

## Implications of Financial Fraud for Audit and Regulation

### -- The Case of Information Disclosure Violation of Swertia Island as an Example

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#### Abstract

On June 24, 2020, Swertia Island's information disclosure violations were announced by the SEC, which also revealed the truth that Swertia Island's stored scallops had "run away" four times in six years. Once the incident broke out, it aroused the discussion of expendable biological assets. Therefore, this paper will take the case of financial fraud of Roe deer Island as an entry point to explore the expendable biological assets. The purpose of this paper is to provide constructive suggestions for the audit and supervision of expendable biological assets and to provide some ideas for the construction of the national financial security system by reflecting on the signs of fraud in Roe Island before the incident broke out, analyzing its fraudulent methods, and then tracing the motives behind its fraud.

#### Keywords

**Expendable Biological Assets; Financial Fraud; Audit and Supervision.**

#### 1. Preface

In the Fifth Plenary Session of the 19th Central Committee held in October 2020, General Secretary Xi Jinping proposed to "maintain financial security and guard the bottom line of no systemic risk", emphasizing the importance of financial security. In contrast, in the 20-year period from 2000 to 2019, according to the data published by the Guotaian database, there were 794 companies with serious financial fraud, covering 2055 fiscal years. This shows the correctness and criticality of this proposal. Massive frauds seriously disrupt the order of financial markets and endanger financial security. Then, it is crucial to abort and kill inventory fraud as one of the links that endanger financial security.

As biological assets held for sale, expendable biological assets are highly susceptible to the influence of natural environment, and it is also difficult to confirm and measure the value and quantity accurately, which leads to many difficulties in auditing and supervision. [1] The audit and regulatory loopholes revealed by these difficulties also provide new ideas for the counterfeiting of agricultural listed companies. In the case of Roe Island, which was heavily fined in 2020, for example, during six years, Roe Island took advantage of the characteristics of scallops and falsely claimed its runaway four times, making a big deal about inventory measurement as a way to secure the title of a listed company. This financial fraud has led to serious damage to the legitimate rights and interests of shareholders, serious loss of national tax money, and serious obstacles to market regulation. [2] Between the representativeness of the Swertia incident in the case of financial fraud of expendable biological assets, it is of profound and important significance to analyze the signs of fraud in Swertia, to explore the fraudulent means behind it, to reduce the occurrence of vicious fraud cases, and to put forward constructive suggestions for auditing and supervision.

## 2. Research Significance

The current audit model is risk-based, and there are many drawbacks in the audit of expendable biological assets, which usually have the risk of material misstatement at the determination level, and often lead to poor monitoring quality and difficulty in accurate counting in the inventory due to the vast and complex monitoring territory. At the same time, because expendable biological assets such as scallops are subject to changes in the natural environment, which leads to difficulties in supervision, even the securities law and criminal law have lighter penalties for falsification of listed companies. [3] The above problems cause difficulties in auditing and supervising expendable biological assets. This study takes the case of financial fraud of Swertia Island as the entry point, and provides constructive suggestions for the audit and supervision of expendable biological assets by analyzing its falsification methods.

## 3. Purpose of the Study

The purpose of this paper is to sort through the relevant literature in academia regarding the analysis of inventory falsification in Roe Island, and to study the annual reports and announcements of the Shenzhen Stock Exchange, and the announcements issued by the China Securities Regulatory Commission, with a view to providing constructive comments on the audit and regulation of expendable biological assets.

## 4. Literature Review

Based on the integration of a large amount of literature from domestic scholars, this paper takes the financial fraud incident of Swire Island as the entry point, and focuses on the means and motives of fraud through the collation and analysis of representative academic results, annual reports of the Shenzhen Stock Exchange, and announcements of the Securities Regulatory Commission, and makes suggestions for auditing and regulation.

### 4.1. Concept Definition

The Chinese CPA Auditing Standard No. 1141 - Consideration of Fraud in the Audit of Financial Statements shows that financial fraud refers to the conscious and purposeful use of seven articles, falsification and other means to obtain improper benefits by the management of the audited entity, etc. [4]

### 4.2. Development of Fraud Motivation Theory

1. In 1895, psychologist Sigmund Freud proposed the iceberg theory, in which he believed that "the structural part is above the sea level and the behavioral part is below the sea level", and explored the motivation of fraud from two factors: structure and behavior.
2. Fraud triangle theory. Lawrence Sawyer proposed the theory that fraud is motivated by the three elements of pressure, opportunity and self-rationalization, and thus initiated the study of the fraud factor doctrine.
3. GONE theory. The theory was proposed by Burogna in 1993, and the factors are summarized as "greed, opportunity, need, and exposure".
4. Fraud risk factor theory. This theory classifies fraud risk factors into individual risk factors and general risk factors, which was developed by G.J. Bologua, R.J. Lindquist, J.T. Wells and others on the basis of GONE theory in 1993, and is considered to be the most complete fraud risk factor doctrine to date.

### 5. Signs of Fraud

Founded in 1958, Swertia Island is a value-added aquaculture company with a global reputation for food quality and safety, and was listed on the Shenzhen Stock Exchange in September 2006. On June 24, 2020, the Shenzhen Stock Exchange issued an announcement imposing heavy fines on the group, while revealing the six-year-long fraud of Swertia Island, an event that caused an uproar in the market. In retrospect, there were early signs of its counterfeiting. According to some of the data intercepted from the annual report of Swertia published by the Shenzhen Stock Exchange, the graph of changes in net profit (such as Chart 1), and asset impairment loss graphs (e.g., Figure 2).

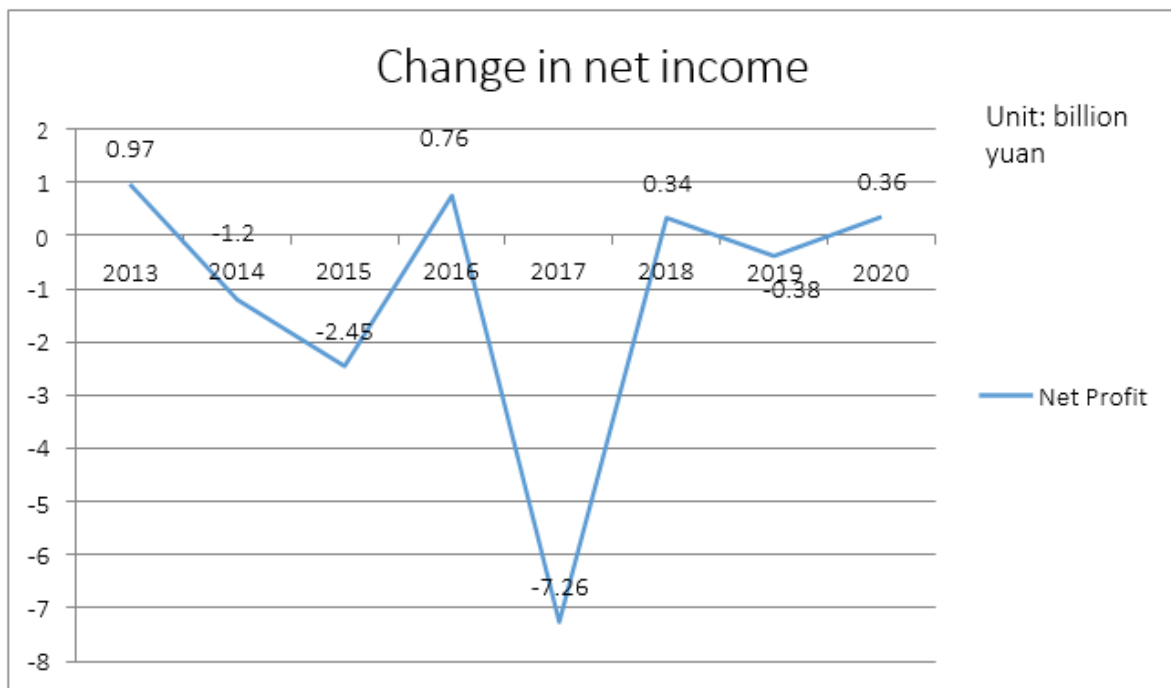


Figure 1. Change in net profit

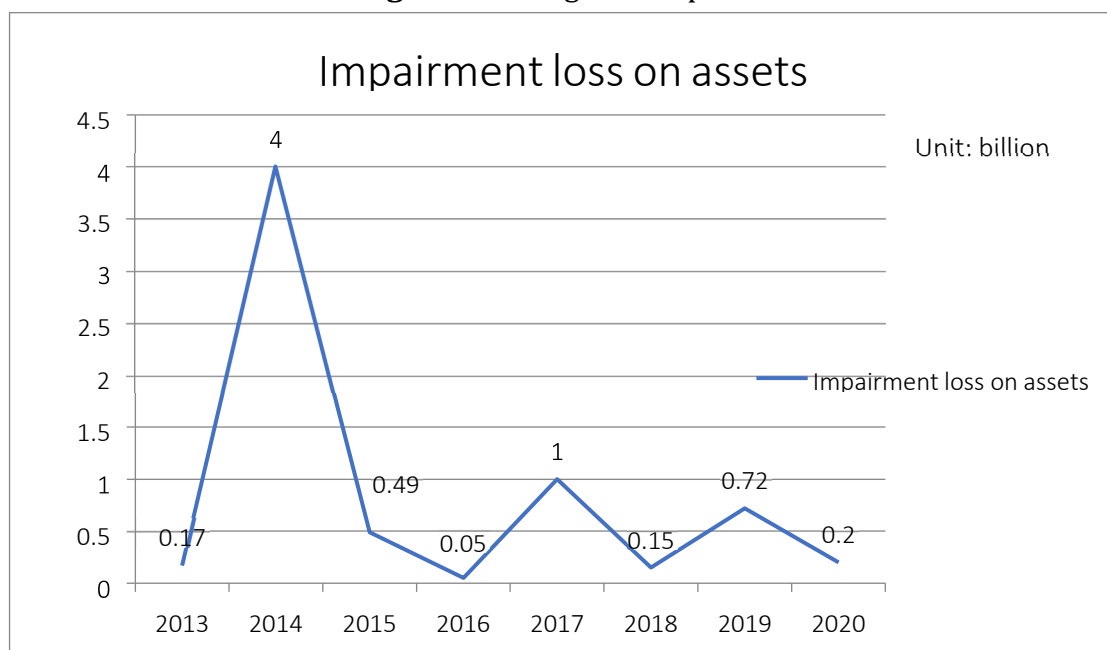


Figure 2. Impairment loss on assets

The fluctuation of the net profit curve can be seen in Figure 1, and there is a regularity in its profit-and-loss situation. When the company lost two years in a row in 2014 and 2015 and faced the threat of being ST, the next year turned into a turnaround. It is no coincidence that when a profit was made in 2016 for one year, a loss occurred again in 2017, and the scale of the loss amounted to a huge amount of more than 700 million yuan. In other words, Roe deer island in just one year occurred nearly 800 million losses. After this year, it started to make profits again in 2018. This repeated pattern of profit and loss is suspicious.

Looking at Figure 2, asset impairment losses fluctuate widely, reaching extreme values in the neighborhood in 2014 and 2017, and even surging to a peak of about 400 million yuan in 2014. Combined with the profit and loss status of Figure 1 in the period 2014-2020, it is worth suspecting that there is a possibility of "financialbathing" in Roe Island.

## 6. Fraudulent Means

### 6.1. Overstatement of Inventory Impairment Loss

In the write-off data announced by Swertia Island in 2017, there is a contradiction between the area for inventory impairment on goby sown in 2015 and 2016 and the actual catch area of Swertia Island in 2015 and 2016 surveyed by a third-party professional institution in 2017. The data announced by Swertia Island and the relevant data of the CSRC Punishment Decision Letter (2020) No. 29 are summarized as follows Table 1 .

**Table 1.** Impaired area and actual harvested area in the impaired area (unit: million mu)

Year	Area of impaired area	Area fished in the accrual area
2015	19.10	6.38
2016	5.20	0.13

From the table, it is easy to see that there are areas that have been caught in the areas where impairment has been charged, and its fraudulent behavior is clear to see. It can be found from the "China Securities Regulatory Commission Penalty Decision Letter (2020) No. 29" that such fraudulent acts have inflated the impairment loss of 11,105,200 yuan for the company, providing a suitable closing loop for the gap in the accounts caused by the company's inflated profits and turnaround of losses in 2016. [5]

### 6.2. False Reduction and Increase in Operating Costs

In 2020, the China Securities Regulatory Commission (CSRC) launched an investigation into Swertia Island, which commissioned CSC Yutu Technology Co. and the China Academy of Fisheries Science to use the BeiDou satellite navigation and positioning system to restore the routes of fishing vessels and calculate the true fishing area in order to accurately measure the actual fishing area of fishing vessels. The fraudulent behavior of Roe Island was finally revealed. [6] Swertia Island achieved an inflated profit by under-carrying the actual fishing area by 139,300 mu in 2016, making the operating cost inflated by RMB 60,299,000.

In 2017, to avoid the falsification being revealed, an additional 57,900 mu was carried over by carrying over the actual fishing area in order to reverse the once falsely reduced cost of 61,593,000 yuan. [7]

### 6.3. Overstatement of Non-operating Expenses

According to the write-off announcement issued by Swertia in 2017, 211,400 mu, 304,200 mu and 556,000 mu of scallops cast in 2014, 2015 and 2016, respectively, were abandoned for harvesting and written off. However, after the BeiDou satellite survey, a total of 442,200 mu of scallops had been harvested in these three years, which means that 442,200 mu of scallops

were overwritten in 2017, resulting in an inflated non-operating expense of 247,828,100 yuan in that year.

On the other hand, according to the SEC's investigation, part of the inventory area recorded at the beginning of 2016 did not show the fishing track in both 2016 and 2017, and the area was re-bottomed at the end of 2017, and according to the principle of consistency in accounting, the above-mentioned area of past inventory assets should be treated as write-offs, as a result, Swire Island Company falsely reduced non-operating expenses by RMB 4,187.27 million in 2017 million yuan.

In summary, the net increase in non-operating expenses in 2017 alone was \$205,954,000. [8]

## 7. Motivation for Fraud

Based on the fraud triangle theory proposed by the theoretical Steven Abrechts, the fraud motive of Sweret Island using inventory fraud is explained from three aspects: pressure, opportunity and self-rationalization.

### 7.1. Pressure

1. Swertia has incurred losses for two consecutive years in 2014 and 2015, and has been subject to delisting risk warning. According to the securities law, if there are three consecutive years of losses, Roe Island will be ST and face the risk of delisting. Under such pressure, swede island was forced to make the profit turn around in 2016 by falsifying.

2. Swertia Island's gearing ratio from 2012-2015 is shown in Figure 3 As shown, the gearing ratio increased year by year during the four years. In 2014 and 2015, the gearing ratio even exceeded 50%, which indicates that the company's long-term solvency is obviously insufficient, which means that it will be under great pressure to turn around in 2016.

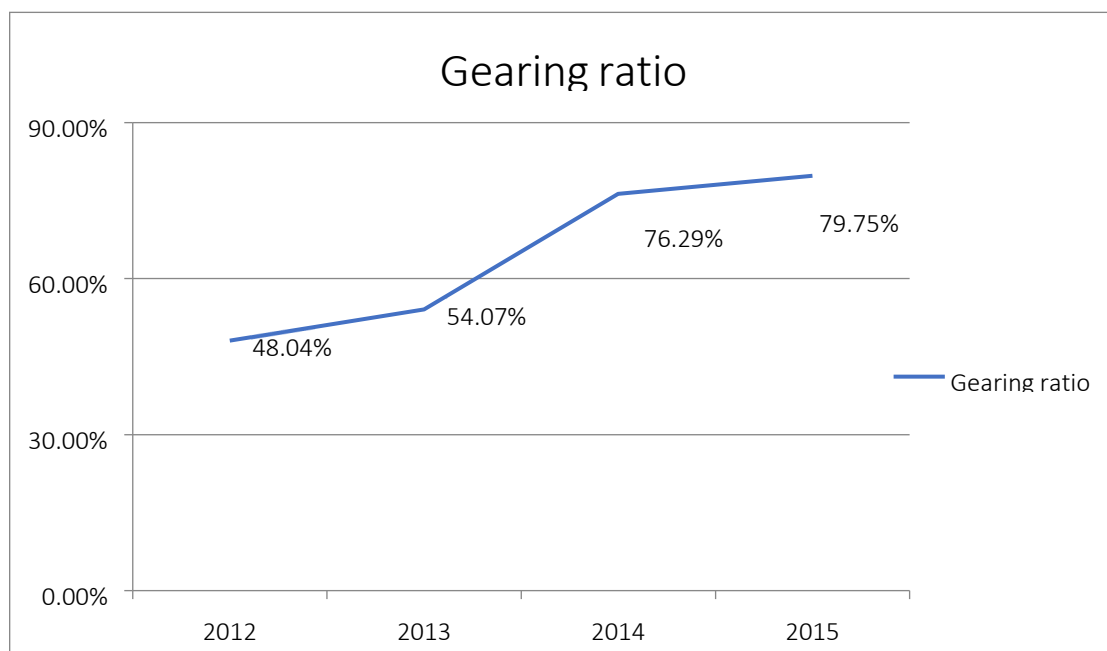


Figure 3. Gearing ratio

### 7.2. Opportunities

1. There are deficiencies in internal controls at Swertia. The chairman and manager of Swertia Island are both held by one person, showing family management, and its staff is composed of family and friends, which becomes completely insider-controlled.

2. expendable biological assets - Scallops are highly susceptible to the natural environment due to their biological characteristics, making their quantity and quality difficult to measure accurately. [10]

3. There is a lack of expertise in biological assets auditing, which leads to the process of determining the area of the sea during the audit and having to listen to the advice of the audited unit, and losing the independence of the audit.

4. The auditor lacked expertise that could be applied to scallops, resulting in the inability to determine the fishing trajectory of roe deer fishing vessels, making the accounted fishing area deviate significantly from the true area.

5. The government has increased support for loss-making enterprises to provide a boost to Roe Island's profitability amidst losses.

### **7.3. Self-rationalization**

Swertia belongs to a local collective enterprise, and many of the residents are shareholders of the company. It nominally works for the welfare of the residents, safeguards employment, and promotes the development of the local economy, but in fact the management hides the truth of the company's poor operation through financial fraud, to the detriment of investors, creditors, customers, and employees. [11]

## **8. Reflections on the Current Situation**

In recent years, the number of fraudulent companies investigated by the SEC has been increasing, and the fraudulent methods are endless. The core financial data such as operating costs, non-operating expenses and asset impairment losses are only the tip of the iceberg.

Kangmei Pharmaceutical, which was involved in the largest amount of cases in 2019, was extremely sophisticated in its counterfeiting methods. It inflated its monetary funds and operating income by forging cash business vouchers, falsifying contracts, shipping orders, and forging and altering term deposit slips or bank statements. What's more, Kangmei not only used 11.619 billion yuan of non-operating funds to purchase stocks and repay financing principal and interest for its controlling shareholders and related parties by concealing the transactions of its controlling shareholders and related parties, but also collaborated with Zhengzhong Zhujiang Firm to issue a higher level of assurance audit opinion to cooperate with Kangmei Pharmaceutical's falsification. All kinds of behaviors make people fall in disbelief.

It is no coincidence that the CITIC Guoan fraud case that broke out in 2021 has a similar approach to the Kangmei Pharmaceutical fraud case. During the seven-year period from 2009 to 2015, CITIC Guoan, on the one hand, illegally conducted connected transactions and, on the other hand, colluded with its auditors to issue a high level of qualified opinions, inflating its profits by a total of 1 billion yuan. The most eye-opening part of the case is that the company has changed four accounting firms, but all four of them were restructured and renamed by the same firm.

Combined with the three cases of fraud, it is not difficult to find that the means we have seen is only a drop in the ocean, fraudulent means are endless, fraudulent means increasingly complex, fraudulent mode more and more hidden. How to eradicate fraudulent enterprises and clean up the trading market will be a greater test for the audit and supervision of all sectors of society.

## **9. Audit and Regulatory Recommendations**

### **9.1. Applying New Technologies to Modern Auditing**

With the advent of the big data era, many unprecedented audit scenarios and audit objects have emerged in the auditing process, which also put forward higher requirements for the

traditional risk-based auditing. The application of the Beidou satellite navigation system in the Roe deer fraud case has shown us the importance and necessity of introducing new technologies, and the feasibility of new technologies in improving audit quality. The law and regulation of new technology lags behind its application, and multiple accounting and manual analysis and cross-validation should be carried out simultaneously in the application process. It is also important to focus on the training of data audit personnel, which will reduce labor costs and enable the acquisition of data while applying it to the audit process. [12]

## **9.2. Cultivate Application-oriented Audit Talents**

The firms should increase the requirements for the auditors to ensure the knowledge base and practical experience of the auditors. Their requirements should not only stay in the assessment of theory, but also focus on the cultivation of applied talents. It can be seen from the Swertia Island incident that the practitioners are not good at auditing biological assets, which makes the auditors forced to follow the arrangement of the audited unit in the selection of specific sampling sea area, resulting in the lack of randomness and representativeness of sampling. [13] The firm can develop applied talents by giving priority to experienced talents in the recruitment talent market and by conducting occasional lectures to teach auditing experience in the work.

## **9.3. Rectification of Audit Institutions, Unauthorized Use of Audit Information**

In both the Kang Mei fraud case and the CITIC Guoan fraud case, the auditors played an important role by continuously issuing standard unqualified audit opinions in violation of the law to provide shade for their fraud. The SEC should crack down on auditors' violations and improve market transparency. In the regulatory process, it can make full use of audit information for fraud detection by measuring the accounting quality of audited companies through audit fees [14], judging the authenticity of information through audit time spent, and speculating the possibility of fraud by observing the experience and qualifications of auditors.

## **9.4. Emphasis on Disclosure of Information on Expendable Biological Assets**

The stock exchange should strengthen the requirements for disclosure of information on expendable biological assets. In the Swertia fraud case, on the one hand, Swertia itself failed to disclose information on expendable biological assets as required, but on the other hand, the SZSE's requirements for relevant guidelines were not meticulous, which provided an opportunity for its fraud. It is suggested that the regulator should take the annual disclosure of spring and autumn inventory stocktaking by Swertia Island's internal control as an example and formulate a detailed set of specific guidelines for information disclosure on expendable biological assets, requiring all listed aquaculture companies to make regular disclosure on the stocktaking of significant expendable biological assets, including the time of stocktaking, sampling locations, the fertility of expendable biological assets, etc. and their changes, and even the disclosure format can be make uniform requirements for the disclosure format [15].

## **9.5. Increasing Penalties for Listed Companies**

The current Securities Law and Company Law punish listed companies for counterfeiting to a lesser extent, which does not serve as a deterrent at all. In the Swertia Island counterfeiting case, the SEC gave the company a warning and imposed a fine of 600,000 yuan; for directors, supervisors and senior managers, they were fined from 30,000 yuan to 300,000 yuan. [16] These fines are only the tip of the iceberg compared to the amount of fraud in Swertia. Thus, it is proposed to amend the relevant laws to make it possible to really kill the counterfeiting of listed companies.

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