

Analysis of Financial Fraud and Governance in Guangyuyuan

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Abstract: In recent years, with the rapid development of the capital market, cases of financial fraud by listed companies have gradually increased, leading to increasingly severe economic consequences. This study takes Guangyuyuan Chinese Medicine Co., Ltd. as the research subject, thoroughly analyzing its methods and motivations for financial fraud, and derives corresponding preventive measures based on this case. The aim of this research is to provide references and insights for the prevention and governance of financial fraud in listed companies.

Keywords: Financial Fraud; Fraud Triangle Theory; Preventive Measures

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1.Introduction

Over the years, there have been an increasing number of financial fraud cases in China's securities market, and the pharmaceutical manufacturing industry is one of the hardest hit areas for financial fraud. Although the country has introduced many relevant laws, this phenomenon still persists despite repeated bans. This paper takes Guangyuyuan Traditional Chinese Medicine Co., Ltd. as the research object, and analyzes the reasons and methods of financial fraud in Guangyuyuan to find better prevention and control measures for such fraud cases. This study can serve as a warning to companies with fraudulent ideas, and also provide suggestions for others on measures to prevent financial fraud^[1].

2.Analysis of Financial Fraud Methods in Er Guang Yu Yuan

2.1 Abuse of income recognition policy

From 2016 to 2021, Guangyu Yuan's annual report disclosed information about the "buyout sales" model that did not match its actual operation. The real situation at that time was that its subsidiary, Shanxi Guangyuyuan National Pharmaceutical Co., Ltd., signed agreements with multiple downstream distributors with clauses stating that "products can be returned unconditionally if they are unsold or on time", improperly utilizing the accounting policy of "recognizing revenue upon delivery", and thus recognizing sales revenue in advance. Due to the existence of return or repurchase agreements, the essence of such transactions is not actual sales, but rather a storage behavior of placing goods at distributors for consignment sales^[2]. Therefore, it cannot be considered as having generated sales revenue. However, the finance department of Shanxi Guangyuyuan still considers the outflow of goods as revenue, resulting in the company's cumulative inflated revenue of approximately 674 million yuan.

2.2 Improper handling of sales expenses

In order to cover up the discrepancies in accounts caused by inflated income, Guangyuyuan also has certain problems in handling sales expenses. Specifically, the attribution period of some sales expenses is inaccurate, or their accounting treatment

does not strictly comply with the relevant provisions of the Enterprise Accounting Standards. For example, by including expenses that should have been attributed to subsequent years in the current period in advance, in order to cover up the fraudulent behavior of recognizing income in advance, this further leads to the distortion of financial data^[3].

3. Analysis of the Reasons for Financial Fraud in San Guang Yu Yuan

In order to better analyze the reasons for financial fraud in Guangyuyuan, this article will analyze this case based on the fraud triangle theory from the three factors of pressure, opportunity, and self rationalization.

3.1 Stress factors

The pressure factor is considered a prerequisite for the occurrence of fraudulent behavior, that is, the motivation for fraudsters to decide to commit financial fraud. In 2016, Guangyuyuan completed the acquisition of 40% equity of Shanxi Guangyuyuan held by its controlling shareholder Dongsheng Group and others. At that time, the transaction price for the 40% equity of Shanxi Guangyuyuan was as high as 1.292 billion yuan. However, by the end of 2015, the net assets of Shanxi Guangyuyuan were only 26 million yuan. One of the counterparties in this major asset restructuring was Dongsheng Group, the controlling shareholder of Guangyuyuan at that time^[4]. Therefore, as the party selling assets and the beneficiary of this high premium transaction, Dongsheng Group has made strict performance commitments: Dongsheng Group promises that Shanxi Guangyuyuan will achieve non recurring net profits of no less than 133 million yuan, 235 million yuan, and 433 million yuan in 2016, 2017, and 2018, respectively. During the performance commitment period, if the actual profit does not meet the standard, Dongsheng Group needs to compensate. However, Shanxi Guangyuyuan's non recurring net profit in 2015 was only 9.7373 million yuan, which undoubtedly brought huge short-term performance pressure to the management. When the actual operation fails to achieve the promised goals, in order to avoid triggering compensation clauses or legal disputes, the management decides to achieve the commitment through financial fraud^[5].

3.2 Opportunity factors

The opportunity factor is usually considered an important condition for the occurrence of fraudulent behavior, that is, whether the fraudster can commit fraud. The internal equity structure of Guangyuyuan is relatively concentrated, with Dongsheng Group holding a share of 19.46% in 2016, ranking as the largest shareholder of Guangyuyuan. Guo Jiaxue holds 72.74% of the equity of Dongsheng Group, making him the ultimate actual controller of Guangyuyuan. This equity structure allows Guo Jiaxue to hold absolute management power over the enterprise, and he can easily appoint loyal directors and executives. This makes the board of directors no longer a decision-making and supervisory body representing the interests of all shareholders, but a "rubber stamp" for executing the will of controlling shareholders, making these power departments unable to exercise their own power, have no substantive role, and are like a mere formality.

In addition to internal reasons within the company, there are also some external factors. At that time, Lianda Accounting Firm, which provided annual audit services for Shanxi Guangyuyuan, did not effectively fulfill its job responsibilities and did not play an external regulatory role. For example, the accounting firm did not correct Guangyuyuan's "buyout sales" and abuse of the accounting policy of "recognizing revenue upon delivery", and ignored obvious financial abnormal signals such as the sharp increase in sales expenses and abnormal extension of accounts receivable turnover days in Shanxi Guangyuyuan. Although we are not sure whether it is due to the insufficient ability of the certified public accountant responsible for the audit business of the company or the existence of a relationship of interest between them, Lianda Certified Public Accountants should bear some responsibility for the fact that Guangyuyuan's financial fraud was not audited.

3.3 Self rationalization factors

The self rationalization factor, often referred to as the excuse factor, played a crucial role in this case. At that time, the company was facing the dilemma of difficult to fulfill performance commitments, and there were objective conditions within the company that could lead to fraud. The management began to self persuade and find reasonable reasons for improper behavior. They mainly justify themselves based on the following two points: firstly, if financial fraud is not discovered, Shanxi Guangyuyuan will be able to smoothly fulfill performance commitments, thereby increasing the company's profits, and the stock price will also rise, bringing higher profits to the company; Secondly, there are many companies involved in financial fraud every year, and not all cases will be exposed. Even if discovered, the relevant penalties will not be very severe.

Overall, the management believes that the potential benefits of fraud not being exposed far outweigh the potential risks and costs. Under this psychological drive, the enterprise ultimately completed the process of self rationalization and took risks, leading to the occurrence of financial fraud in Guangyuyuan^[6].

4.Prevention and control measures for financial fraud cases in Siguang Yuyuan

4.1 Improve internal governance structure

Firstly, the equity structure should be improved. Currently, many listed companies have a highly concentrated situation of “one dominant shareholder” in terms of equity. Therefore, in order to improve the internal governance structure of the company, the top priority is to diversify the shareholding ratio of major shareholders, form effective equity checks and balances, and create a fair internal environment. Next is to ensure that governance institutions such as the shareholders’ meeting, board of directors, and supervisory board can operate independently and play their roles, so that they can mutually constrain and supervise each other, thereby avoiding the occurrence of financial fraud.

Secondly, we need to improve the system of the board of directors. The board of directors is the decision-making body for a company’s operations. If the board of directors cannot be independent of shareholders and management, it is difficult to have independent and objective judgment. However, currently, the board of directors in Chinese companies rarely plays a supervisory role. Therefore, it is necessary to improve the system of the board of directors, enhance the professional ability and level of the board of directors, prevent the management from harming the interests of shareholders in order to obtain higher benefits, supervise the behavior of the management, and prevent various interferences of shareholders in the decision-making of the management, so as to avoid the occurrence of financial fraud.

Finally, we need to improve the system of the supervisory board. The supervisory board is the internal supervisory body of the company. If the supervisory board wants to truly play its supervisory role, it must ensure that the members of the supervisory board are elected reasonably, legally, fairly and justly by the shareholders’ meeting and the company’s employees. Only when the supervisory board has real power and is not controlled by directors or senior management can it better play its role in review and supervision, thereby reducing the occurrence of fraudulent behavior.

4.2 Improve the system of external audit institutions

In the financial fraud case of Guangyuyuan, Lianda Accounting Firm bears some responsibility. If the firm gives an unqualified audit opinion, it means that the registered accountant’s professional ability of the firm is insufficient or there is an interest relationship between the firm and Guangyuyuan. In order to reduce the opportunity factors brought by external factors for financial fraud in enterprises, we can take the following measures.

Firstly, external audit firms can adopt an audit rotation system, which stipulates that accounting firms cannot provide services to the same client for more than two years or for a specific period of time. By regularly changing audit firms, external audit firms can be better made independent of the audited entity, directly reducing the risk of collusion between both parties from a systemic perspective, and ensuring the objectivity and fairness of audit work.

Secondly, a third-party payment system can be established, which stipulates that the audit fees of the audited entity shall be uniformly paid to the special account of the China Securities Regulatory Commission, and then the designated audit institution appointed by the China Securities Regulatory Commission shall provide audit services to the audited entity. This can ensure that there is no direct economic interest relationship between the audited entity and the external auditing agency, to a certain extent, reducing the risk of joint fraud from the source, and ensuring the objectivity and fairness of the audit work.

4.3 Strengthen punishment

From the analysis of the above methods, we can see that Guangyuyuan committed a huge amount of fraud, up to 674 million yuan, but the company only faced a fine of 8 million yuan. The huge gap between these two figures makes the punishment seem powerless. If stricter punishment mechanisms are not established, it is likely that more business managers will choose to engage in fraudulent activities in order to attract more investors and obtain higher profits. We can consider it from the following aspects:

At the legal level, for those involved in financial fraud, the amount of fines can be significantly increased, and penalties can be introduced to increase the cost of financial fraud and create a greater deterrent effect on potential offenders; At the

administrative level, for certain enterprises or individuals who seriously violate industry regulations, their licenses or business licenses may be revoked, making it impossible for them to continue engaging in related business.

5. Conclusions and Implications

China's securities market was established in 1986. Compared with some developed countries, China's securities market started relatively late, which has led to the insufficient function and role of the securities market. As a result, many enterprises ignore the laws and regulations of the securities market and continue to engage in financial fraud. In order to prevent this situation from happening, we should find preventive measures from different perspectives, fully play the supervisory role, and prevent or reduce the occurrence of such cases from the source. The research object of this article is Guangyuyuan Traditional Chinese Medicine Co., Ltd., and prevention and control measures are proposed for the fraudulent methods used in this case. These prevention and control measures may not be applicable to every enterprise that engages in financial fraud, but there are some suggestions for prevention and control measures such as improving internal governance structure that can provide inspiration for other listed companies. At the same time, it is believed that improving the system of external audit institutions and increasing punishment measures can also provide some ideas for the supervision department of the securities market to curb such behavior, in order to provide reference for the healthy and orderly development of Chinese enterprises.

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Conflict of Interests

The authors declare that there is no conflict of interest regarding the publication of this paper.

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