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Research on Corporate Financial Fraud Governance Based on the Fraud Triangle Theory: A Case Study of Blue Mountain Technology Company

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Abstract

This paper takes the financial fraud case of Blue Mountain Technology as the research object, analyzes and compares relevant financial data, reveals the motives and methods of its financial fraud, and proposes targeted preventive measures under the combination of internal governance and external supervision of the company, aiming to strengthen audit supervision and improve investors' discernment ability. This study is of great significance for strengthening corporate financial supervision and safeguarding investor rights.

Keywords

Financial Fraud; Blue Mountain Technology; Enlightenment Introduction.

1. Introduction

Multi channel fund allocation for investment and wealth management, preventing investment risks, and maximizing returns has become an inevitable choice for most investors. As of the end of 2023, the number of accounts opened by investors in the Chinese securities market has reached 212 million, of which approximately 50 million have stock market value accounts. Most securities investors make investment decisions by publicly disclosing information about the cash flow, profitability, and asset status of listed companies. Due to the lack of sound laws and regulations in the regulatory field of listed companies in China, as well as insufficient supervision over the audit of listed companies, financial fraud incidents of listed companies are not uncommon. A considerable number of companies use false means to beautify financial statements, overestimate company revenue, and inflate profits to mislead investors, leading to incorrect investment decisions and seriously damaging the interests of investors, which has a negative impact on the healthy development of China's securities market.

This paper aims to analyze the causes and characteristics of financial fraud in Blue Mountain Technology Company, propose preventive measures, and provide reference for other companies to strengthen audit supervision and prevent financial fraud, as well as for investors to improve their discernment ability.

2. Related concepts and theoretical foundations

2.1. Definition of Financial Fraud

Financial fraud refers to the intentional manipulation of accounting records and financial reports by a company to distort its financial condition and performance. This behavior involves forging transactions, concealing debts, exaggerating income, underreporting expenses, and other means to mislead or deceive investors and stakeholders about the true financial situation of the company. Financial fraud not only harms the interests of investors, but also has a serious impact on market fairness and transparency.

2.2. Fraud Triangle Theory

The fraud triangle theory was proposed by W. Steve Albrecht, founder of the Association of Certified Fraud Auditors (ACFE) and president of the American Accounting Institute. He believes that the emergence of corporate fraud is composed of three elements: pressure, opportunity, and self rationalization. Just as a certain amount of heat, fuel, and oxygen must be present simultaneously to ignite, without any of these elements, it is impossible to truly form corporate fraud. Pressure may be due to operational or financial difficulties, as well as an urgent need for capital; Motivation usually comes from external financial pressure or internal performance goals, while opportunities are related to weak internal control and supervision mechanisms of the company; Self rationalization refers to how individuals psychologically justify their inappropriate behavior, making it appear acceptable or reasonable. The fraud triangle theory provides an important theoretical framework for us to understand and prevent financial fraud. By strengthening internal controls, enhancing the effectiveness of supervision mechanisms, and strengthening ethical education and training, the occurrence of financial fraud can be reduced. In addition, strengthening external auditing and supervision is also a key measure to prevent financial fraud. By comprehensively applying these measures, we can better protect the interests of investors, maintain market fairness and transparency, and promote sustainable development of enterprises.

3. Introduction to Financial Fraud Cases of Blue Mountain Technology Company

3.1. Company Overview

3.1.1. Company Profile

Beijing Blue Mountain Technology Co., Ltd. was established in September 2005. It is a provider of optical transmission connection products and service solutions that integrates multiple businesses such as optical communication product development, manufacturing, and marketing services. Its products and services are mainly applied in the fields of fiber optic cable to the home, three network integration, and large customer access, with business scope covering multiple industries such as telecommunications, municipal, power, and education. In June 2014, the company successfully went public on the New Third Board, and its development prospects were highly anticipated by investors. However, later on, when the company submitted application materials on the national stock transfer system, internal audit agencies and the China Securities Regulatory Commission's internal data sampling discovered doubts about information disclosure, and it was ultimately investigated by the China Securities Regulatory Commission at the end of 2019.

3.1.2. Analysis of important indicators in the company's financial statements during the period of fraud

During the period from 2016 to 2019, Beijing Blue Mountain Technology Co., Ltd. maintained a total operating revenue of around 600 million yuan. Although the total profit decreased year by year, considering the impact of the epidemic and the downturn of the market economy, the overall profitability and sustainable operation ability are acceptable. As a star stock among the New Third Board companies at that time, its prospects were bright. However, from 2017 to 2019, the company illegally exaggerated its total revenue by forging purchase and sales and R&D business, increasing R&D expenses by more than 200 million yuan, and falsely reporting profits of more than 80 million yuan. This series of financial fraud ultimately led to false records in the company's public offering documents, seriously misleading investors and the market.

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Table 2-1 Key Indicators of Blue Mountain Technology's Financial Statements (before being penalized by the China Securities Regulatory Commission)

Main subjects	2019 Annual Report	2018 Annual Report	2017 Annual Report	2016 Annual Report
gross revenue	674 million	642 million	676 million	614million
Year on year total operating revenue (%)	4.88	-5.05	10.1	5.82
Total profit	47 million 889 thousand	45 million 986 thousand and 241	76 million 414 thousand and 700	118 million
Net profit	49 million 112 thousand	45 million 25 thousand and 100	70 million 699 thousand and 600	105 million
Net profit year-on-year (%)	9.08	-36.31	-32.66	5.94
Total Assets	1 billion 131 million	1 billion 73 million	1 billion 107 million	960 million
Total assets year-on-year(%)	5.42	-3.06	15.3	19.64
Total Liabilities	234 million	225 million	299 million	212 million
Total owner's equity	897 million	848million	808 million	748million
Total owner's equity year-on-year (%)	5.79	5.02	8	15.31

The data comes from Tianyancha's public annual report information

3.2. Financial fraud methods of Blue Mountain Technology Company

Based on the announcement released by the China Securities Regulatory Commission, as well as the financial statements and the correction of major errors in the previous period, we have compiled the specific methods and contents of financial fraud of Blue Mountain Technology Company from 2017 to 2020 according to the timeline.

Table 2-2 Financial Fraud Methods and Processes of Blue Mountain Technology Co., Ltd

Year	Fraudulent methods	Details
2017-2018	False accounting	At the end of 2017 and 2018, the company's book bank deposit balance was 88.6499 million and 47.4307 million , respectively. At the end of the two-year period, the actual bank deposit balances of the company were630.05 million and 333.87million , respectively. The company inflated bank deposits through false accounting methods, and at the end of 2017, the inflated bank deposit balance was 82.3494 million , with an exaggeration ratio of 92.89%; At the end of 2018, bank deposits were inflated by 44.092 million , with an inflated proportion of 92.96%.
2017-2019	Using real customers to fabricate	From 2017 to 2019, the company and its wholly-owned subsidiary Beijing Zhongjing Cyber Technology Co., Ltd. falsely increased revenue by 810.9226 million , sales profit by

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	procurement and sales cycle business	2458.8896 million , inventory by 106.1068 million yuan, and accounts receivable by 63.0333 million through fictitious procurement and sales cycle business.
2017-2019	Overinflated research and development expenses	The company fabricated research and development contracts and payments for Shusheng and Gupu Interstellar, with a total fictitious R&D expenditure of 248.588 million .
2017-2019	Fictitious freight expenses	From 2017 to 2019, the company falsely listed a total of 41.4675 million in freight expenses for New Moon Union.
December 2019	Fictitiously disposing of fixed asset income	The company and Zhongjing Cyber disposed of and sold production equipment due to the adjustment of production mode, with a sales amount of 43.8318 million . After investigation, the company fabricated the disposal and sale of production equipment business, and the purchaser Ipsese was actually a related party of the company and the company did not actually receive the sales proceeds. The company fabricated the disposal and sale of production equipment worth 43.8318 million.
April 2020	Suspected of violating regulations	Blue Mountain Technology has announced the application documents for the public issuance of stock prospectus (application draft) to investors and listing on the selected layer. The authenticity of the information disclosure is questionable, and it is suspected of violating relevant regulations such as the Securities Law (Measures for the Supervision and Administration of Non listed Public Companies).

The data comes from the penalty documents of the China Securities Regulatory Commission

The above materials show that Blue Mountain Technology has engaged in comprehensive fraudulent activities in various aspects such as procurement, production, sales, inventory management, logistics and transportation, and financial accounting. The important fraudulent matters are as follows:

3.2.1. Analyze the process of exaggerating the purchase and sales scale using real customers

Blue Mountain Technology claims that its top five customers account for 78.03% of the company's annual sales. By reviewing the supplier lists and procurement amounts of these clients in 2019, it was found that the procurement amount of Aibo Information (Shenzhen) Co., Ltd. was 79.4561 million yuan, the procurement amount of Donghua Boyuyun Co., Ltd. (a subsidiary of Donghua Software Co., Ltd.) was 97.9437 million yuan, and the procurement amount of Shenzhen Innovation Science and Technology Co., Ltd. was 36.1834 million yuan, all of which were significantly lower than the sales disclosed by Blue Mountain Technology in its 2019 financial statements. Furthermore, Beijing Shanghai Wentian Technology Development Co., Ltd. did not include the name of Blue Mountain Technology in its 2019 supplier list, despite having only Blue Mountain Technology as its supplier in 2017.

These inconsistencies have raised doubts among investors that Blue Mountain Technology may have fabricated sales based on past sales records. The punishment decision of the China Securities Regulatory Commission further confirms these suspicions, pointing out that Blue Mountain Technology does indeed have financial fraud issues.

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Table 2-3 Top Five Customers of Blue Mountain Technology

Top Five Customers	Main business	Sales amount	Annual sales proportion	Is it a related party
Aibo Information (Shenzhen) Co., Ltd	IoT reading devices	134,260.003.85	19.93%	No
Donghua Software Co., Ltd. and its affiliates	Software	123,093,675.45	18.27%	No
Shenzhen Innovation Technology Co., Ltd. and its affiliates	Storage and cloud computing	117,725,633.06	17.47%	No
Beijing Tianyue Wuzhou Technology Co., Ltd	Newly registered in 2017, Main business unclear	94,403.653.21	14.01%	No
Beijing Shanghai Wentian Technology Development Co., Ltd	IT Overall Solution	56.220.220.97	8.35%	No
Total	/	525,703,186.54	78.03%	/

Data source: Blue Mountain Technology 2019 Annual Report

3.2.2. Fictitious R&D business and R&D expenses to offset inflated funds

According to the annual reports of the company from 2017 to 2019 and a comparative analysis of capitalization rates with peers in the same industry, it can be seen that the company's R&D expenditure surged in 2018, with a year-on-year increase of 207.9%, reaching 239 million yuan, and a capitalization rate of 16.57%; Compared to 2019, R&D expenditure decreased by 47.8% year-on-year, but its capitalization rate was as high as 63.86%, and the R&D expenditure of 125 million yuan in 2019 was still much higher than the R&D expenditure of 78 million yuan in 2017. In business practice, enterprises usually need to have a high-quality R&D team. However, the proportion and educational level of R&D personnel at Blue Mountain Technology at the end of 2019 were not high, with R&D personnel accounting for only 19.39% of the total number of employees, and the proportion of employees with doctoral degrees was as low as 3.13%. Regarding this, Blue Mountain Technology explained that the company has focused its main resources on research and development. In 2019, the number of research and development projects increased by three compared to the previous year, and the company's research team is mainly responsible for key research and development processes, while specific research and development work has been outsourced to suppliers.

However, these explanations have raised doubts from the outside world, as people suspect that Blue Mountain Technology may use fictitious monetary funds for research and development investment, and secretly consume monetary funds by capitalizing research and development expenditures and transferring them to intangible assets. The Administrative Penalty Decision (No. 98 of 2021) also confirms that Blue Mountain Technology has the following problems: the company itself lacks actual research and development capabilities, the personnel and acceptance experts involved in project research and development have not truly participated in the research and development and acceptance process, the research and development results have not been combined with production activities, the company has fabricated on-site inspections to respond to intermediary agencies' inspections, and fabricated research and development materials to respond to the review and inquiry of the national small and medium-

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sized enterprise share transfer system, without actually conducting real research and development activities. During the period of 2017 to 2019, the company fabricated research and development contracts and payments with Chengdu Shusheng and Tuopu Interstellar, with a fictitious total research and development expenditure of 248.588 million yuan (excluding tax), thereby inflating assets and increasing management expenses.

According to the Enterprise Accounting Standards, the conditions for capitalizing research and development expenses are very strict, and it is necessary to prove that the products produced by the developed intangible assets or the intangible assets themselves have a market; And the enterprise has the intention to complete the intangible asset and use it for production or sales. Based on the principle of prudence in accounting, most companies typically treat research and development expenses as expenses. However, Blue Mountain Technology's R&D capitalization rate in 2019 was as high as 63.86%, which is much higher than other companies in the same industry. Therefore, the authenticity and rationality of its financial processing have been questioned.

4. Inspiration from the Financial Fraud Case of Blue Mountain Technology Company

4.1. Inspiration for internal enterprises

4.1.1. Internal control level

The financial fraud case of Blue Mountain Technology reveals serious deficiencies in its internal control system. Specifically, the company lacks effectiveness in financial reporting and its monitoring mechanisms, failing to promptly identify and correct errors or improper financial behavior. In addition, Blue Mountain Technology has not established an independent internal audit department, and its internal audit function is not independent of the finance department, which hinders the effectiveness of internal audit in supervising and preventing financial fraud. This case emphasizes the necessity of strengthening the company's internal control system, especially in ensuring the accuracy and reliability of financial reports to prevent financial fraud.

4.1.2. At the governance level

The Blue Mountain Technology case highlights the role of fragile corporate governance structures in driving financial fraud. In the pursuit of maximizing short-term profits, senior management of the company has neglected ethical constraints and legal awareness, as well as long-term development and corporate social responsibility. In addition, due to the lack of independence of the board of directors, it failed to effectively supervise the management, resulting in financial fraud by the management in an environment of insufficient supervision. This situation highlights the necessity of establishing a sound corporate governance structure, especially enhancing the functionality and independence of the board of directors to prevent financial fraud.

4.1.3. In terms of equity structure

The financial fraud case of Blue Mountain Technology highlights the significant impact of equity structure issues on corporate governance. This case demonstrates that equity is highly concentrated in the hands of minority shareholders, especially when these shareholders hold senior management positions in the company, making it easy for them to manipulate financial statements and abuse their power for personal gain. This equity structure is prone to internal control issues, and the risk of financial fraud increases due to the lack of effective external supervision and checks and balances. Therefore, by optimizing the equity structure, increasing equity dispersion, and introducing independent shareholders to participate in corporate governance, the transparency of the company can be effectively enhanced and financial fraud can be prevented.

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4.2. Implications for the external market

4.2.1. Regulatory intensity

Regulation plays a crucial role in preventing financial fraud in listed companies. A sound regulatory system can significantly reduce the likelihood of financial fraud. Taking Blue Mountain Technology as an example, if regulatory agencies strengthen the strict review and regular inspection of financial reports, they can detect and prevent financial fraud earlier. In addition, when financial fraud is discovered, regulatory agencies should take decisive measures, including punishing companies and executives, to warn other potential fraudsters. Effective regulation not only relies on clear rules and regulations, but also requires ensuring that regulatory agencies have sufficient authority and resources to enforce these regulations.

4.2.2. Management of accounting firms

Accounting firms play a crucial role in preventing and exposing financial fraud. As the core link of external auditing, these accounting firms bear the responsibility of independently and objectively auditing the financial statements of enterprises, aiming to ensure the authenticity and accuracy of information. In the financial fraud case of Blue Mountain Technology, if auditors can adopt stricter audit procedures and conduct detailed inspections of all financial records, it is possible to expose fraudulent behavior. Therefore, accounting firms must continuously improve their professional capabilities and ethical standards to ensure the high quality of audit work.

4.2.3. Social and media supervision

The supervision of society and media is equally important in exposing and preventing financial fraud. Public opinion and media coverage can provide key information for regulatory agencies and market participants, thereby helping to identify and address financial fraud in a timely manner. Taking the Blue Mountain Technology case as an example, if the media can raise questions about its financial reports early on and attract public and regulatory attention, it may accelerate the investigation and handling process of financial fraud. Therefore, cultivating a healthy media environment and enhancing public awareness of financial information are key to preventing financial fraud. The supervision of the media and the public can not only reveal financial fraud that has already occurred, but also have a certain deterrent effect, preventing potential fraudulent behavior.

4.2.4. Regulations and laws related to corporate governance

The regulations and laws related to corporate governance constitute the cornerstone of ensuring the financial integrity of listed companies. A good corporate governance structure can effectively prevent financial fraud. Its measures include establishing an independent board of directors, ensuring the effective operation of the audit committee, and implementing internal control mechanisms. Taking Blue Mountain Technology as an example, strengthening internal control and supervision mechanisms, strictly monitoring the behavior of senior management personnel, can effectively reduce the possibility of financial fraud. In addition, a sound legal system, including clear punishment provisions for financial fraud, is a key means of preventing financial fraud. Therefore, strengthening corporate governance and improving laws and regulations are crucial for establishing an honest and transparent capital market environment.

5. Conclusion

In this case, the pressure faced by the management, feasible opportunities for fraud, and their motivation to rationalize the behavior collectively led the company to manipulate financial statements through means such as fabricating sales revenue, exaggerating profits, and concealing liabilities. This behavior not only violates financial reporting standards and relevant laws, but also seriously infringes on investor rights and triggers a crisis of trust. In addition, the

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occurrence of financial fraud is influenced by internal factors such as the lack of internal controls, imperfect management systems, and inadequate audit supervision, while the intensification of market competition and fluctuations in economic cycles are important external driving factors. To effectively prevent future financial fraud incidents, comprehensive improvements must be made from multiple dimensions such as corporate governance, audit quality, and investor education. Firstly, strengthening the corporate governance structure is crucial. By establishing a sound internal control system and clearly defining responsibilities, the accuracy and transparency of financial reporting can be significantly improved. Secondly, regulatory agencies should strengthen their supervision of audit practices to ensure the independence and quality of audit work, which has a direct impact on the authenticity of financial reports. Meanwhile, enhancing investors' financial knowledge and risk identification ability is also extremely important, as it helps them make wiser investment decisions. In addition, in-depth study of the fraud triangle theory can help us to have a more comprehensive understanding and prevention of financial fraud behavior; Extensive and in-depth case studies will also provide more empirical data to support the development and improvement of the theory. The comprehensive implementation of these strategies will lay a solid foundation for the healthy development of the market.

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