looking at the announcement of the Shanghai Stock Exchange and the punishment letter of the CSRC, we can see that the punishment result of TY Shares includes all the directors, supervisors and senior executives who were in office during the fraud period, which further proves that the directors, supervisors and senior executives of TY Shares have lost their due supervision and management role, and there is no evidence in the announcement that the above-mentioned directors, supervisors and senior executives have performed their duties diligently. Most of the directors, supervisors and senior management had concurrently held positions or held shares in the related party company of Zeng Zhaoqin, the actual controller. TY Group is the largest controlling shareholder of TY Shares; General Holdings was the second largest controlling shareholder of TY Shares in all years except 2016, which was the fourth largest shareholder of TY Shares; Jinyuan Company is a Sun Company indirectly controlled by TY Shares through TY Gold. Most of the directors, supervisors and senior executives work or hold shares in the related companies of TY Shares, and the financial fraud of TY Shares lasted for 5 years. Therefore, it can be inferred that the directors, supervisors and senior executives have a high probability of being controlled and directed by Zeng Zhaoqin, forming a consensus of action with

Zeng Zhaoqin and forming a concerted action person.^[8] Then the failure of the board supervision system and the imbalance of the governance structure of TY Shares are the opportunities for TY Shares to commit financial fraud.

4.3. Failure of internal control

The internal control system is a system established within an enterprise to make various activities within the enterprise operate more efficiently and more competitively in the increasingly fierce external competitive environment. It enables various businesses to be interrelated and mutually restricted. The most important and important aspect of the internal control system is to ensure the authenticity and integrity of production and operation information and financial information, especially in the detection of financial fraud and the prevention of financial fraud, effective internal control is more important.

According to the 2017 internal control audit report issued by Ruihua Certified Public Accountants on TY Shares, during the audit of TY Shares, two major defects were identified in the internal control of the financial report of TY Shares: the first major defect was the external guarantee amount of 1,167 million yuan provided by TY Shares, which violated the relevant provisions of the Measures for the Administration of External Guarantees of Shandong TY Shares. The second significant defect was that TY Shares did not fully accrue the borrowing costs of RMB212,462,200 in accordance with the borrowing contract when preparing the financial report. According to the quantitative criteria for evaluating the internal control defects of TY Shares, misstatement of more than 0.4% of the total operating income constitutes a material defect in internal control. The operating income of TY Shares in 2017 was RMB1,836,799,000, the 0.4% of the total operating income was RMB7,737,000, and the misstatement of RMB212,622,000 was as much as 28 times of the quantitative criteria for material defects, which was enough to show that internal control in TY Shares did not effectively identify its major defects, did not achieve the desired effect, and internal control lost its effectiveness.^[9]

In the financial fraud case of TY Shares, the Company manipulated the financial data by improperly recognizing the investment income, not recognizing the construction cost in a timely manner, concealing related party transactions, providing guarantees in violation of regulations, manipulating income tax expenses, etc. However, in the internal control evaluation report issued by TY Shares in 2014-2016, it was shown that TY Shares considered that the Company had neither significant internal control deficiencies in financial reporting nor significant internal control deficiencies in non-financial reporting. The Board considers that the Company's internal control is effective, and the Company's internal control can basically meet the regulatory requirements of the securities regulatory authorities on the management of internal control systems of listed companies in all aspects.

5. Conclusion

The development of China's capital market has always been accompanied by financial fraud. Although the functions of China's capital market are gradually improving, there are still some loopholes. Some listed companies have the opportunity to conduct financial fraud to cheat the investment in the market, which affects the fairness and justice of the market and the order of the market. TY Shares began to commit financial fraud in 2014, but the case was not exposed until 2017, when Ruihua Certified Public Accountants presented an audit report that could not express an opinion. From the disclosure of the incident to the issuance of the administrative penalty in October 2019, the CSRC took one and a half years.

Based on the theory of fraud GONE theory and iceberg theory, this paper analyzes the motivation of financial fraud of TY shares, and finally puts forward specific suggestions from the perspective of corporate governance. Through in-depth study and analysis of this case, the motives of financial fraud can be identified from the source, so as to prevent and prevent financial fraud of listed companies. It can improve and ensure the quality of financial information of listed companies, and can provide certain help to improve the capital market environment. It is also expected to provide certain reference for the prevention and governance of financial fraud of listed companies in China.

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