Analysis and thinking of Hongda New Material Financial Fraud Case

-- Based on the Perspective of Business Ethics and Accountant Professional Ethics

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Abstract: With the continuous development of the economy, emerging companies in various industries are also competing for flowers, so information stakeholders in all aspects will pay more attention to the appreciability of profits when using financial statements, and accountants will be more likely to whitewash the statements. However, the occurrence of financial fraud will not only cause huge losses to enterprises, but also expose some shortcomings in various aspects of business ethics and professional ethics. Therefore, this paper analyzes the financial fraud incidents of Hongda New Materials, which then leads to various business ethics and professional ethics thinking problems such as the lack of ethics of financial personnel, the ineffective internal control system of enterprises, and the incomplete construction of industry rule of law, and gives suggestions for feasible measures.

Keywords: Hongda New Material, Financial fraud, Business ethics, Professional ethics.

1. Introduction

Recently, Hongda New Materials has been involved in 4 cases due to private lending disputes and sales contract disputes. The prosecutions included Beijing Changfeng Microelectric Technology Co., Ltd., Shanghai Wujiaoanchang Branch of Agricultural Bank of China, and Bank of China Shanghai Qingpu Branch, and several bank accounts of the company were frozen. On January 6, Hongda New Materials ushered in a turning point, and the company announced that many bank accounts that had been frozen before had been unfrozen. Then on January 9, the first stock of the New Year's letter fell to Hongda New Materials. This is less than half a year since Hongda New Material New Controller took the helm. Until January 9, Hongda New Materials issued an announcement that it had received the "Notice of Case Registration" from the China Securities Regulatory Commission, and the CSRC decided to file a case for investigation due to suspected violations of laws and regulations. Hongda New Materials said that during the investigation period, it will actively cooperate with the work of the CSRC and strictly fulfill its information disclosure obligations in accordance with regulations. On April 4, 2023, the China Securities Regulatory Commission issued a penalty announcement against Hongda New Materials.

The following is the relevant research on business ethics and financial fraud used in this article:

Ye Chenyi said that the breach of trust and responsibility of accounting information, and its root causes should be explored from a social perspective. [3]

2. The basic introduction of the "Hongda New Material Incident"

(1) Hongda New Materials Company Profile

Shanghai Hongda New Materials Co., Ltd. (hereinafter referred to as "Hongda New Materials") was established in 1992 and is one of the earliest enterprises involved in high-temperature silicone rubber in China. In 2008, the company was successfully listed on the small and medium-sized board of the Shenzhen Stock Exchange. In 2019, with the help of the high-quality resources and new technologies of the new controlling shareholder, the company began to explore the strategic transformation of its main business. In February 2019, the company laid out information security and quantum communication technology and established Shanghai Hongyi Information Technology Co., Ltd.; In September of the same year, the company acquired Shanghai Guanfeng Information Technology Co., Ltd., opening up the upstream and downstream industrial chain in the field of private network communication and information security.

As the pioneer of the strategic transformation of the company's main business, Hongyi and Guanfeng have laid a solid foundation for the company in the field of private network communication and information security. The company seizes the opportunity period of rapid development of the private network communication and information security industry, continuously strengthens the company's research and development strength, based on independent innovation, focuses on advanced technology, actively explores the deep combination of cryptography technology and application with a new generation of private network communication, mobile Internet of Things, industrial Internet of Things and other fields, continues to consolidate and enhance the company's market share and brand image in the industry, and actively builds a new industrial development strategy, hoping to create value for customers, create income for shareholders, and create the future for employees.
3. Reflection on Fraud: Based on the Perspective of Business Ethics and Accounting Professional Ethics

(1) The quality of financial personnel is insufficient
In 2019, Hongda New Materials inflated the total profit through private network communication business by 29.7188 million yuan, accounting for 38.93% of the absolute value of the total profit disclosed in Hongda New Material's current annual report; In 2020, Hongda New Materials increased its total inflated profit through private network communication business by 103.4475 million yuan, accounting for 146.09% of the total profit disclosed in Hongda New Material's current annual report (accounting for 151.08% of the total corrected profit).

First of all, the hand of fraud implementation must come from the "grassroots financial personnel", and it can be seen from the relevant penalties that Le Meiyu received, and the accounting personnel must bear their relevant responsibilities. Due to the asymmetry of information, there are some differences in the degree of understanding of various types of information of listed companies by investment personnel, so financial personnel can hide the data obtained through their professional knowledge and rich experience in accounting. For the fraud cases in the CSRC's penalty announcements in recent years, the responsibility of accountants is often ahead, and some accountants are blinded by high-value reports.

In terms of professional quality, taking Kangmei Pharmaceutical as an example, some financial personnel did not implement necessary alternative procedures for the audit evidence with obvious discrepancies in the fraud process, and failed to maintain due professional suspicion. [4] In this incident, it is worth mentioning that the audit business of fictitious income in recent years has been hired by notary Tianye accounting firm, and the firm has not only issued a 100% unqualified opinion on internal control, but also responded to the key matters of the audit report, so the accounting firm and its related certified public accountants should also bear relevant responsibilities in the occurrence of fraud cases.

(2) The failure of internal control causes accounting personnel to lose their independence
To a large extent, the occurrence of financial fraud is due to the different purposes of financial statements between investors and business operators, business operators hope that the information disclosed in the financial statements is conducive to the expansion of the company, while investors need to see the real performance information to invest. Like Sui Tianli and Yang Xin in this case, they carried out related party transactions for their own interests, and overconfident management is often overly optimistic about the judgment of affairs, and they may underestimate the probability of deviation from the control objectives caused by the problems in the design or operation of internal control, or underestimate the negative impact on the achievement of the control objectives. [5]

And since a long time ago, Le Meiyu has become the company's accounting head, if the company's financial personnel turnover is in a constant state, in the long run, the relationship between the accountants and the management is likely to become no longer simple, mixed with certain personal emotions, and even reach a profit exchange. This accident is precisely due to the lack of independence of accountants, and the process of accounting is mixed with...
various factors that affect accountants, resulting in financial
fraud. This also indirectly highlights the huge problems in the
company's internal control, and the major flaws in ethics and
the relevant values of the company's management. In 2021,
the two firms hired by Hongda New Materials issued
reservations and could not express opinions on the company
respectively, so until after the fraud, the shortcomings of the
company's internal control system were gradually revealed.

(3). The awareness of corporate social responsibility is not
strong

Hongda New Material is one of the earliest enterprises
involved in high-temperature silicone rubber in China, as a
pioneer in the industry, it should set a good example for the
emerging enterprises behind. However, the business operators
of Hongda New Material hope that the information disclosed
in the financial statements is conducive to the expansion of
the company, and by polishing the company's financial
statements, Hongda New Materials shows that in addition to
the false information in good operating conditions, coax
investors, so as to achieve the purpose of raising the stock
price, in order to expand the development space of the
enterprise through financing. When the business is not doing
well, the company may often choose to use financial fraud to
make the company's financial statements look more potential,
so as to attract investors. In addition, the audited unit is
Hongda New Material's own internal control management
system has a problem, when the executives of the listed
company choose to commit financial fraud, the fraud is
usually very hidden and difficult to be discovered. Therefore,
as a pioneer, enterprises do not think about their
responsibilities in the entire industry and the financial
industry.

(4). The severity of securities penalties is not large

It is difficult to say that the occurrence of Hongda new
material fraud incident is not related to the low punishment of
the supervision and management department. For example, in
2014, Kangzhi Pharmaceutical in other industries was
suspected of financial fraud and information disclosure
violations, and the final punishment was only a warning and
a fine of 350,000 yuan; From the perspective of cost-
effectiveness principle, the huge benefits obtained by listed
companies from financial fraud far exceed the cost of
violations of laws and regulations, so the punishment for
financial fraud is too light, and it will still be repeatedly
prohibited. In addition, accounting fraud cases in China's
securities market have occurred repeatedly, and the scale and
nature of data fraud are getting bigger and bigger, which is
esentially inseparable from the imperfect market supervision
mechanism. However, fortunately, with the introduction of
the new securities law, the problem of insufficient penalties
for audit failures of accounting firms and financial fraud of
listed companies will be gradually solved, and the nature and
degree of punishment will also be related to the judgment
before the implementation of the act, so as to provide a
sufficient deterrent to potential fraudsters. [6]

4. Countermeasures and Suggestions

(1) Improve the quality of financial personnel

Most of the financial fraud incidents are due to the low
moral level of management, hoping to obtain more capital
investment or cash out by deceiving investors. Therefore,
more attention and supervision should be paid to the
comprehensive quality of the company's internal management
and more financial staff.

For most accounting firms, factors such as self-interest,
self-evaluation, over-promotion, close relationships and
external pressure will adversely affect the ethical aspects of
auditors, thereby promoting financial fraud. Therefore,
financial personnel should adhere to the basic principles of
professional ethics, maintain their independence in assurance,
maintain integrity and integrity, and maintain objectivity and
fairness when providing company information for financial
statements. The real situation of the market cannot be
concealed, and any financial whitewashing operation is to
quench thirst. Certified public accountants should also always
pay attention to improving their own professional quality,
maintain their audit independence, and always pay attention
to improving their business capabilities, maintain audit
independence, and consciously avoid the interests of the
audited unit to reduce the risk of audit failure.

It is suggested that the Institute of Certified Public
Accountants must establish a mandatory professional ethics
education system, for example, mandatory professional ethics
training for certified public accountants every year. Through
the systematic training of professional ethics for current
certified public accountants in batches and stages, so that they
can always maintain "walking on thin ice" in practice. [7]

(2) Strengthen the internal control system

The internal control system is the measures, methods and
procedures established within the unit to make various
business activities interrelated and mutually restrictive. The
internal control system is also the institutional foundation of
corporate governance and the core system of enterprise
management.

Lawrence (2009) believes that the effectiveness of internal
control operation can test the manager's operating ability, and
the more effective the internal control system operates, the
higher the ability of enterprise management, the more it can
improve the profitability of the enterprise.

With the rapid development of the Internet, the internal
management and supervision of enterprises have also
undergone essential changes, if enterprises ignore the role of
internal control, it is possible to breed internal corruption, so
to enterprises must eradicate corruption from the source and
build an anti-corruption system around the construction of
clean government. For example, for the control of the
accounting system, enterprises need to strengthen the daily
operation and standardized management of accounting
personnel and related personnel, reasonably set up posts,
clarify the scope of rights and responsibilities, approval
procedures and scope of authority of each person in the post,
so that each position can form an internal control situation of
mutual supervision and constraint, and effectively avoid the
occurrence of favoritism. To improve the professional quality
of accounting personnel, accounting personnel should
exercise their powers and bear risks within the scope of
authority, strictly control the operation links, prevent the
occurrence of violations, and ensure the safe operation of the
system. [8]

Therefore, in the increasingly competitive external
environment, in order to enhance their competitiveness,
enterprises need to continuously improve internal
management, improve work efficiency and improve product
quality. In view of the behavior and attitude of the
management and internal staff in this incident, Hongda New
Materials Future and other companies should implement a
strict internal control system to avoid improper operations
within the company.
(3) Strengthen awareness of social responsibility

Whether companies should assume social responsibility has always been a topic of debate. From a short-term perspective, assuming social responsibility is likely to reduce the growth rate of corporate efficiency, and the growth rate of word of mouth and goodwill is also slower. Some articles show that the value creation mechanism of corporate social responsibility exists, but there is a lagging effect. From a long-term perspective, companies can create company value by fulfilling their social responsibilities and disclosing social responsibility information (Servaes and Tamayo, 2013), reducing risks (Lee and Faff, 2009), reducing the cost of equity capital (Dan et al., 2012), positively impacting the future performance of the business (Sylvia and Yanivi, 2010), and improving product market awareness (Bardos et al., 2020). Increase corporate revenue and enhance company value (Flam-mer, 2012). Similar conclusions have been drawn by domestic scholars (Jia Xingping, 2016; Huang et al., 2017; Tu Hong and Zheng Wei, 2018; Zhu Qingxiang et al., 2019)

Enterprises should build the concept of fulfilling social responsibility, and at the same time standardize and promote the performance of corporate social responsibility by strengthening the construction of the internal control system of the enterprise, while effectively curbing management opportunism, improving the value creation ability of social responsibility, and forming a virtuous circle between corporate social responsibility and corporate value creation. Enterprises carrying out social responsibility activities help them gain a good reputation and further access to resources, thereby improving the long-term competitiveness of enterprises. [9] Therefore, for enterprises, firmly fulfilling social responsibilities is the right choice for the sustainable development of enterprises. [10]

(4) Improve laws, regulations and industry supervision

When an accounting firm was inspected by the Ministry of Finance for the quality of accounting information, its audit quality in that year was significantly improved, which was reflected in a significant decrease in the degree of earnings management of its audit clients, a significant decrease in the degree of earnings management on the weighted average of clients’ total assets at the accounting firm level, and a significant increase in the ratio of non-standard audit opinions. The possible reason may be that the Ministry of Finance’s accounting information quality inspection and announcement has a deterrent effect, and accounting firms will strive to improve the quality of audits for reasons of reputation, thereby reducing the degree of earnings management of audit clients. [11] The conclusions are also supported by theory.

Although the Ministry of Finance has organized accounting information quality checks for decades, there are still many imperfections. Because the domestic punishment system is relatively light, the firm will rely more on the client’s ideas to complete the work, which greatly reduces the effectiveness of the inspection work. Therefore, the work on the intensity of punishment and inspection procedures should be further improved, and a corresponding compensation mechanism for fraud liability should be established as soon as possible, so as to increase the cost of fraud violations economically, so as to strengthen the risk awareness of financial personnel from the source. [12]

References

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