Analysis and Countermeasures of Financial Fraud of Listed Companies—Taking Greencool Incident as an Example

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Abstract: The sustainable development of China’s economy stimulates the continuous increase in the number of listed companies, and the competition among them is also intensifying. Financial fraud is used to cover up the real operation of the company, which has a serious impact on the order of economic development. So, it is necessary to analyze the causes of financial fraud of listed companies, and we need to deal with the behavior from the root. Therefore, this article selects one of the typical cases in this field, Greencool incident, and combines with the fraud triangle theory to explore the essential causes of financial fraud, and puts forward relevant governance countermeasures, so as to reduce the occurrence of financial fraud.

Keywords: Financial Fraud; Greencool Incident; Fraud Triangle Theory; Governance Countermeasures

1. Introduction

Since the 21st century, the phenomenon of financial fraud in China’s listed companies has emerged one after another. Financial fraud is a serious violation of market operation rules and threatens the sustainable development of China’s economy. Therefore, how to deal with financial fraud is of great significance. Based on this, this paper, which takes the Greencool incident as an example, will use the fraud triangle theory to analyze the causes of financial fraud and put forward reasonable countermeasures.

2. The concept of financial fraud

Financial fraud is a kind of illegal behavior that listed companies intentionally misrepresent or ignore the figures or notes of financial statements in the balance sheet, income statement and cash flow statement published by the company in order to deceive the users of reports[1]. This behavior has damaged the market participants’ confidence in financial information, weakened the effectiveness of corporate governance, and worsened the quality of audit function. It urgently needs governance and prevention.

3. Case analysis of financial fraud—Based on the fraud triangle theory

3.1 Review of Greencool incident

Gu Chujun, the core figure of the Greencool incident, established Greencool Co., Ltd. in Canada in 1992 and returned to China to establish Greencool refrigerant (China) Co., Ltd. in Tianjin in 1995. The Tianjin company is mainly
engaged in the production of Greencool refrigerants, which is the largest non-fluorine refrigerant production base in Asia. But the company’s real production situation is not known to the outside world. In October 2001, Greencool purchased Kelon Electric appliances (2). Since then, the Greencool incident has begun to take shape. Gu Chujun used the 187 million yuan of capital was registered in Shunde Greencool by means of repeated reverse (2) and repeated account transfer. The state-owned land was defrauded and the preferential land-use rights related interests obtained by Jiangxi Kelong, a wholly-owned subsidiary of Kelon Electrical appliances, were defrauded; secret accounts were opened and funds were transferred illegally as high as 355 million yuan; absorbed 176 million yuan of sales money from Kelon Electric appliances through related party transactions, and at the same time forced to buy and sell, forced to sell refrigerant to Kelon Electrical appliances in the name of other companies, defrauding payment of 40.8 million yuan.

There were countless financial frauds in the Greencool incident, which caused serious misrepresentation of Kelon Electric’s financial reports from 2002 to 2004, inflating profits by 120 million yuan, 114 million yuan, and 149 million yuan respectively. In the 2003 cash flow statement, the “cash received from borrowings” was under-counted by 3.026 billion yuan, the “cash paid for debt repayment” was under-counted by 2.136 billion yuan, and the cash flow from operating activities was over-counted by 890 million yuan.

The Greencool incident occurred in the period of economic transition, involving Deloitte & Touche Tohmatsu, one of the “four largest” accounting firms. At the same time, it was mixed with many topics such as “the dispute between Lang and Gu” and the loss of state-owned assets. This incident has attracted attention from all walks of life and is a typical case of financial fraud. Therefore, this article takes the Greencool incident as an example, which is more representative of research.

3.2 Financial fraud motivation

The fraud triangle theory was proposed by W. Steve Albrecht, the founder of the American Association of Certified Fraud Examiners (ACFE) and the current president of the American Accounting Association. He believes that the formation of corporate fraud is composed of pressure, opportunity and rationalization (3). Just as it is necessary to have certain heat, fuel and oxygen to burn at the same time. Without any of the above elements, it is impossible to truly form corporate fraud. Therefore, based on the fraud triangle theory, this paper analyzes the fraud motivation of Greencool incident, as shown in Figure 1.

3.2.1 Pressure—Financial performance

The factor of pressure is the motivation of corporate fraudsters. According to the public financial statements of Greencool technology, in 1998, the company’s income was only 110,000 yuan, and the profit was -8 million yuan. In order to make up for the loss, Gu needs to absorb funds by means of a large number of acquisition schemes. In order to
attract shareholders’ investment, Gu needs to make the financial performance of the merged enterprise remain excellent on the surface. Therefore, he manipulated Kelon Electric to inflate the profit of the annual report through fictitious sales business[4], so that investors mistakenly believed that the business situation of the enterprise after acquisition was booming and constantly invested in it.

3.2.2 Opportunity—Internal control deficiency

The opportunity element refers to the environment where fraud occurs. The Greencool incident took place in the context of “national retreat and private advancement”. The local government was eager to deal with companies with difficult business conditions but good production conditions and market foundations. At the same time, Kelon’s internal governance has already suffered serious defects. Gu Chujun used his strong control over Kelon, at the cost of other shareholders’ interests, to make profits for Greencool by taking advantage of the opportunity of “national withdrawal and private advancement”, which led to Kelon falling into a new crisis[5].

3.2.3 Rationalization—Misinterpretation of legal provisions

When the company satisfies the two factors of pressure and opportunity, it only needs to find a self rationalization excuse to cover up the nature of financial fraud[6]. The essence of excuse element is a kind of individual moral value judgment. Gu Chijun deliberately exploited legal loopholes and misinterpreted the legal provisions during the period of economic transition, and registered with Shunde Greencool to make it conform to the relevant provisions of the company law on the surface. At the same time, he entered the acquired company as a director and manipulated the operation of the company in the so-called “rationalization” way, making the company easier to be acquired.

4. Governance countermeasures

4.1 Improve the governance structure of the financial system

As part of the Greencool incident, Kelon had a cash inflow and outflow of RMB 7 billion, which was seriously abnormal. In addition to the superb means of fraud operation, the Greencool incident can also realize the high level of cash fraud, and it is also the defect of bank governance structure. Besides, the Greencool incident has designed securities, banking and other fields[7]. It is far from insufficient if it is only controlled from the bank level. Therefore, it is necessary to improve the entire financial system and strengthen cooperation and supervision among various fields and departments, so that a large amount of undisclosed financing information of Greencool can be found as soon as possible.

4.2 Design effective audit procedures

One of the important reasons why the Greencool incident was a sensation was that it involved Deloitte & Touche Tohmatsu. This is Deloitte’s Waterloo incident. As Kelon’s auditing agency, Deloitte’s audit reports’ credibility can attract more investors. However, in this incident, the issue of Kelon’s sales revenue recognition reflects Deloitte’s failure to properly interpret and apply accounting standards. At the same time, it also shows that Deloitte has failed to collect sufficient and appropriate audit evidence[8]. For “sales return”, Deloitte did not implement the necessary audit procedures. It can be seen that the four major firms taking Deloitte as an example should make substantial adjustments in accordance with the characteristics of financial fraud in Chinese listed companies, and design audit procedures in line with Chinese accounting standards, rather than purely pursuing formal perfection.

4.3 Establish an effective internal control and supervision system

The reason why Gu can quickly control Kelon with super strong control is that Kelon’s internal control and supervision system has serious problems, and the company’s independent director system has been in name only. Therefore, enterprises need to establish an effective internal control and supervision system, and form a right balance mechanism among the shareholders’ meeting, the board of directors and the board of supervisors[9], so as to avoid the loss of corporate control and prevent financial fraud.
4.4 Maintain independence and optimize the audit environment

The phenomenon of financial fraud is still not perfect if only relying on external audit to detect. If an external audit institution has insufficient professional competence or bad accountants, it is easy to cause major losses. In order to reduce the risk of major misstatements, companies should continuously improve and optimize the internal audit environment. When performing internal audit work, adhere to the principle of independent audit\(^1\), not be controlled by shareholders or senior management. Companies should clarify their audit responsibilities, prevent audit risks, achieve a two-way drive for internal and external audits, try their best to reduce audit misreports, and detect and manage financial fraud in a timely manner.

5. Conclusion

Greencool has been delisted, but scams similar to the “Greencool incident” continue to unfold. Financial fraud incidents such as Kangmei Pharmaceutical, Erkang Pharmaceutical, and Ruixing Coffee have attracted attention from all walks of life. The governance of financial fraud has been urgent. It requires not only internal self-examination, but also the joint supervision of all sectors of the external society.

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