

Analysis of Management Fraud in Listed Companies Based on Fraud Triangle Theory

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Abstract. In the financial cases of listed companies, management fraud has occurred frequently, which has aroused widespread concern in society. Domestic and foreign scholars have begun to study the motives and effects of management fraud extensively. This paper summarizes the literature at home and abroad with a lot of reading and discusses the theory of fraud triangle. We also analyze the motivations of the listed companies in agriculture based on the three aspects including opportunity, pressure and self - rationalization. Finally, it discusses the audit countermeasures of management fraud from internal audit.

Introduction

In recent years, a lot of financial fraud cases have emerged in China and the international community, which have serious influence on society and need to arouse great concern. In these cases, many are related to management fraud. The managers collude with one another to seek their own interests. Some basic practices include the use of derivative financial instruments and frequent financial transactions to cover liabilities, the use of related parties to transfer funds and so on. When the company accepts external auditing, the audit evidence of the company is relatively completed, which matches cash flow with income to lift the audit concerns. Therefore, this increases the difficulty of audit work.

At present, China's internal auditing system is lack of perfection. Our country has not established a sound system with many problems in the external audit that may lead to audit failure. What's more, the fraud measures used by listed companies are becoming more and more difficult to be discovered. Therefore, there is more difficulty for auditing. How to coordinate the role of internal audit and external audit becomes very important. From many fraud cases, we can see that fraud practices and motives of different companies which belong to different industries are different with various attributes. This paper will analyze the motivations of the listed companies in agriculture based on fraud triangle theory, which is shown in Figure 1. And this paper will finally discuss the audit countermeasures of management fraud from internal audit.

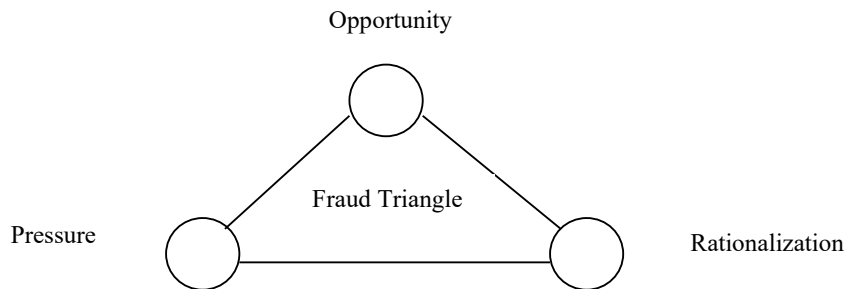


Figure 1. Fraud triangle theory.

Fraud Triangle Theory

The academia put forward a number of theories to explain the reasons for the fraud of listed companies, including the fraud triangle theory, GONE theory, fraud risk factor theory and so on. Fraud triangle theory was proposed by Steven Albrecht, the founder of the American Association of Certified Fraud Examiners (ACFE), current president of the American Institute of Accounting. He studied a series of fraud cases and proposed that the occurrence of corporate fraud is caused by three factors including pressures, opportunities and rationalization. Three factors interact each other which cannot be lacking.

Pressure

Pressure is the primary condition of management fraud, and the pressure from different people causes management to practice fraud. In this regard, this paper discusses different sources of pressure on the management from the perspective of different stakeholders.

The first one is pressure from their own. Some managers in management may lack of funds, have difficulty in promotion and performance assessment. In the face of these pressures, management will continue to look for opportunities for fraud, which is generally the main source of pressure. Personal economic pressure also will drive management continue to find ways to seek the benefits. Once the interests of the management are satisfied or his predicament is solved, fraud will occur. The second one is pressure from shareholders or investors. With one of the company's development goals, maximizing shareholder interests will inevitably interfere with management's decision-making. At present, the fiduciary duty system makes the separation of the two powers in the listed company. The company's management rights owned by the management, while shareholders are concerned about the company's profitability so that they propose many requirements that do not match the company's development. The management may make a corrupt act based on this pressure. There is also pressure from the market. In the management process, once the shortage of raw materials and insufficient supply of the market happen, the operation of the company can only stop. To avoid a series of consequences, the management may implement fraud.

Opportunity

When the management is under pressure, he will certainly find opportunities for fraud in order to avoid the punishment from all sides. At present, the sources of the opportunity involve the following points.

First of all, an important point is whether the company has established internal control of mutual checks and balances. On one hand, the regulation of shareholders and investors should be in place. On the other, whether the checks and balances of various departments within the company are perfect is very important. Even if there is good internal control, management is likely to go beyond the limits of internal control and practice fraud. In addition, due to the existence of asymmetric information, the information obtained by investors and management is quite different. This may cause adverse selection. At present, the punishments of financial fraud in our legal system do not pose a threat to management, which will inevitably increase the possibility of management fraud. Finally, the auditor's professional ability and the spirit of independence are also important factors for the management of listed companies to implement fraud. The management uses a variety of means to whitewash the financial statements, create perfect audit evidence, and deceive auditors. If the auditor does not have a higher level of professionalism and proper audit procedures are not implemented, the auditing failure will be likely to occur.

Rationalization

After the management finds the right opportunity, there must be a tendency to be fraudulent. Under normal circumstances, the managements of all listed companies often have a certain moral quality, so they will consider some reasons to rationalize their fraud.

On one hand, the management will make excuses from the company's interests. They believe that fraud is for the benefit of the company. As long as the final company operating is in good condition, the process is not important. On the other, from their own interests, the management believes that even if the current decision is not conducive to the development of the company, such as misappropriation of funds, but it will be better if the profits earned back are returned to the company later. In other words, they regard the funds as their own contribution to the company, so they think they deserve it. Based on the above two aspects, the management will be fraudulent self-rationalization, then to implement fraud.

Analysis of Management Fraud in Listed Companies

Based on the above analysis of the fraud triangle theory, we can see that there are many factors influencing the fraud of listed companies. In recent years, the management of agricultural listed companies has been related to financial fraud cases frequently. They implement different forms of fraud based on different pressures, opportunities and excuses. This part will take Wanfu Biotechnology as an example to indicate specific factors leading to financial fraud occurred in agricultural companies based on fraud triangle.

Brief Introduction to Wanfu Biotechnology

Wanfu Biotechnology (WFB) is a provincial high-tech enterprise and a provincial agricultural industrialization leading enterprise. Its businesses involve grain acquisition, rice and oil processing, rice starch sugar and protein powder production and so on. Its profits are based on sales and scientific research and development. WFB was successfully listed in the Shenzhen Stock Exchange on September 27th in 2011, with the registered capital of 67 million yuan after listing, the sponsor of Ping An Securities, and the audit institution of Zhonglei Certified Public Accountants.

On the evening of May 10th in 2013, the CSRC (China Securities Regulatory Commission) published the investigation results of WFB suspected of fraudulent listing and listing of information disclosure violations and other matters on the official website. The results of the survey are shown in Table1.

Table 1. Sales revenue and operating profit inflated of WFB 2008-2012.

Time	2008.12	2009.12	2010.12	2011.12	2012.06
Inflated sales revenue[million yuan]	120	150	190	280	165
Inflated operating profit[million yuan]	28.51	38.57	45.90	66.35	34.35

Financial Fraud Motives of Wanfu Biotechnology

In terms of pressure, as mentioned in the above analysis, shareholders and investors bring greater pressure to the management for the company's profitability and growth. As a commodity processing companies listed, WFB has the same problems like others. Products of WFB have characteristics like long life cycle, low added value, and low utilization ratio. So there is no way to achieve a higher profitable level in a short period. At the same time, when it comes to the external environment, the government encourages high-tech companies to carry out technological transformation, improving the technology content of the company's product. In order to get the government's policy support and achieve investor's expectations, the management selected the financial fraud.

In terms of opportunities, agricultural listed companies often exploited some loophole in some rules or law system. In the audit process, it is difficult to verify agricultural products and biological assets. To estimate the cost and amount clearly is of great challenge. In addition, the size of each sale of agricultural products can be large or small. They usually involve cash transactions, rather than traditional bills transactions, which is not conducive for auditors to audit. What's more, there are many preferential policies for agricultural products, which can reduce the costs of management fraud.

In terms of excuses, one of the agricultural listed companies' probable excuses for self-rationalization is a natural disaster. Agricultural products may be affected by climate factors, pests and diseases, thus reducing the company's sales and profitability. This undoubtedly gives a general explanation for a listed company to clarify the decline in performance.

As an agricultural listed company, WFB was affected by the three above factors, pressure, opportunities, excuses, which affected the management decision-making and led to management fraud.

Discussions on Audit Countermeasures Based on Internal Auditing

After the establishment of a fiduciary relationship in the listed companies, the authorized client must be required to supervise the trustee to protect their own interests. The emergence of auditing is based on the creation of fiduciary responsibility. Internal audit refers to independent evaluation on various types of business and control of an organization. It aims to make sure that the company is in compliance with recognized principles and procedures, in line with rules and standards. Good internal audits can effectively monitor all aspects of the company and maximize the profits of the company.

Enhance the Level of Corporate Governance

In terms of corporate governance, internal audits maintain communication between the upper and lower levels by providing internal audit reports. At the same time, internal audits deal with management fraud in the following aspects. On one hand, make a general assessment on the operation, financial accounting, administration of the enterprise, and give a feedback through the audit report. On the other, assess the performance of the management and the existence of fraud, and conduct a compliance check. In these two aspects of information checks, the internal audit departments should report to the top management based on the problems they found in details. However, there is often a vague of responsibility in the internal audit department of the corporate organizational structure, and there is an overlap between the internal auditor, the board of directors and the management, which inevitably limits the role of the internal audit. So the internal audit cannot effectively detect and prevent fraud. Therefore, to enhance the level of corporate governance and to handle the internal checks and balances have a direct impact on the prevention of the management fraud.

Improve the System of Internal Control

The legislative purposes of the internal control requirements in the Sarbanes-Oxley Act of 2002 (SOX) are to reduce the likelihood of corporate misconduct and fraud and to constrain corporate insiders' ability to extract private benefits. Since the promulgation of the bill, internal control has attracted growing attention in the listed companies. The internal control of financial reporting mainly has the following three functions: (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements. The internal control of non-financial reporting mainly includes procedures, plans, processes, systems, activities and functions at all levels of the company. However, management fraud tends to go beyond the limits of internal control. Therefore, identifying whether there are general defects or major deficiencies in internal control must be based on a sound internal control system to find clues to management fraud.

Strengthen the Control of Fraud Risk

Management fraud risk must be included in the overall framework of corporate risk control. Only all levels of the company understand the importance of management fraud risk, can the company effectively monitor and prevent it. Internal audit can help the company improve the risk management system, improve the management of fraud risk, improve the anti-fraud consciousness of the internal auditors at all levels, build the company's anti-fraud atmosphere, establish the senior management tone and carry out the professional ethics code. In addition, it is important to assess existing fraud risk, identify fraud risk factors, and take preventive measures before the occurrence of management fraud.

Conclusion

Management fraud exists in listed companies based on three drivers including pressure, opportunities and excuses. Pressure comes from collective pressure and personal stress. Collective pressure is focused on the expectations from stakeholders on the company's future development, while individual pressure is focused on the performance goals and aspirations that management desires to achieve. Opportunity factors may be due to lack of internal control to find corporate fraud, lack of appropriate means of punishment and so on. Excuse mainly comes from the management of the weak sense of integrity and so on. This paper starts from the case of agricultural listed companies, indicating the specific reasons on the implementation of management fraud of agricultural listed companies based on the fraud triangle. At the same time, based on these reasons, this paper explores specific audit countermeasures of internal audit. Internal audit should improve the level of corporate governance, the internal control system, and the management of fraud risk, to improve the quality of internal audit and reduce the risk of management fraud.

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