

Analysis of the Causes and Consequences of Corporate Financial Fraud—Take HANGZHOU CENTURY CO., LTD as An Example.

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Abstract:

In recent years, financial fraud by listed companies has become increasingly frequent, significantly disrupting the normal functioning of the capital market. It not only damaged investors' trust but also hindered the effective allocation of resources. This paper takes the financial fraud incident of HANGZHOU CENTURY CO., LTD as the research object. Based on the fraud triangle theory, it analyzes the internal and external motivations of enterprises to commit fraud from the three dimensions of motivation, opportunity, and rationalization. It uses the event study methodology to examine the market reaction to the company's stock price after the disclosure of the penalty announcement. Research shows that after the announcement is disclosed, the company's cumulative abnormal return during the event window period is significantly negative. It indicates that the capital market has a strong negative attitude towards financial fraud, and investor confidence has been severely damaged. The case of HANGZHOU CENTURY CO., LTD reflects the serious harm that financial fraud poses to enterprises, investors, and the market. This paper suggests that companies should strengthen their governance, investors should enhance their risk identification capabilities, and regulators should effectively fulfill their duties to maintain market credibility.

Keywords: Financial fraud; fraud triangle theory; event study methodology; HANGZHOU CENTURY CO., LTD

1. Introduction

In recent years, financial fraud cases have occurred frequently in domestic and foreign capital markets,

and the repeatedly exposed fraudulent behaviors have seriously damaged the interests of investors and market credibility. True and transparent financial information is the prerequisite for the effective allo-

cation of resources in the capital market [1]. If financial information is distorted, investors will not be able to accurately judge the company's operating conditions and risk levels, which will ultimately lead to uneven resource allocation and increased financing costs. Therefore, the causes and consequences of financial fraud have become an issue of great concern to the academic community. In China's capital market, the problem of financial fraud is very prominent. According to the China Securities Regulatory Commission's (CSRC) enforcement white papers, in 2022 alone, the CSRC investigated 20 typical cases of financial fraud, with inflated revenues and fictitious transactions being the most common. In 2024, administrative penalties were imposed on 61 cases of financial fraud, with an average penalty of 15.77 million yuan per case. This shows that financial fraud has become a significant factor hindering the healthy development of the capital market. Academic research has systematically examined the causes and methods of financial fraud. The fraud triangle theory states that the motivations for financial fraud are primarily pressure, opportunity, and rationalization. Companies are more likely to engage in fraud when facing financing and performance pressures. Internal control deficiencies or insufficient external oversight create opportunities for fraud. Management often rationalizes fraud through self-justification, downplaying moral hazard [2]. In terms of fraudulent methods, research shows that companies often commit fraud by inflating revenues and manipulating acquisitions [3]. These theories provide important theoretical support for this article's research. Among the many cases of financial fraud, HANGZHOU CENTURY CO., LTD. is a typical example. To meet refinancing needs, such as issuing convertible bonds, HANGZHOU CENTURY CO., LTD.'s management falsely inflated operating income by over 100 million yuan through fictitious sales and premature revenue recognition, resulting in serious distortion of financial statements. After the China Securities Regulatory Commission verified the company's financial fraud, it fined the company and banned the chairman from the market. At the same time, regulatory authorities transferred relevant clues to public security organs, and some executives involved in the case were held criminally responsible. This case formed a "full chain" path, from false disclosure, administrative penalties, and criminal prosecution, becoming one of the most typical fraud cases in China's capital market in recent years.

Based on this, this paper selects the financial fraud case of HANGZHOU CENTURY CO., LTD as its research object. First, based on the Fraud Triangle Theory, it can gain a deeper understanding of the mechanisms by which companies commit fraud under the influence of financing pressure, governance deficiencies, and rationalization. Second, this paper employs an event study methodology to assess the impact of financial fraud on investor confidence from

the perspective of market reaction. This not only serves as a warning to listed companies on how to regulate their governance, but also provides a reference for regulatory authorities to improve their systems. Overall, this paper aims to reveal the mechanisms and market consequences of financial fraud through analysis of the typical case of HANGZHOU CENTURY CO., LTD, providing insights for enhancing the transparency and credibility of the capital market.

2. Case Analysis of HANGZHOU CENTURY CO., LTD.

HANGZHOU CENTURY CO., LTD. was founded in 2003 and is headquartered in Hangzhou. It was listed on the Shenzhen Stock Exchange's ChiNext board in 2010 (stock code 300078). HANGZHOU CENTURY CO., LTD is a high-tech enterprise integrating research, production, and service. Initially focusing on business intelligence systems and information products, it has gradually shifted its development focus to the field of smart medical information technology, gradually forming a „smart medical + Internet of Things“ business model.

The financial fraud at HANGZHOU CENTURY CO., LTD. was closely related to the company's financing and performance pressures. Between 2019 and 2020, to complete the issuance of convertible bonds, the company needed to demonstrate sustained operating growth in its financial statements. However, its actual operating performance fell short of expectations of the capital market and regulators. To address this performance shortfall, HANGZHOU CENTURY CO., LTD. implemented several fraudulent operations through its wholly-owned subsidiary. These fraudulent practices primarily involved fabricating business transactions and prematurely recognizing revenue. HANGZHOU CENTURY CO., LTD. signed contracts with numerous companies with no real business dealings, issued invoices, and fabricated bank statements, thereby inflating its revenue on the books. In 2019, the company inflated operating revenue by 34.92 million yuan and profit by 33.02 million yuan, representing 20.03% of its total profit for the period. In 2020, the company inflated operating revenue by 96.46 million yuan and profit by 83.94 million yuan, representing 67% of its total profit for the period. Some funds were even provided by the company itself, transferred back through third-party accounts, creating the illusion of customer repayments. Furthermore, the company prematurely recognized revenue for projects that had not yet been delivered, further inflating current profits. However, regulatory authorities' review of contract documents and bank statements ultimately revealed the fabricated transactions and premature revenue recognition.

In 2024, the China Securities Regulatory Commission imposed penalties on HANGZHOU CENTURY CO., LTD for violating information disclosure laws: HANGZHOU CENTURY CO., LTD was ordered to correct the violations, given a warning, and fined 85.7 million yuan; Chairman Zhang Lizhong was given a warning and fined 7.5 million yuan.

3. Analysis of the Causes of Financial Fraud at HANGZHOU CENTURY CO., LTD- Based on the Fraud Triangle Theory.

The Fraud Triangle Theory is an important classic theory that explains the occurrence of financial fraud. The theory believes that fraud is mainly caused by the combined effects of three key factors: pressure, opportunity, and rationalization. The Fraud Triangle Theory emphasizes that fraud is more likely to occur only when these three factors exist at the same time. Therefore, the theory is widely used in auditing and fraud risk assessment.

3.1 Pressure Factors

First, HANGZHOU CENTURY CO., LTD faced direct pressure from its financing needs. From 2019 to 2020, HANGZHOU CENTURY CO., LTD. planned to issue convertible corporate bonds, raising approximately 817 million yuan. The issuance review and market subscription for convertible bonds depend on the company's profitability. According to the China Securities Regulatory Commission, listed companies issuing convertible bonds must meet the requirement that their average distributable profits over the past three years are sufficient to cover one year's interest on the bonds. If HANGZHOU CENTURY CO., LTD's financial statements show declining performance, this could lead to increased financing costs or even a failure to raise funds. Therefore, HANGZHOU CENTURY CO., LTD must present idealized financial data in its filings and annual reports to maintain the trust of the capital market. In reality, HANGZHOU CENTURY CO., LTD's operating profits did not meet the issuance requirements. To address this situation, HANGZHOU CENTURY CO., LTD. engaged in fraudulent business operations to obtain the qualification to issue convertible bonds. Second, the smart healthcare industry in which HANGZHOU CENTURY CO., LTD operates is highly competitive. Around 2019, the smart healthcare market expanded rapidly, and national policies promoted the informatization of healthcare. However, market share gradually shifted to large companies, and HANGZHOU CENTURY CO., LTD had yet to establish a clear advantage in this field. If it discloses the true data, it may lead to a decline in investor confidence and a drop in stock prices, thus exacerbating

its financing difficulties.

3.2 Opportunity Factors

HANGZHOU CENTURY CO., LTD's internal governance and external audit issues created the conditions for fraudulent activity. First, the company's structure was clearly flawed. At the end of 2019, three specific investors, including shareholders Lu Nan and Fang Zhenchun, disbanded their concerted action relationship, leaving HANGZHOU CENTURY CO., LTD without a controlling shareholder. As of May 2020, as Lu Nan continued to reduce his holdings, Zhang Lizhong had become the company's largest shareholder, due to the decrease in both the number and proportion of Lu Nan's shares. Zhang Lizhong directly and indirectly controlled a 13.29% stake, thereby exercising substantial control over its core subsidiary. In the absence of effective checks and balances, management decisions could almost directly influence the compilation of financial data, facilitating the fabrication of transactions and premature recognition of revenue. Furthermore, according to the CSRC's penalties, Wang Jun, as Chairman of the Supervisory Board, was aware of and participated in the fabricated business transactions arranged by Zhang Lizhong. This indicates that HANGZHOU CENTURY CO., LTD lacks an independent internal risk and compliance department, making the timely detection of financial fraud difficult. Secondly, external audit firms failed to perform their due duties. Tianjian Accounting Firm, retained by HANGZHOU CENTURY CO., LTD, failed to identify fraudulent transactions and unusual cash flows. Tianjian audited the 2019 and 2020 financial statements and provided audit verification services for HANGZHOU CENTURY CO., LTD's issuance of convertible bonds to unspecified entities. The regulatory agency cited Tianjian's inadequate audits of key risk areas as evidence of significant professional negligence. This audit lapse significantly undermined the effectiveness of external oversight and enabled the company to commit financial fraud. Therefore, internal governance deficiencies and external audit lapses combined to create an "opportunity environment" for HANGZHOU CENTURY CO., LTD's fraud.

3.3 Rationalization Factors

Under the coexistence of pressure and opportunity, whether fraudulent behavior actually occurs depends on whether the management can psychologically find a reasonable explanation for the fraudulent behavior. In the case of HANGZHOU CENTURY CO., LTD, the rationalization factors are manifested in the following aspects: cognitive delay - temporary rationalization [4]. The company's management believes that inflating performance is a short-term behavior. They have the idea of "using future

real profits to make up for the current false data”, which reduces the moral vigilance against fraudulent behavior. Cognitive reconstruction of the behavior - moral defense [5]. Management rationalizes financial fraud as protecting the interests of shareholders. Under stock price fluctuations and financing pressure, inflated profits are seen as a means to avoid stock price declines and ensure successful financing, and are then packaged as a profit for the company and shareholders. Covering up or distorting responsibilities - diffusion of responsibilities [5]. The capital market’s pursuit of high growth and high profits makes it easy for management to regard fraudulent behavior as a common phenomenon, reducing the moral shame of their own behavior.

In summary, rationalization factors enable management to psychologically accept or even actively promote financial fraud, thereby allowing fraudulent behavior to continue.

4. Consequences of HANGZHOU CENTURY CO., LTD’s Financial

Fig. 1 Scatter plot of normal rate of return of HANGZHOU CENTURY CO.,LTD based on market model

Finally, according to $ARI_{i,t} = R_{i,t} - (\alpha_i + \beta_i R_{m,t})$, the abnormal rate of return and the cumulative abnormal rate of

Fraud – Event Study Methodology

To objectively assess the market consequences of the financial fraud at HANGZHOU CENTURY CO., LTD., this paper employs an event study methodology. By analyzing the abnormal stock price returns of HANGZHOU CENTURY CO., LTD. before and after the regulatory penalty announcement, this paper explores the actual impact of the fraud on the company’s market value. On January 8, 2024, the China Securities Regulatory Commission issued an administrative penalty against HANGZHOU CENTURY CO., LTD. January 8, 2024, is used as the event study date, and the four days before and after the incident (-2, 2) are defined as the event window. This paper uses the Shenzhen Component Index to calculate market returns, selecting the 203 to 11 trading days before the incident as the estimation window. Using the model $R_{i,t} = \alpha_i + \beta_i R_{m,t} + \epsilon_{i,t}$ to calculate the normalized return, and substituting the relevant data in the estimation window, obtain the formula $R_{i,t} = 1.2225R_{m,t} + 0.0008$. The resulting scatter plot is shown below:

return are calculated. The results shows in Table 1.

Table 1. Short-term market reaction to HANGZHOU CENTURY CO., LTD’s (-2,2) trading window

Relative Date	HANGZHOU CENTURY CO.,LTD’s Benefits Rate of Return %	Shenzhen Component Index market return %	Abnormal Returns%	Cumulative Abnormal Return%
-2	-0.47%	-1.24%	0.97%	-1.19%
-1	-1.88%	-1.07%	-0.65%	
0	-2.40%	-1.85%	-0.22%	
1	0.49%	0.27%	0.08%	
2	-1.96%	-0.55%	-1.37%	

Figure 1, based on event study data, shows that HANGZHOU CENTURY CO.,LTD’s stock price experienced significant abnormal fluctuations in the days surrounding the regulatory penalty announcement. Prior to the announcement, the company’s stock price had already experienced significant negative abnormal returns, suggesting that the market may have already captured some negative information before the announcement, leading investors to react in advance. However, on the first trading day after the official announcement, the abnormal return showed a slight increase, rather than the expected decline. This may be due to a preemptive information reaction. Some investors had anticipated the regulatory penalty, leading to a preemptive decline in the stock price before January 8th, allowing the negative information to be digested in advance. This led to a slight rebound on January 8th and

9th. The cumulative abnormal return of HANGZHOU CENTURY CO., LTD’s stock was significantly negative within the (-2, +2) window, indicating a negative market reaction to the penalty announcement and a general loss of investor confidence in the company’s future profitability. Therefore, the positive short-term abnormal return after the announcement can be considered merely a temporary fluctuation and does not alter the market’s overall negative assessment of the HANGZHOU CENTURY CO., LTD fraud incident.

The consequences of this incident can be felt across different entities. From a corporate perspective, the China Securities Regulatory Commission (CSRC) fined HANGZHOU CENTURY CO., LTD a total of approximately 85.7 million yuan for false disclosures and fraudulent issuance, directly increasing its financial burden. As a list-

ed company, public fraud would severely undermine the trust of the public and partners, with long-term negative impacts on the company's reputation. Future refinancing in the capital market will become significantly more difficult for the company, and it will face stricter regulatory scrutiny. At the investor level, the stock price plummeted after the announcement, resulting in direct losses for investors. Fraudulent behavior undermined the trust of small and medium-sized investors in the information disclosed by listed companies, further increasing uncertainty in the investment market. Finally, at the regulatory level, the HANGZHOU CENTURY CO., LTD fraud case exposed the inadequate quality of corporate information disclosure, forcing regulators to increase law enforcement and accountability.

5. Conclusion

This paper examines the financial fraud case of HANGZHOU CENTURY CO., LTD. Drawing on the theory of the fraud triangle, it analyzes the motivations for the fraud and employs the event study methodology to examine the market reaction following the penalty announcement. The results indicate that the financial fraud at HANGZHOU CENTURY CO., LTD. resulted from a combination of pressure, opportunity, and rationalization. Regarding the consequences, the empirical results of the event study methodology reveal significant negative abnormal stock price returns following the penalty announcement, resulting in a significant decline in investor wealth and a long-term impact on the company's reputation and financing capabilities. This study reveals the underlying mechanisms of financial fraud from both the perspective of motive and consequences and demonstrates its detrimental impact on capital market stability and investor confidence.

This study demonstrates that curbing financial fraud requires a coordinated effort from multiple parties. Companies should establish a long-term development philosophy and strengthen internal controls; investors should enhance their risk identification capabilities; and regulators should fulfill their responsibilities. This paper also has limitations. First, the study focuses on a single case, limiting the generalizability of its conclusions. Second, event study methodology primarily captures short-term market reactions following public announcements and fails to reveal the ongoing impact of fraud on companies. Future research could conduct multi-case comparisons within a larger sample size and incorporate factors such as corporate governance structure, audit quality, and the institutional environment to further explore the multidimensional drivers and long-term consequences of financial fraud.

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