
| RESEARCH ARTICLE

Financial and Internal Control Compliance Supervision of Listed Companies from the Perspective of Independent Directors

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| ABSTRACT

With the increasing regulatory requirements for listed companies in the securities market and investors' increasing attention to the compliance of listed companies, independent directors of listed companies are also facing higher performance requirements to better play the role of supervising the board of directors of listed companies as an independent third party, making suggestions on the management of listed companies and protecting the interests of minority shareholders. Independent directors have a systematic theory of financial and internal control and a wealth of practical experience, which undoubtedly provides a great gain for them to perform their duties effectively. From the perspective of independent directors, this paper analyzes the sources of financial and internal control compliance risks of listed companies, points out the focus of independent directors' attention on financial statements and internal control compliance and puts forward that the independent investigation mechanism is an effective scheme for independent directors to supervise the compliance of listed companies and prevent risks, which provides a practical reference for independent directors to perform their duties with high quality.

| KEYWORDS

Independent Directors, Listed Companies, Financial Supervision, Internal Control and Compliance.

| ARTICLE INFORMATION

ACCEPTED: 10 March 2023

PUBLISHED: 24 March 2023

DOI: 10.32996/jbms.2023.5.2.7

1. Introduction

The independent director system is a system of establishing independent directors in the board of directors to form checks and balances and supervision. It originated in the United States. The reason why China has introduced the independent director system of listed companies is, on the one hand, due to the need for perfect governance structure and institutional arrangement of listed companies in the development of the securities market, and on the other hand, due to the fact that the practice of mature western securities markets has proved the value of the independent director system. After the rapid development of the securities market, the independent director system in our country has been developed and perfected.

The Guidance on the Establishment of Independent Director System in Listed Companies issued by the China Securities Regulatory Commission in 2001 is the first normative document of the independent director system in our country. According to the normative document, listed companies should establish an independent director system. An independent director of a listed company is a director who does not hold any position other than a director in the company and has no relationship with the listed company and its substantial shareholders that may hinder his independent and objective judgment. The independent directors shall, in accordance with the relevant laws and regulations, in line with the guidance and the requirements of the Articles of Association, earnestly perform their duties and safeguard the interests of the Company as a whole, paying particular attention to the fact that the legitimate rights and interests of small and medium shareholders are not impaired. In practice, the independent directors

mainly supervise the Board and provide independent judgment and opinion to the Board. Therefore, they are still concerned about the financial and internal control compliance risks of listed companies.

2. Sources of Financial, Internal Control and Compliance Risks of Listed Companies

The risks arising from the listed company's own financial and internal control and compliance are mainly concentrated in the following areas, which the independent directors should focus on and supervise:

The first type of risk source is financial fraud. The financial fraud of Kangmei Pharmaceutical, a domestic listed pharmaceutical company that shocked the capital market in recent years, has involved many years, covering almost all important financial data, triggering the most severe punishment in the history of the CSRC. Judging from past cases, the financial fraud of listed companies usually involves a wide range of areas, and the means of fraud are systematic, which brings significant risks to the effective performance of duties of independent directors.

The second type of risk sources is related party fund occupation, illegal guarantee and benefit transmission through related party transactions. This risk mainly arises from the behavior of the majority shareholders of listed companies to infringe upon the rights and interests of minority shareholders by concealing related party transactions, unfair transactions and other means from their own interests. Such matters are generally transactions directed by the majority shareholder to the management and will use the influence of the majority shareholder to influence the judgment of the independent directors. The capital market is full of related party transactions and related irregularities. For example, some major shareholders and actual controllers of listed companies arbitrarily occupy the funds of listed companies for a long time, deliberately concealing the important facts of the actual controllers in order to conceal the significantly related party transactions between the companies related to the actual controllers and form the fact that the related parties occupy the funds for non-operating purposes.

The third type of risk source is information disclosure violation. Irregularities mainly involve false statements, material omissions and improper disclosures, with the aim of misleading investors and small and medium-sized shareholders and achieving the purpose of illegal profits for listed companies.

3. Focus of Independent Directors' Supervision on Financial Statements and Internal Control and Compliance

Unlike regulators who use law enforcement powers to conduct inspections and intermediaries who conduct audit inspections, independent directors, as relevant personnel of listed companies, often have limited access to information and materials. How to timely detect and even stop the irregularities of listed companies and properly express the opinions of independent directors under the condition of limited information and materials requires independent directors to make full use of the rights granted to independent directors under the Securities Law and the Independent Directors' Guidance, and to make full use of the work of intermediaries to assist in making judgments. Therefore, independent directors should focus on the key areas in the financial statements and internal control audits.

At present, the scale of financial fraud cases in the capital market of China has entered the era of RMB 10 billion. Financial fraud cases of listed companies are characterized by systematic and complicated fraud methods, hidden means, long fraud cycles and significant amounts involved. Internationally, in recent years, China's overseas listed companies have been frequently short-listed by various short-selling institutions due to suspected financial fraud. The frequent occurrence of such phenomena has also led independent directors to think about how to improve the supervision, prevention and investigation mechanism of financial fraud risk of listed companies.

3.1 Financial Statements Audit Need to Pay Attention to the Common Signs of Fraud

In my opinion, independent directors need to pay close attention to the following common fraud signals in the audit of financial statements:

- ① Related party transactions. The so-called related party transactions, including hidden connections with customers and suppliers, as well as changes in key suppliers and customers, and over-concentration of sales or procurement, are generally worthy of great attention.
- ② Significant transactions. Including questionable acquisitions and disposals.
- ③ Anomalies in financial indicators and cash flows, as well as unreasonable phenomena that are obviously better or worse than peers in comparison with peers, such as: sufficient funds but high debt ratio, prepayment to third parties without commercial substance, negative cash flows from operating activities despite earnings, the mismatch between production costs and production capacity, unreasonable capitalization of research and development expenses, the mismatch between capital expenditures and depreciation, unreasonable gross profit margin higher than peers, the mismatch between interest income and bank deposits, etc.

Independent directors should improve their ability to identify financial fraud. When identifying the above situations, they must be highly vigilant to identify significant third parties and significant transactions, fully understand the reasons and challenge their commercial reasonableness, and master the substance of underlying transactions.

In addition, the independent directors should also fully communicate, understand and pay attention to the ability of the accounting firms responsible for the audit of listed companies to identify financial fraud, attach importance to and do a good job in high-quality communication with the auditors in the audit planning stage and the audit report stage, and should suggest that the auditors actively adopt advanced big data audit methods and equip forensic accounting teams and other means to provide professional anti-fraud support to the auditors. These measures will be of great help in preventing audit failures.

3.2 Common Fraud Risk Signals at Internal Control and Governance Levels

The author believes that the common fraud risk signals and concerns in internal control and governance of listed companies include: the management's weak compliance awareness, lack of integrity culture, and poor stability of management members; Changing auditors frequently; The lack of internal control measures for the retention of financial records is not described here.

The independent directors should pay full attention to the construction of the risk assessment system and the supervision and inspection of the implementation of internal control of the listed companies and put forward suggestions for the improvement of the company's business and management processes; Paying attention to the feedback and notification from the regulatory authorities; Understand the development of internal control of the Company, and confirm the effective operation of the Company's internal control system in accordance with the requirements of the Basic Standards for Enterprise Internal Control, the Exchange's Guidelines for Internal Control of Listed Companies and other regulatory documents; Understand and evaluate the Company's internal control deficiencies based on communication with internal audit department and third-party accounting firms. Follow up on the company's improvement measures and solutions for internal control defects.

4. Independent Investigation Mechanism is an Effective Plan for Independent Directors to Supervise the Compliance of Listed Companies and Prevent Risks

One of the oversight functions that the independent directors of listed companies should perform when participating in the Board of Directors and the Audit Committee is to conduct an internal audit, internal investigation or independent investigation on matters with significant risks and signs of fraud. When allegations of financial fraud or signs of fraud are found against the Company, the Board of Directors and the management shall exercise independent and professional judgment on the incident and, through active and independent investigation, release the signal of positive response of the Company to the market, and enhance the market's trust in the Company.

The investigation procedures include but are not limited to, internal and external interviews, background investigations, field visits, collection of internal and external information, big data analysis, document review, electronic evidence collection, etc., as well as access to funding accounts, securities accounts, bank accounts and other account information with payment, custody, settlement and other functions of the relevant units, credit information, access to and verification of the relevant units' bank account funds and loans, mortgages, guarantees and other information.

Referring to international practice, an independent investigation Committee is usually set up by the listed company's governance level to conduct an independent investigation with the help of a more professional forensic accountant. This approach is highly recommended by regulators. There are also many cases and usual procedures in the world. In the United States, China, Hong Kong and Australia, the relevant regulatory documents all mention the procedures for forensic services to investigate discovered or suspected fraud and corruption. Investigations of misconduct should include forensic accounting experts and forensic computer experts. In Hong Kong, China in particular, the Exchange will require forensic investigations to be carried out when the issuer of a suspended listed company discovers possible fraud. With the development of information technology, the business model is constantly innovating and changing, and new forms of fraud are emerging and becoming more hidden. It is more necessary for forensic experts to participate in the audit anti-fraud investigation.

How should the independent directors respond appropriately when there are signs of fraud, false or misleading information disclosure, false trading and other management misconduct, or even queries and short selling?

First, the directors of the Company are entrusted with the responsibility of deciding whether to conduct an independent investigation to protect the Company and its shareholders by investigating whether the Company complies with laws and regulations. Especially when the company encounters short selling, as the short selling report often claims that the short selling company has fraud and fraud in its financial statements, the subsequent impact is to directly cause abnormal fluctuations in the company's stock price and even lead to more serious consequences such as delisting of the company or investigation by law enforcement agencies. In particular, independent directors are generally required to immediately initiate an independent investigation when the shorting agency's report contains a significant amount of credible factual evidence.

Then, after determining to initiate the independent investigation, it is necessary to determine who will lead the independent investigation. Generally speaking, when there is evidence of fraud in the company, the independent director or the CPA has the right to request the company to set up a special investigation Committee at the governance level, which is mainly composed of independent directors who have not participated in the executive level of the company, to investigate. For investigations involving senior management and involving material financial fraud, the Special Investigation Committee shall engage a third method accounting institution other than the auditor to assist in the investigation. The main purpose of doing so is to ensure the independence and objectivity of the investigation. At this time, the listed company should also fulfill the obligation of the announcement.

In determining the scope of an investigation, the company should weigh the breadth of the investigation against its cost effectiveness. The independent directors should also evaluate the independence and ability of the forensic investigation team, and it is also important to consult with external legal counsel and maintain dialogue with the accounting firm.

From the perspective of the accounting firm responsible for the audit of listed companies and the signed certified public accountant, the composition of the investigation Committee, the independence of the forensic accounting institution and the ability of the forensic investigation team should be assessed, the content, scope and specific methods of the investigation, and the conclusion of the investigation should be fully communicated with the investigation Committee and the forensic accounting institution engaged, and the relevant findings and conclusions of the investigation should be verified. During the investigation, the investigation Committee shall update the CPA on the progress and findings of the investigation and discuss with the CPA whether the content and scope of the investigation need to be adjusted accordingly. The CPA shall, based on professional judgment, perform appropriate supervision and review the key procedures of the investigation, the important information obtained in the investigation and the relevant documents forming the conclusion of the investigation.

In the final stage, the Independent Investigation Committee will report and clarify the results of the full investigation to the regulatory authorities and make a disclosure to shareholders and the public at the same time so as to dispel the doubts of shareholders and the public. It can be seen from this that mastering the identification method of financial fraud, maintaining effective communication with accounting firms and effectively using the independent investigation mechanism are the sharp tools for independent directors to effectively supervise the compliance of listed companies and guard against risks.

5. Conclusion

In the context of global competition, not only China but also governments and international organizations have significantly strengthened the competition supervision of enterprises. Legal compliance management has begun to be highly concerned at the national level. Continuing to strengthen corporate compliance management has become a new trend. Listed companies naturally have higher compliance risks due to their higher degree of marketing. The independent directors should continuously and actively convey the awareness and policy requirements of financial and internal control compliance to the listed companies, which will help the listed companies to establish the management concept of full compliance from top to bottom and promote the listed companies to strengthen the management's promotion and transmission mechanism of compliance concept and compliance culture from point to surface.

Conflicts of Interest: The authors declare no conflict of interest.

Acknowledge: Chen Xiaoxin (1978—), male, master of business administration, Ph.D. in economics, research direction: world economy, finance, taxation. He works for Zhuhai Huazheng Consulting Services Co., Ltd. and Zhuhai Huatian Certified Public Accountants. He is a senior Australian public accountant (FIPA) and a senior British financial accountant (FFA), a full-time member of the British Securities and Investment Association (MCSI), an international member of the Hong Kong Institute of Certified Public Accountants (HKICPA IA) and a member of the expert database of the Zhuhai Xiangzhou District Government Investment Fund.

Funding: This research received no external funding.

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