Study on the Motivation of Corporate Financial Fraud Based on Fraud Risk Factor Theory based on the Acquisition of Longxin Technology by Connie E&M

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Abstract. Financial fraud has always threatened the healthy development of the capital market. Financial malpractice in M&A can cause huge losses to the acquirer and even face the risk of delisting, jeopardizing the legitimate rights and interests of enterprise investors and creditors. Mergers and acquisitions as one of the important forms of enterprise development and expansion, and enterprises as an important pillar of economic growth are of great significance to the stable development of the capital market. The correct M&A of enterprises can form a synergistic effect and improve the competitiveness of enterprises in the fierce market competition. This paper, with the help of fraud risk factor theory, explores the causes of corporate financial fraud in mergers and acquisitions, how to establish an effective preventive mechanism for financial fraud in mergers and acquisitions, and how to reduce the current capital market to minimize corporate financial fraud and reduce its impact and other issues to put forward proposals.

Keywords: Longxin Technology; Mergers and Acquisitions of Listed Companies; Financial Fraud; Fraud Risk Factor Theory.

1. Introduction

The increasingly prosperous development of the global capital market is always accompanied by frequent occurrences of fraud and other phenomena. China is currently in the development stage of the capital market structure, and financial fraud has brought a huge adverse impact. on February 17, 2023, CSRC released the full implementation of the registration system of stock issuance-related system rules. In the context of the full registration system, with the lowering of the listing threshold and financing conditions, the financial abuse of listed companies has become more serious. At present, China has not yet formed a strict supervision and punishment system for financial fraud, and the fraud phenomenon of listed companies seriously affects the sustainable development of China's capital market. Enterprises have to take social responsibility for their investors, creditors, and stakeholders such as mergers and acquisitions. Therefore, to prevent the risk of financial fraud faced by listed companies, as well as the occurrence and treatment of financial fraud in mergers and acquisitions, and to reduce the dangerous impact of financial fraud, we analyze the root causes of fraud from the perspective of the fraud risk factor theory and put forward suggestions.

2. Analysis of Financial Fraud in M&A Cases of Listed Companies

2.1. M&A Case Review

Founded in October 2001, Connie E&E's main business is railroad vehicle door systems. It was listed on August 1, 2014, on the Shanghai Stock Exchange. Revenue from rail transportation-related products is the most important source of revenue for Conny E&E, accounting for 73% of the total revenue. After listing, Connie E&E, as a leading enterprise in the industry, faced the dilemma of product homogenization and higher customer concentration, Connie E&E chose to open up the consumer electronics market on the original railroad door business to realize the dual-main business drive. 2016, Connie E&E announced that it would merge and acquire Longxin Technology, an industry leader in the field of surface treatment of consumer electronics, through the issuance of shares and cash payment. 2017 October 13 On October 13, 2017, Connie E&E passed the major asset reorganization audit, the stock resumed trading and acquired 100% of the equity of Long Xin Technology with 3.4 billion yuan from Liao Liangmao, the major shareholder of Long Xin Technology, and other people. After the audit, Long Xin Technology consolidated its statement of net assets of 815 million yuan, appraisal value-added ratio of 317.6%. At the same time, its main business gross margin is up to 34% or more, and Long Xin technology to Connie electromechanical performance commitment in the subsequent two years. The market generally believes that Connie Electromechanical in the dual industry under the drive of the market value will continue to pull high time, in June 2018, Connie Electromechanical released a notice that Long Xin Technology chairman Liao Liangmao private in the name of Long Xin Technology violations of the guarantee. in August 2018 the Securities and Futures Commission investigation found that before the merger and acquisition of a large number of Long Xin technology financial fraud to improve the valuation of the company. Resulting in a break in the capital chain of Longxin Technology, resulting in substantial losses in 2018 Longxin Technology's gross profit margin plummeted to 9.1%, causing Connie Electromechanical's 2018 net profit year-on-year a huge decline of 1221.66%. After the incident of Long Xin Technology, Connie E&E was hit by a major blow, facing bankruptcy and reorganization, and hovering on the edge of delisting. In 2019, Connie E&E sold the 3.4 billion merger and acquisition of Long Xin Technology for 400 million yuan to reduce the impact on the main body of the company.

2.2. Analysis of Financial Fraudulent Means of Enterprises

2.2.1. Raising revenue through false VAT invoices or recognizing revenue without invoicing

After the SFC intervened in the investigation, it was found that, according to Table 1, between 2015 and 2017, Longxin Technology, through the way of false VAT invoices or recognition of revenue without invoicing, through 11 customer companies in normal business based on the cumulative increase in revenue of 900,694,200 yuan. During the three years, the annual inflated revenue accounted for 22.02%, 30.09%, and 40.59% of the total revenue of Longxin Technology respectively. Long Xin Technology's false increase in revenue led to the formation of a large number of false accounts receivable balances at the end of the period, three years of cumulative false accounts receivable totaling 544,106,800 yuan. The inflated income of the payback by Longxin Technology Chairman Liao Liangmao private control of Longguan Vacuum and Dejulong two companies by the name of the customer to pay. At the same time, Long Xin Technology by normal business gross profit margin carries forward false cost, and then through the false cost of inverted launch the need for raw material procurement data. To balance the false costs carried forward, Longxin Technology will make false purchases paid to Longguan Vacuum and Deyulong false purchases [1].

Table 1. Amount of inflated accounts of Longxin Technology

Projects/billion yuan	2017	Semi-annual report 2017	2016	2015
Inflate revenue	4.5	0.96	3.06	1.44
Percentage of Operating revenue	40.59%	21.51%	30.09%	22.02%
Inflate profits	1.74	0.23	1.19	0.56
Inflated accounts receivable balances	2.15	1.19	0.78	1.32
Inflated purchases	3.05	0.83	3.37	1.87
Inflated accounts payable balances	0.42	1.03	0.02	1.16
Fictitious returns	4.67	NA	3.45	0.2

2.2.2. Concealment of the pledge of cash certificates of deposit and illegal guarantees

After the acquisition of Longxin Technology by Conny E&E, when conducting financial cleanup to prepare for the recovery of Longxin Technology's cash deposit certificates totaling more than 300 million yuan on Longxin Technology's books, it was found that the 300 million yuan cash deposit certificates had long been pledged by Liao Liangmao and that Longxin Technology had concealed them from Conny E&E in the merger and acquisition audit. in May 2018, Conny E&E received a copy of the deposit certificates provided by the Xiamen International Bank and a copy of the pledge contract that provided a guarantee for Xinlianke. It was found that the chairman of Longxin Technology had privately and illegally guaranteed or assumed debts of more than 400 million yuan in the name of Longxin Technology before the M&A.

3. Financial Fraud Motivation Analysis Based on Fraud Risk Factor Theory

3.1. Fraud Risk Factor Theory

The development of fraud motivation theory has gone through three stages: iceberg theory, fraud triangle theory, and Gone theory, until 1995, when G. Jack Bologna proposed the fraud risk factor theory based on Gone theory. As the most comprehensive theory for financial fraud research, it divides fraud risk factors into individual risk factors and general risk factors, individual risk factors refer to factors outside the control of the organization determined by moral character and motivation, while general risk factors refer to factors controlled by the organization, including the opportunity for fraud, exposure risk and the degree of being disciplined after exposure [2-4].

3.2. Drivers of Financial Fraud from the Perspective of Fraud Risk Factor Theory

3.2.1. General risk factors

(1) Opportunity for fraud

Under the influence of external regulation and imperfect internal control, the opportunity for financial fraud exists in every company. Summarizing the Longxin Technology M&A case, as shown in Table 2, the absence of internal risk control and the inadequacy of the acquirer's external audit are the main reasons for the opportunity for financial fraud. Connie E&E, as a party to the M&A, found shortcomings in the review of the acquiring company and did not detect Longxin Technology's abnormal indicators in time, resulting in high premiums and high valuations, such as Longxin Technology's abnormal receivables and net profit suddenly increasing in the second half of 2017. Hidden transactions with related parties in corporate mergers and acquisitions often have a link to financial fraud, and the investment banking team and the brokerage firm's auditors failed to detect any anomalies after carrying out checks, sending letters, conducting interviews, etc. Deficiencies in the parent company's internal controls also provided Longxin Technology with opportunities for fraud. The Stock Exchange imposed a penalty mentioned after the acquisition of mechanical and electrical control of Connie's subsidiaries for the existence of major defects, mergers, and acquisitions one year after the discovery of financial fraud in the subsidiaries [1, 5].

Table 2. Selected abnormal financial indicators of Longxin Technology (Unit: billion yuan)

Sports event	2017	2017 Mind-year Report	2016	2015
Net profit	2.41	0.83	1.8	1.39
Accounts receivable	5.95	4.71	4.4	4.56
Accounts receivable growth rate	26.33%	7.05%	-5.58%	NA

(2) Fraud exposure risk

The level of exposure risk of financial fraud determines the cost of fraud to be paid by the enterprise. The likelihood of discovery is high, fraud is difficult, and the possibility of corporate fraud will be greatly reduced. After the acquisition of Longxin Technology, Conexant appointed Liao Liangmao as the vice president of Conexant to continue to manage the related business, so that it can get a greater say in Conexant, which provides an opportunity to continue to conceal the financial fraud. At the same time, because consumer electronics is a new field for Conexant, the company team and the management of a lack of understanding of the relevant business, which also reduces the likelihood of exposure to the subsidiary's financial malpractice.

(3) Degree of punishment after fraud exposure

The possibility and intensity of being punished after information disclosure is an important constraint on corporate fraud, and relevant stakeholders who discover corporate fraud and malpractice can be punished through the media and the Internet, and the relevant departments take penalties against the enterprise through the provisions of the law.2020 On November 12, 2020, the former chairman of Longxin Science and Technology was sentenced to life imprisonment, confiscation of his income, and returned about 1.9 billion yuan of the proceeds of the crime to Connie's E&E. On July 28, 2021, Connie E&E received a penalty decision letter, pointing out that Longxin Technology committed financial fraud in the restructuring process, and fined Longxin Technology 600,000 yuan, chairman Liao Liangmao 300,000 yuan and a 10-year market ban, and the person in charge of finance was fined 200,000 yuan and a 5-year market ban. [1]

3.2.2. Individual risk factors

(1) Moral character of management

Moral character is a reflection of personal values, and the value orientation of the management has a significant impact on the strategic development of the enterprise and the formation of corporate culture. Only when the management has correct values can the company develop healthily and steadily. The chairman of the board of directors of Longxin Technology pledged 300 million cash deposit certificates in the company's books and hid them, and at the same time privately guaranteed a large number of irregularities in the name of Longxin Technology. Jointly with the head of finance since 2015 to implement a series of financial fraud operations, the use of the name of the control of the company in the name of the customer to legalize the inflated accounts. It can be seen that if the concentration of power in an enterprise is too high, the moral quality of the founders and leaders has a huge impact on the operation and fraud of the enterprise. The legal awareness of the management should be raised [6, 7].

(2) Motive for fraud

The motive of fraud is closely related to the economic situation and development purpose of the enterprise. This paper argues that the root of the study of corporate fraud motives is to explore the core needs of the enterprise at that stage of development. Standing in the perspective of the fraud enterprise analysis, in 2015, Longxin Technology failed to prepare for the listing, and in 2016 contacted Connie's electromechanical attempts to asset reorganization. In order to improve the possibility of reaching a merger and acquisition, Long Xin Technology's cash deposit pledge and a large number of violations of the guarantee have the necessity of concealment. The core purpose of enterprises in the period of mergers and acquisitions is to maximize the valuation and high premium acquisition. This means that the acquired party can obtain a high transfer contract consideration, and shareholders can profit from it. Longxin technology in order to realize high premiums, and improve goodwill, through financial fraud to mergers and acquisitions before the high growth and high performance base and mergers and acquisitions after the performance of the commitment to support. Longxin Technology by inflating revenue to improve operating income, gross margin accounts receivable, and other financial indicators, so that it presents sizable financial data in the merger and acquisition. At the same time by inflating net profit in 2017 to 241 million yuan of net profit to over-completion of the performance commitment set by Connie mechanical and electrical mergers and acquisitions of 2017-2019 continuous with a rate of close to 30% continuous growth in net profit. Longxin Technology's net profit in 2015 and 2016 was about 139 million yuan and 180 million yuan respectively, as shown in Fig.1, with a growth rate of 29.58% [8, 9].

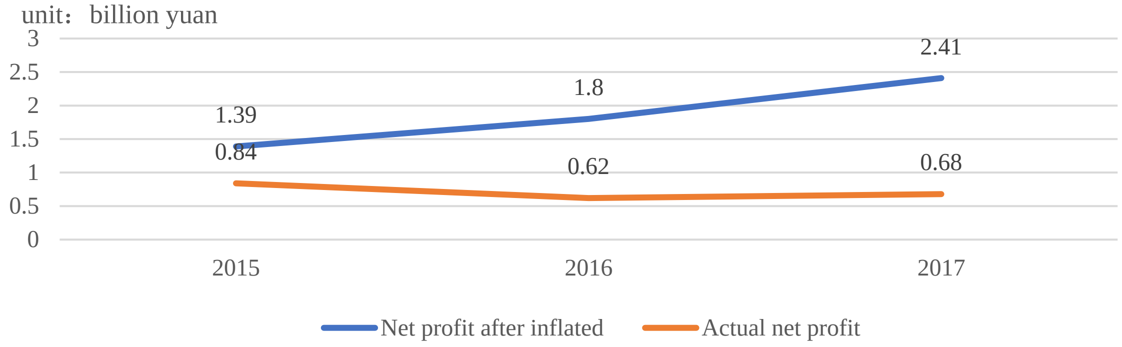

Fig 1. Comparison of Net Profit before and after Fraud

4. Implications and Suggestions

4.1. Reduce the Opportunity for Corporate Fraud and Improve the Mechanism for Detecting Financial Fraud

Since the external auditing organization has an employment relationship with the enterprise and is an independent third party, it cannot provide a completely objective audit report most of the time. M&A parties need to strengthen the internal audit department's auditing of the acquired company and improve its independence, establish effective communication between the internal audit committee and the external auditing organization, etc. to establish a perfect review mechanism. Hidden parties need to raise their awareness of their responsibilities, strengthen their verification of the business undertaken, and reduce the chances and possibilities of corporate fraud.

4.2. Increase the Penalty for Financial Fraud and Raise the Cost of Fraud

According to the SEC, this financial fraud in the enterprise's punishment, 2021 penalty decision letter pointed out that Long Xin Technology imposed a fine of 600,000 yuan. In comparison, the amount of billions of dollars of premium for the acquisition of Connie E&M far exceeds the amount of the penalty. The gains from fraud are much higher than the penalties, which greatly incentivizes companies to take the risk of financial fraud. Compare the penalties for financial fraud in the U.S. market horizontally, and the penalty for the Rexchip Coffee fraud case is as high as $180 million. It is recommended to further improve the penalty system for fraud according to the large fines and recovery of illegal income in the United States, and increase the cost of fraud [10].

4.3. Broaden the Financing Channels and Improve the Ethical Level of Management

Management to mergers and acquisitions to cash for business development seriously affects the market operating environment, management should improve the legal awareness and moral standards. At the same time, the financing channels of private enterprises should be broadened to support the continuous operation of private enterprises and to avoid private enterprises choosing financial fraud due to capital chain and debt problems.

5. Conclusion

In this article, the fraud risk factor theory is adopted to study the fraud motivation of the case of Connie's M&A of Longxin Technology. In the process of M&A, the parent company's internal control deficiencies and internal and external auditing department's negligence provide opportunities for subsidiary fraud, and the subsidiary's shareholders and management's pursuit of interests provide incentives for financial fraud to increase the company's valuation. Therefore, the parent company should strengthen the financial review of the subsidiary and improve the internal control before M&A.

Stage payment can be also considered to reduce the risk of financial fraud in M&A, and better utilize the synergies brought by M&A for the company.

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