

Research and Analysis of Material Misstatement Risks of Financial Statement

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Abstract. The material misstatement risks have wide relationship with financial statement, which may influence identifications. The risk generally relates to control environment, and it may have correlations with other facts. And the risk is difficult to be defined to identify a transaction, account balance and presentation. The paper mainly analyzes how to effectively find and analyze the risk of material misstatement of financial statement.

Knowing the Units to Be Audited and the Environment

Industrial status and legal environment. Wanfu Shengke Hunan Agricultural Development Incorporated Company is a company of developing, selling and producing finish-machining products. It is honored as golden rice, and it logged in A share market of GEM on September 27th in 2011. The industry of Wanfu Shengke includes food manufacturing industry and rice intensive processing industry.

The main products of the company include starch sugar and rice protein powder. There are many types of starch sugar products, and different products have their own features, so they are widely applied in different fields. Protein powder is obtained from hydrolyzing vegetable protein, and it can be used for alimentary feed additives. As the supplement of amino acid, it can replace fish meal and soya-bean cake to be added to fodder for manufacturing animal feed with high nutritional value, which can improve nutritional level.

The fraud cases of agricultural enterprise accounting are common, such as Yin-guang-xia, Lantian Stock, Green Land and Grassland High Fact. The typical fraud cases in security market are nearly from agricultural enterprises in China. As the agricultural industry operation is special and agricultural stock is easy for counterfeiting, the following aspects need to be emphasized.

Feature of the audited units. The ownership structure of Wanfu Science is incorporated company, and it was established on October 28th, 2009. By December 31st in 2011, Tong Yongfu and Yang Ronghua have had 29.99% and 29.99% of the stock right of the company, and are the first majority shareholders of the company. They are the common real controller of the company. And there is no change during report period. And there is no institutional shareholder whose share is more than 5%. The total number of stakeholders was 6044 at the end of 2011, and that was 6280 at the end of the month. The ownership structure of powerful shareholder in Wanfu Science Company is easy to make that the majority shareholder randomly operates the company and occupy the interest of the minority shareholders.

Important related transaction. On August 18th in 2012, the first board of directors approved Proposal of Related Transaction about Accepting Financial Assistance of Dominant Stakeholders. The dominant stakeholders and Tong Yongfu provided RMB 30 million to assist the company. The deadline is one year and the interest rate is 6%. The proposal has been approved in the first temporary stakeholders' meeting on August 18th in 2012.

Selection and application of the units to be audited for accounting policy. There are no other changes of accounting policy and accounting estimation, and there are no early accounting errors during report period.

From the notes to the annual report of Wanfu Science in 2011, we find that the company didn't count the depreciation reserves of taking delivery of goods and inventory. The note shows that there was no depreciation for inventory and fixed assets, so the depreciation reserves were not counted. It is inadvisable for the company not to count the depreciation reserves of taking delivery of goods and inventory under the condition of market competition intensifying poor market. Meanwhile, the same industrial company, Gold Gereals Industry counted near 1.03 million yuan of depreciation for the goods in stock in 2012. So the purpose of not counting depreciation reserves may be to reduce the expense and inflate the profits and assets.

There are abnormal phenomena in the semiyearly report and not of Wanfu Science in 2012,. And it is the most evident that the current amount of cash flow statement, reduction of inventories, reduction of the program and increase of operative payable program is 0, which is nearly impossible for normal operating enterprises, and needs to be focused on.

The fields with material misstatement risks include identification of existence of stock, identification of existence of receivables, and identification of integrity of receivables.

Target, strategies and operational risks of units to be audited. Wanfu Science devotes to becoming the leading cereal and oilseed processing industry and supplier of healthy food. The rich rice resources in Dongting Lake District are used to provide healthy food and high-quality life service, and implement brand strategy. The president of Wanfu Science, Tong Yongfu, said that a rice needs to be manufactured to have the value of Maotai. While being interviewed by the journalists, the executives said that the target of the company is to become Sany Heavy Industry in food processing industry in China.

For the present operation status of Wanfu Science, the target is too high, which has the risk of varnishing financial statement and inflating profit. The identification of incidence of operation revenue and identification of integrity of liabilities should be checked.

There is strong equity financing preference for the management layer of Wanfu Science. Listed company financing in developed countries consists with pecking order theory, for which endogenous financing is the first, debt financing is the second, and stock financing is the last. However, in China, stock financing cost is low, and the enterprises prefer to stock financing. In order to achieve the purpose of listing, many enterprises are anxious to achieve quick success and get instant benefit, and use unscrupulous divisive tactics to make change on financial statement. In recent years, there are more and more fraud listing cases. Earnings management is common for IPO company. Many companies make earnings management to inflate asset before issuing shares. Wanfu Science which was listed in September in 2009 has the risk of inflating profit for fraud listing.

Financial policy. Participating in profit not aligned as specified. On August 1st, 2012, the sixteenth meeting of the first board of directors approved the proposal of Modifying Articles of Company, and revised the distribution policy of dividend of the company. The company meets the dividend condition during report period. But the financial statement has no instruction.

From the above analysis, we consider that the material misstatement risks of the units to be audited are higher level.

Knowing Internal Control of Units to Be Audited

It includes authorization, performance evaluation, information processing and separation of duty.

Control environment. Powerful stakeholder. Tong Yongfu and his wife Yang Ronghua masters 29.99% of the stock respectively, and are the largest stakeholder in the company. They own the greatest right, and the board of directors is only nominal. They actually master the control right of the company, which forms the governing structure of powerful stakeholder, and is typical centralized stock-right controlling right. Under the situation, the major issues and development direction of the company is the independent performance of Tong Yongfu and Yang Ronghua. The situation of concentrated stock right and great control right makes the company develop towards Gong's family profit maximization, which is easy to have fraud behaviors.

Insider control is severe. Insider control means that the company is controlled by the management layer, and the right of stakeholders is nominal. The researches of many scholars consider that it has negative correlation with the performance of the company.

Ownership is not separated from management right. The annual report of Wanfu Science in 2011 shows that the actual controller of the company, Gong Yongfu, not only is the president, but also is the general manager. The legislation model in China makes that legal representative has greater right. The actual controller can control the listed company by directly taking charge of the president. And the pattern of two power gathering one of the president and the general manager makes that the actual controller controls the management and supervision layer. And the internal supervision mechanism is inhibited.

Independent director and supervisor is nominal. The company lacks of effective internal monitoring mechanism, and the independent director and supervisor is nominal. The data indicates that the company has the disgusting conduct of fictional material purchase, inflating sales revenue and inflating profit for many years. However, from the annual report of the company in 2011, we can see that the company held 6 board of directors meeting, and three independent directors joined the board of directors. The independent directors with rich management experience and professional knowledge never proposed a negative vote or abstention vote. We can see that three independent directors didn't fulfill their responsibilities, and had no the ability of funding major financial fraud.

Professional quality of the executives is lower. The company only has 9 internal senior managers, in which only one is master degree or above, one is bachelor degree, six are college degree and one is high school education. The general manager and the president, Gong Yongfu, and the deputy president, Jiang Jianchu are only college degree. The supervisory and the employee supervisor, Liu Yanxi, is only vocational degree. The chief financial officer, Tan Xuejun, is only the college degree. Lower educational level causes deficient professional knowledge and deficiency of management ability, which makes them not manage the business well.

Control activities. Control activities is the policy and procedure which is implemented combined with the countermeasures to risks. It includes incompatible duty separation control, authorization approval control, accounting system control, property protection control, budget control, operation analysis control, performance assessment control and contract control. It should be blended in operating management activities or administrative rules, operating process and post manual of the company. And the necessary control program should be set for each risk.

However, we find that the company has the following problems in the actual operation process, separation of duty and responsibilities, circulation of purchase prepaid, circulation of production and inventories, inventory management control flow, budget control loophole, and circulation of sale and collection.

Information and Communication. Wanfu Science issued Supplement of Important Information Disclosure and Correction of Semiyearly Report in 2012 on October 26th, 2012, as follows. From January to June in 2012, the inflated operation revenue, cost and profit of the company was 188 million yuan, 146 million yuan and 40.2316 million yuan. After correcting the performance, the actual operation revenue and net profit was 82.17 million yuan and -13.68 million yuan, which reduced by 64.61% and 143.87%. The notice disclosed that the company concealed the production suspension of production line in the first half year.

Concealing major capital expenditure. The information which is disclosed in semiyearly report indicates that the investment budget of sewage treatment project reaches 80 million yuan. From the condition of the construction in progress in June in 2011 which is disclosed in prospectus, we can see that there is no sewage treatment project, and it conceals major capital expenditure plan for the investors.

Internal supervision. Wanfu Science is the listed company with equity dispersible for ownership structure. The actual controllers of the company, Gong Yongfu and his wife Yang Ronghua, are the first majority shareholder of the company, and are the actual controller of the company. They hold 59.98% of the shares of the company, and own absolute control right. The decision-making right is mastered by them, and the board of directors is nominal.

Internal auditors are deficient. The professional quality of internal auditors can't meet the requirements of business development and management control of the company, and the internal control system construction is not improved. The company has 392 regular employees, in which there are 3 auditors, only accounting for 0.3%.

The professional quality and independence of financial staff is low. The chief executive officer Tan Xuejun is a graduated from a college, and the professional ability and quality is lower. She began to work in Wanfu Science in 2003, and is on good terms with the president Gong Yongfu. She is controlled by the president, so there is serious financial fraud behavior.

Above all, the company doesn't execute internal control system, the operation system is not improved, the professional talents are deficient, the accounting and supervision function of finance is not played well, the responsibility of the posts is not clear, and legal consciousness and legal sense is deficient.

By the above analysis, we consider that the units to be audited may have major misstatement risks. The fields with material misstatement risks include accounts receivable, prepayment account, inventory, construction in process, operating revenue, operating cost, management expense and gross profit rate.

Outcome of Incident

Financial fraud of Wanfu Science. On September 14th, 2012, Hunan SEC initiated an investigation. Wanfu Science was suspended to accept the survey of China Securities Regulatory Commission on September 19th. On October 26th, Wanfu Science admitted that the semiyearly report in 2012 had financial fraud (inflated operating revenue was 188 million, inflated operating cost was 146 million and the inflated net profit was 40.23 million). Wanfu Science was resumed on October 29th, and the share price was directly shut down. It was publicly denounced on November 23rd. On March 2nd, Wanfu Science published self-inspection announcement and admitted the financial fraud (from 2008 to 2011, the inflated income was about 740 million, the inflated operation profit was 180 million and the inflated net profit was 160 million. Fabrication was the most severe in 2011. The inflated revenue was 280 million, the inflated operation profit was 65.41 million yuan and the inflated net profit was 59.13 million yuan). And Wanfu Science was denounced by Shenzhen Stock Exchange again on March 15th, 2013. According to the provision of GEM Stock Listing Rules, if the company is publicly denounced again in 36 months (from November 23rd, 2012 to November 23rd, 2015), it may have the risk of delisting. And Wanfu Science may become the first delisting stock in GEM.

Penalty decision. On May 10th, 2013, CSRC made notification, and gave the penalty decisions including warn, fine and limited-access market to Gong Yongfu and Tan Xuejun. For the financial fraud case of Wanfu Science, Zhonglei Accounting Firm didn't take the responsibilities, which accelerated mildew of Golden Rice. CSRC informed the audition negligence of Zhonglei Accounting Firm, and proposed that it didn't take the responsibilities in annual report in 2011. And it confiscate 1.38 million yuan, and imposed two times of penalty, and repealed securities services business license. The signature CPA, Wang Yue and Huang Guohua, could be warned and imposed the fine of 100000 yuan and 130000 yuan. Zou Hongwen, the signature CPA, was warned and imposed the fine of 30000 yuan. The penalty of CSRC for Zhonglei Office was after repealing the security service business of Grassland Pengcheng Accounting Firm.

Enlightenment and Thinking

For the company, the corporation governance should be strengthened, the internal control system needs to be sounded, the legal awareness should be enhanced, and the capital market should be revered. The ownership structure of Wanfu Science is too concentrated, and there is no a set of feasible internal control system, and lacks of improved decision-making system. The defect of governance structure of the company is the deep-level reason for financial fraud of Wanfu Science. Therefore, the enterprise should establish effective internal control framework system, protect the

legal interest of investors, promote specified development of the company, optimize corporation governance, and improve risk management and control, form making that stable development of capital market becomes the power of improving enterprise system and enhancing operation and management of enterprises.

For accounting firm, ignoring audit quality is the direct reason for audit failure. The auditor should concern specified industrial risk points, achieve the direct data by on-the-spot visit, and enhance analytical review procedures. It can't only inspect the statement for audit, and it needs to think of the correlation of statements. The more detailed the information which is disclosed by the notes, the more the frauds.

For the regulator, the licensing authority should strictly control the source of IPO public offering. The regulator should enhance the supervision on listed companies. Especially the companies with frequent performance change should be surveyed and contained timely to promote the investor protection to the legal dimension.

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