

Research on the Internal Control Defect Behind Financial Fraud

Wenlu Zhao*

School of Business, University of Jinan, Jinan, China

Abstract. In recent years, financial fraud governance has emerged as a critical issue in corporate governance and financial sectors. Despite the establishment of regulatory frameworks to standardize capital market development both domestically and internationally, financial fraud incidents continue to occur. These incidents not only severely harm investor interests but also significantly disrupt socio-economic order and the entire capital market system. Therefore, research on financial fraud remains highly relevant. This paper reviews domestic and international literature on the definition, causes, methods, identification, prevention, and governance of financial fraud, aiming to provide insights for corporate listings. The paper firstly clarifies the concept of financial fraud, pointing out that it refers to intentional deceptive acts committed by relevant parties in financial activities with the purpose of obtaining illegal benefits, which violate laws, regulations, and ethical norms. It then delves into the causes of financial fraud from multiple perspectives such as internal corporate governance structure, external regulatory environment, and individual psychological factors. Regarding the methods of financial fraud, it comprehensively analyzes common techniques including financial statement fraud, insider trading, and market manipulation.

Keywords: Financial fraud, financial fraud, summarize, review

1. Introduction

Financial fraud has emerged as one of the most destructive systemic risks in global capital markets. Over the past two decades, cases ranging from Enron and WorldCom scandals to recent major frauds like Wirecard and Kangmei Pharmaceutical have demonstrated that in today's highly complex, digitalized, and globalized economic environment, fraudulent activities have become significantly more concealed, technologically sophisticated, and cross-organizational. Financial fraud not only disrupts resource allocation and erodes investor confidence but also drives up regulatory costs, posing persistent threats to capital market stability. These profound risks to both corporate interests and societal welfare have further heightened concerns among governments and the public. Consequently, scholars have consistently emphasized the importance of systematically mapping and evaluating the evolution of financial fraud research, covering theoretical frameworks, methodological innovations, and regulatory practices. Existing studies have yielded substantial achievements in understanding fraud motivations, identification methods, and economic consequences. Researchers have proposed multiple theoretical frameworks to explain fraudulent mechanisms, spanning from the fraud triangle theory to governance structures, audit procedures, and managerial behavior characteristics. For instance, some earlier research developed a logistic

regression-based model for identifying corporate fraud behaviors. At the methodological level, research paradigms have undergone rapid evolution from traditional ratio analysis and statistical models to machine learning and deep learning. Some scholars applied novel techniques such as text analysis, graph neural networks, and GRU in their study of financial fraud behaviors among listed companies in China, proposing a robust framework for identifying financial fraud with extremely high accuracy in detection. Other researchers constructed an indicator layer and used random forest methods to judge financial fraud behaviors, conducting in-depth exploration of key factors. Some studies utilized voice recognition, text analysis, and financial information detection to accurately identify fraudulent behaviors in listed companies. However, these studies still failed to effectively quantify the influencing factors of fraud behaviors. To address this issue, subsequent work proposed a theoretical framework for financial fraud identification using the Transformer and SHAP method, trained with extensive corporate data, and compared it with traditional statistical models such as multiple regression and machine learning algorithms like XGBoost and LightGBM. The study ultimately validated the effectiveness of Transformer in identifying financial fraud behaviors, further expanding the toolkit for solving black-box problems in current fraud identification research. Despite ongoing methodological innovations, the field remains plagued by critical limitations. The scarcity of

* Corresponding author: FlagBetty@163.com

fraudulent samples and imprecise labeling expose models to data drift and overfitting risks. Meanwhile, other scholars argue that while many models demonstrate high predictive accuracy, their lack of interpretability renders them unsuitable for regulatory oversight, auditing, or judicial applications. Furthermore, some scholars argue that existing research predominantly focuses on post-facto identification, with insufficient attention to deeper issues such as the formation mechanisms of fraud, organizational culture impacts, and cross-institutional collaborative supervision. In this context, a systematic review of financial fraud research is necessary. This study argues that current scholars should first deepen their research on financial fraud. In the literature review section, they should not only critically evaluate the theoretical contributions and methodological limitations of existing studies, but also constructively propose potential research directions for future breakthroughs. The research covers cross-source data integration, explainable AI (XAI), causal inference, regulatory technology (RegTech), and multi-tiered fraud governance mechanisms. This study aims to construct a systematic framework for financial fraud research across three dimensions: theoretical, methodological, and regulatory practice. It provides pathways for future academic exploration and offers evidence-based support for policy-making and auditing practices.

2. A review of domestic and international research

2.1 Concept of financial fraud

Domestic and international experts share a broad consensus on the essential nature of financial fraud definitions, yet diverge in specific formulations, with no unified definition established to date. Financial statement fraud has been defined as a narrow form of financial fraud referring to material misstatements in financial statements intentionally designed to deceive or mislead creditors, investors, and other information users. From an accounting perspective, financial fraud has also been identified as a deliberate act where company employees or managers fabricate financial statements through concealment or deception to gain improper benefits, violating generally accepted accounting principles. The International Accounting Standards (IAS 240) describes financial fraud as intentional misstatements in financial statements caused by internal personnel or third parties, typically through manipulation, alteration, or modification.

Despite persistent conceptual disagreements regarding financial fraud, both domestic and international perspectives recognize its shared essence: a deliberate intent to misrepresent information. This review will examine the motivations, methods, identification, impacts, and prevention and governance of financial fraud. The exploration of motivations for financial fraud by scholars both domestically and internationally can generally be divided into two aspects: internal motivations and external motivations. Internal motivations involve

multiple factors. First, financial fraud occurs when management seeks to increase corporate performance or enhance profitability. Based on this, targeted legal countermeasures have been proposed in response to the actual situation of financial fraud in China's listed companies. Second, research has verified the correlation between equity incentives and financial fraud by executives, finding that executives involved in financial fraud were significantly more likely to engage in such behavior compared to those who did not. Finally, a case study taking Longli Biological as the research object reviewed the financial fraud means of the company and deeply analyzed its causes, finding that the reasons mainly include five aspects: greed, capital demand, avoiding delisting, unbalanced governance structure, and weak internal control environment.

2.2 Research status

Direct fraud involves manipulating accounting information (e.g., revenue, assets, and profits) in financial statements. Prior research has identified four primary types of financial fraud after analyzing its methods: inflated revenue, inflated assets, false statements, and harmful corporate interests. Subsequent research revealed that asset overstatement was the most prevalent financial fraud technique through questionnaire surveys. Another study concluded that companies may commit financial fraud by inflating revenue, violating accounting standards for income recognition, or fabricating transactions.

A substantial body of research has examined the specific forms that fraudulent behavior can take. One widely referenced classification identifies four dominant patterns: inflated revenue, inflated assets, false or misleading disclosures, and conduct that undermines the firm's legitimate interests. This framework underscores both the numerical manipulation of key accounting items and the broader governance failures that accompany fraudulent activity. Building on this, survey evidence indicates that asset overstatement, including exaggeration of inventory levels, inappropriate capitalization of expenditures, and overvaluation of assets, is among the most frequently observed fraudulent techniques.

Revenue manipulation has also attracted significant scholarly attention. Prior studies note that firms may overstate revenue by recording sales prematurely, recognizing income without proper supporting transactions, or relying on circular trade arrangements to artificially expand reported turnover. Such practices directly violate revenue recognition standards and create a misleading impression of operating performance. Fraudulent reporting may further extend to the understatement of liabilities or expenses, a tactic designed to obscure financial pressure or mask declining profitability. By delaying expense recognition or omitting major obligations, firms create a distorted representation of their financial position.

Another important category of fraudulent behavior concerns inadequate or deceptive disclosure, especially in the context of related-party transactions. Companies may engage in complex intra-group dealings or resource transfers while intentionally withholding critical information, thereby obscuring the economic substance of these activities. Such nondisclosure not only compromises investors' ability to evaluate firm performance but also facilitates tunneling and other forms of value diversion. Taken together, these diverse forms of financial fraud erode investor confidence, weaken the integrity of financial reporting systems, and undermine the stability of financial markets. The multiplicity and evolving nature of fraudulent schemes also impose substantial challenges on regulators and auditors, reinforcing the need for more sophisticated detection techniques and stronger governance safeguards.

3. Conclusion and enlightenment

This article reviews and synthesizes domestic and international literature on financial fraud through its definition, motivations, methods, identification, and prevention and governance. Through literature review, we find that research on financial fraud governance has made significant progress. From early statistical methods focusing on abnormal financial indicators to the application of psychological and economic theories based on behavioral finance, researchers have proposed various detection models and methods for financial fraud. These models and methods cover multiple aspects including financial reporting, internal controls, supervision, and legal frameworks, providing valuable tools and theoretical foundations for identifying financial fraud. Secondly, in studying factors influencing financial fraud, scholars have focused on management behavior, corporate culture, internal controls, regulatory environments, and economic pressures. Through empirical research and case analyses, they have revealed correlations between these factors and financial fraud. Additionally, some studies have explored the heterogeneity of financial fraud behaviors across different industries and cultural contexts, offering practical guidance for implementation. However, current financial fraud governance still has some shortcomings. According to research findings, future financial fraud governance can be strengthened in the following aspects. First, in terms of financial fraud detection and prevention methods, although various models and approaches have been proposed, there is still a lack of a highly universal, efficient, and precise method. Particularly, research on the application of emerging technologies such as blockchain and artificial intelligence in financial fraud prevention remains relatively limited.

Early studies primarily relied on statistical analyses of abnormal financial indicators, such as unexpected accruals, deviations in financial ratios, or anomalies in earnings patterns, to identify suspicious activities. As the field progressed, researchers began incorporating insights from psychology, behavioral economics, and organizational theory, shifting attention toward managerial incentives, behavioral biases, and corporate governance structures that may foster fraudulent behavior. This theoretical evolution has led to the development of a wide array of fraud detection models that span financial reporting analytics, internal control assessments, textual and linguistic analysis, whistleblower mechanisms, supervisory frameworks, and legal enforcement tools. These methodological advancements have not only improved the accuracy of fraud identification but also enriched the conceptual foundations for understanding how fraud emerges within firms.

In examining determinants of financial fraud, the literature highlights the importance of management opportunism, board oversight, corporate culture, internal control quality, regulatory pressure, and broader macroeconomic conditions. Empirical studies across various institutional settings provide consistent evidence that weak governance structures, insufficient oversight mechanisms, and high external pressures can significantly increase the likelihood of fraudulent practices. Case-study-based analyses further underscore the heterogeneity of fraud behavior, demonstrating that fraudulent schemes vary across industries, ownership structures, and socio-cultural environments. This line of research contributes to a more refined understanding of how contextual and organizational features shape fraud propensity, offering actionable guidance for firms and regulators seeking to design targeted governance interventions.

Despite these valuable contributions, the literature also reveals several limitations that constrain the advancement of financial fraud governance. First, although numerous detection models have been proposed, there remains no universally applicable, highly accurate, and efficient method capable of addressing the full complexity and adaptability of fraudulent schemes. Existing models often perform well under specific data conditions but struggle with generalizability, particularly as fraud techniques evolve alongside technological and institutional changes. Research incorporating emerging technologies, such as blockchain for transparent transaction verification, artificial intelligence for anomaly detection, and natural language processing for disclosure analysis, remains in an early stage. Further empirical validation and real-world application studies are needed to determine the effectiveness, reliability, and scalability of these technologies in fraud prevention and detection.

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