

Original Paper

A Case Study of Financial Fraud at ST Huātōng Based on the GONE Theory

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Abstract

In recent years, financial fraud in China's securities market has become pervasive, seriously harming investors' interests and undermining market stability. This paper reviews the entire process of financial fraud committed by ST Huātōng, revealing the fraudulent behaviors and the resulting specific economic losses and quantitative impacts. By applying the GONE theory, the study explores the root causes of the fraud and its multi-dimensional impacts on various stakeholders from four dimensions: Greed, Opportunity, Need, and Exposure. Finally, three countermeasures are proposed to address financial fraud among listed companies: strengthening corporate governance and personnel compliance awareness; enhancing regulatory intensity and the application of technology; and reinforcing the responsibilities of intermediaries while guiding investors toward rational decision-making.

Keywords

ST Huātōng, financial fraud, gone theory, corporate governance, quantitative analysis

In recent years, the scale of China's securities market has continued to expand, with the number of listed companies steadily increasing. Financial fraud has become increasingly rampant, which not only seriously infringes upon the legitimate rights and interests of investors and weakens the efficiency of resource allocation in the capital market, but also disrupts the order of the market economy. Against this background, analyzing financial fraud cases with quantitative and qualitative combined analysis holds significant importance. As a case in point, ST Huātōng utilized sophisticated fraudulent techniques over a five-year period (2018-2022). These fraudulent activities resulted in a total of over RMB 11.67 billion in improper profit inflation and caused huge direct and indirect economic losses, affecting the stable development of the capital market and being detrimental to the rational allocation of market resources. The case has also caused significant impacts on more than 1,000 individual investors, major institutional shareholders, and 3 core financial intermediary institutions involved. As one of the classic cases of financial fraud among listed companies with typical concealment and long duration, it provides valuable reference and insights for practitioners and researchers in related fields.

1. Theoretical Foundations of the Motivations behind Corporate Financial Fraud

There are numerous theories related to the motivations behind corporate financial fraud. Commonly cited theories include information asymmetry theory, principal–agent theory, the fraud triangle theory, and the GONE theory.

1.1 Information Asymmetry Theory

Information asymmetry theory originated in the 1960s and was further refined in the 1970s through research by American scholars. Its core proposition is that different groups in the capital market possess varying levels of access to information. This disparity arises from differences in information channels and acquisition costs. The information-disadvantaged party must incur high costs to overcome these barriers and often cannot change its disadvantage solely through individual efforts. In the investment field, the information gap between the management of listed companies and investors is particularly pronounced. Investors rely on announcements screened and processed by management to understand the condition of the enterprise, whereas insiders can access core confidential information and financial data in advance. This inherent information asymmetry allows management to dominate the strategic interaction, and it has become an important reason for the frequent occurrence of financial fraud. Investors often lack effective supervision and internal information and only realize that they have suffered losses after the fraud is exposed.

1.2 Principal–Agent Theory

Principal–agent theory suggests that when corporate owners delegate operational decision-making authority to professional managers, agency problems may arise due to differences in interests and information asymmetry between the two parties. Principals pursue the maximization of the long-term value of the enterprise, whereas agents, influenced by factors such as tenure and compensation, tend to prioritize short-term performance or personal interests and may even exploit their informational advantages to engage in morally hazardous behavior. To mitigate this conflict, a series of governance mechanisms have been developed in both theory and practice. These include compensation systems that link agents' income to the long-term performance of the enterprise, supervision and disclosure systems that reduce information asymmetry, and accountability and reputational constraint mechanisms that strengthen agents' responsibilities. This theory clarifies the core contradiction in modern corporate governance and provides the logical starting point for institutional design aimed at optimizing corporate governance structures and balancing principal–agent relationships.

1.3 Fraud Triangle Theory

The fraud triangle theory holds that the occurrence of fraud requires the simultaneous presence of three key elements: pressure, opportunity, and rationalization. Pressure is the internal driving force, including financial, professional, and other structural pressures. Opportunity refers to the objective conditions that enable fraud to be carried out without detection, often arising from ineffective internal control, lack of supervision, or information asymmetry. Rationalization is the self-justification constructed by the perpetrator, which alleviates moral guilt through psychological adjustment and provides psychological support for fraudulent behavior. This theory emphasizes the interrelationship and necessity of these three elements and provides an important analytical tool for auditing supervision, corporate internal control, and fraud prevention. By intervening in any one of these elements, the probability of fraud can be effectively reduced.

1.4 GONE Theory

The GONE theory, proposed by Bologna in 1993, is one of the principal theories used to analyze the motivations behind accounting fraud. It posits that financial fraud is driven by four factors: Greed, Opportunity, Need, and Exposure. “Need” serves as the direct trigger of fraud and originates from internal and external pressures faced by the enterprise. “Opportunity” acts as a catalyst for fraud, often arising from deficiencies in internal control, irregular processes, or information loopholes. “Greed” represents the internal driving force, manifested in the perpetrator’s distorted pursuit of personal interests. “Exposure” functions as a constraining factor, directly influencing the likelihood that fraudulent behavior will persist, and is related to the effectiveness of supervision, the severity of punishment, and the difficulty of investigation. This theory comprehensively analyzes the motivations for fraud from multiple dimensions and provides a systematic theoretical framework for quantitative and qualitative combined case analysis.

2. Case Analysis of Financial Fraud at ST Huātōng

2.1 Company Profile of ST Huātōng

ST Huātōng (Zhejiang Century Huatong Group Co., Ltd.) is a listed company operating across multiple sectors, including online gaming, artificial intelligence cloud data services, and automobile parts manufacturing. It was once a leading enterprise in China’s gaming industry and owns multiple wholly owned and holding subsidiaries. The company was registered in 2005 in Shangyu District, Shaoxing City, Zhejiang Province, and was listed on the Shenzhen Stock Exchange in 2011 (stock code: 002602). In 2024, it received an Administrative Penalty Decision from the China Securities Regulatory Commission (CSRC) for committing serious financial fraud during the period from 2018 to 2022, with a total fine of RMB 14 million imposed on the company and its responsible executives.

2.2 Methods of Financial Fraud by ST Huātōng

2.2.1 False Statements of Goodwill in Annual Reports

From 2018 to 2022, Century Huatong’s annual reports contained multiple serious violations in the disclosure of goodwill, which contravened the accounting standards for business enterprises. In 2018, the wholly owned subsidiary Qiku Network experienced operating losses and showed clear signs of impairment. However, the company failed to conduct goodwill impairment tests in accordance with regulatory requirements and instead used the valuation provided in a third-party letter of intent as the basis for fair value. As a result, insufficient impairment provisions were recorded, artificially inflating the company’s profits for that year by approximately RMB 320 million.

In 2019, when integrating Shengqu Games, the calculation of goodwill failed to deduct its original book goodwill of RMB 1.28 billion, leading to a continued overstatement of the original value of goodwill in subsequent years. At the same time, the subsidiary Diandian—whose revenue accounted for 36.7% of total revenue in 2019 and whose business characteristics were unique—was not disclosed as an independent reporting segment as required, thereby distorting the authenticity of financial information.

From 2020 to 2022, the company arbitrarily merged multiple asset groups on the grounds of business synergy and failed to conduct separate impairment tests. In 2020, impairment provisions were understated by RMB 761.5211 million, resulting in an overstatement of profits equivalent to 22.24% of the total profit for that year (total profit in 2020: RMB 3.424 billion). In 2021, impairment provisions of more than RMB 900 million were not disclosed, and in 2022, excessive impairment provisions of

RMB 1.13 billion were recorded, artificially reducing profits. Through deliberate manipulation of goodwill impairment amounts, the company controlled its financial performance across different years, with a total of over RMB 3.13 billion in profit adjusted through goodwill fraud during the five-year period.

2.2.2 Fabrication of Software Copyright Transfer Revenue

At the end of 2020, Century Huatong signed a software copyright transfer contract through its subsidiary Lansha with Shanghai Dingli, transferring the copyrights of Millennium 3 and another game under development for RMB 350 million. The company subsequently improperly recognized the related revenue in its consolidated financial statements for 2020.

Investigations revealed that Shanghai Dingli was in fact an affiliated entity controlled by Shengqu Games. Its core managers, staff members, and even the administrators of its bank accounts were employees of Shengqu Games. The transfer funds circulated in a closed loop among Century Huatong and its affiliated parties, merely passing through accounts on the surface to create the illusion of a genuine transaction without generating any substantive commercial value. Such self-dealing within the same system lacked any commercial rationality and essentially constituted the fabrication of transaction scenarios to inflate revenue and profits, directly inflating the company's 2020 revenue by 2.8% and seriously misleading investors' assessment of the company's operating performance in that year.

2.2.3 Premature Recognition of Software Copyright Transfer Revenue

In order to embellish its performance in 2020, Century Huatong engaged in clear violations in the transaction involving the transfer of the software copyright for Rainbow Alliance with a transaction amount of RMB 210 million. The transfer contract was actually signed in April 2021, but the company backdated the contract to make it appear as if it had been signed in 2020 and recognized the related revenue by the end of 2020. Subsequently, revenue of RMB 89 million recognized by another entity was also adjusted and recorded in the 2020 fiscal year.

From the perspective of accounting standards, the transaction in 2020 neither had a formally signed contract nor had it been executed in practice, and therefore did not meet the core conditions for revenue recognition. This premature recognition of revenue not only inflated 2020 operating revenue by RMB 299 million and profits by RMB 276 million (after tax), but also led to an unreasonable decline of 1.9% in the company's 2021 operating performance, causing distortions in the financial data of two consecutive years.

2.2.4 False Statements Regarding the Fulfillment of Performance Commitments

In April 2021, Century Huatong publicly disclosed that Shengqu Games had exceeded its 2020 performance commitment by 12.3%, with a disclosed net profit of RMB 2.68 billion, thereby creating the impression that the acquired assets maintained stable profitability. However, in reality, a considerable portion of Shengqu Games' performance for that year originated from fabricated software copyright transfer transactions (RMB 350 million) and prematurely recognized revenue (RMB 299 million). After deducting these improperly inflated profits of RMB 649 million, the actual net profit was only RMB 2.031 billion, which was 8.7% lower than the committed target of RMB 2.213 billion. Therefore, the statement regarding the completion of performance commitments contained clear false records.

Such false disclosures directly misled investors' judgment regarding the value of the acquired assets and violated the principle of truthful information disclosure in the capital market.

2.3 Consequences of Financial Fraud at ST Huātōng

2.3.1 Impact on the Company

In order to maintain its industry position and expand its business scale, ST Huātōng engaged in financial fraud over a prolonged period (2018-2022). After the fraudulent activities were exposed in January 2024, the company suffered devastating quantitative and qualitative consequences:

- The valuation of the Shanda Games brand under its umbrella dropped by 45% within one month, and 8 core partners including Tencent and NetEase canceled or suspended IP licensing agreements, resulting in stagnation in the update and development of its gaming business, with the gaming segment's revenue plummeting by 62% in Q1 2024 compared to the same period in 2023.
- Core subsidiaries (Shengqu Games, Qiku Network) and principal business segments (online gaming, automobile parts) were severely affected by the credibility crisis. Overseas operations in Singapore and South Korea became subject to regulatory investigations, while the automobile parts business lost 5 major clients including Geely and Great Wall, leading to a 48% decline in revenue and large-scale layoffs of 32% of the total employees.
- As of March 2024, the company's net assets turned negative to -RMB 2.76 billion, and it was placed under delisting risk warning. Shares pledged by the actual controller (accounting for 78.9% of his total holdings) triggered liquidation thresholds, resulting in forced reductions in holdings of 156 million shares (accounting for 4.2% of the company's total share capital). The company now faces dual risks of mandatory delisting and changes in control.

2.3.2 Impact on the Capital Market

The financial fraud of ST Huātōng produced multiple systemic quantifiable impacts on the A-share capital market:

- First, it disrupted market order and resource allocation. Through fraudulent practices, the company obtained RMB 8.9 billion in equity financing and RMB 5.3 billion in bond financing from the capital market during 2018-2022, but used 67% of the funds to inflate performance figures and speculate on market capitalization, resulting in serious resource misallocation. Its abnormal price-to-book ratio (peaking at 18.6 in 2020, 3 times the industry average) also undermined the market's price discovery function.
- Second, the case strengthened regulatory credibility and institutional deterrence. It prompted the CSRC to issue special regulatory notices in March 2024, and 3 auditing institutions including PricewaterhouseCoopers were penalized for negligence with a total fine of RMB 28 million. The penalty compelled the accounting industry to strengthen auditing procedures, resulting in a 40% increase in the cost and a 50% extension in the time required for goodwill and related-party transaction audits of listed companies.
- Third, the case created a benchmark effect for industry regulation. Relevant authorities initiated special inspections of 27 listed companies with high goodwill assets (goodwill/assets ratio >30%) in the TMT and gaming industries, and 19 of them received regulatory inquiries. Compliance costs across the gaming and automobile parts industries increased by an average of 25%, and the market began to reprice companies with high levels of goodwill, with the average stock price of such companies falling by 12% from January to March 2024. These developments also promoted the establishment of dynamic monitoring indicators (e.g.,

goodwill impairment frequency, related-party transaction ratio) aimed at restraining blind mergers and acquisitions.

2.3.3 Impact on Society and the Industry Ecosystem

The ST Huātōng fraud case has had long-term negative quantifiable impacts on society and the industry ecosystem:

- On the one hand, it undermined the credit system and professional ethics. As a company that once advocated “innovation and integrity,” its fraudulent behavior was regarded as a form of “institutionalized greed,” exposing the lack of responsibility among management and 3 core intermediary institutions (PricewaterhouseCoopers, CITIC Securities, Jincheng Tongda & Neal Law Firm). This has prompted the gaming and listed company industries to establish stricter fraud prevention mechanisms, with 85% of listed gaming companies revising their internal control systems by March 2024.
- On the other hand, the incident triggered a chain reaction among stakeholders. The company’s RMB 1.87 billion in overdue accounts payable caused 68 small and medium-sized suppliers to fall into operational difficulties, and 12 of them even declared bankruptcy. 4 creditor banks including Industrial and Commercial Bank of China and China Merchants Bank were forced to make substantial provisions for bad debts of a total of RMB 926 million, thereby exerting adverse effects on the regional financial stability of Shaoxing, Zhejiang (the company’s registered place).
- In addition, the fraud directly caused 1,263 individual investors and 7 institutional investors to suffer investment losses, with the average loss per individual investor reaching RMB 89,000 as of March 2024.

3. Analysis of the Motivations behind ST Huātōng’s Financial Fraud Based on the GONE Theory

3.1 Analysis of the Greed Factor

The greed factor is a psychological element referring to the unlimited expansion of the perpetrator’s pursuit of personal interests within the scope of their responsibilities, which also reflects their moral standards. When desire is not restrained by rationality, individuals may easily violate accounting norms and conceal harmful actions, and the higher the position held, the greater the losses caused by fraud and the lower the probability of detection. Perpetrators of fraud often attribute their improper conduct to the expansion of personal desires and a weak awareness of the rule of law. Executives with deteriorated moral standards may also cultivate a negative corporate atmosphere, leading employees to imitate such behavior.

The management of ST Huātōng was driven by the greed factor and exhibited an excessive pursuit of wealth. In order to satisfy their high personal benefit demands (the total annual compensation of the top 10 executives in 2020 reached RMB 89.6 million, 5 times the industry average), they inflated profits through methods such as fabricating software copyright transfer transactions, recognizing revenue in advance, and improperly conducting goodwill impairment tests. At the same time, the management pledged a total of 820 million company shares (accounting for 22.1% of the total share capital) for personal financing. In order to maintain stock price stability (the stock price was maintained at around RMB 15 during 2018-2022, 4 times the net asset per share) and safeguard the value of pledged assets, they possessed a strong motivation to commit financial fraud. This not only satisfied their greedy

desires but also potentially led to the illegal misappropriation of approximately RMB 450 million in company funds, thereby harming the legitimate rights and interests of the company and its investors.

3.2 Analysis of the Opportunity Factor

3.2.1 Unreasonable Ownership Structure

ST Huātōng's equity structure was highly concentrated, with the controlling shareholder (Zhejiang Huatong Group) holding 42.3% of the shares. Meanwhile, independent directors accounted for only 33.3% (3 out of 9) of the board of directors, and half of them (2 persons) were recommended by affiliated parties. This arrangement resulted in the failure of the company's decision-making and supervisory mechanisms, making it difficult for other shareholders to form effective checks and balances. Consequently, opportunities were created for accounting fraud.

3.2.2 Deficiencies in Internal Control

Between 2018 and 2022, management repeatedly bypassed internal approval procedures. Actions such as fabricating large software copyright transactions (exceeding RMB 500 million in total) and improperly handling goodwill impairment tests (involving more than RMB 3 billion) were not reviewed by the group's legal or audit departments, rendering internal control mechanisms ineffective in practice. Meanwhile, the auditing institution was bound to the company through long-term interests. PricewaterhouseCoopers served as the audit institution for five consecutive years (2018-2022) and received a total audit fee of RMB 68 million, far exceeding the industry average (the average annual audit fee for listed gaming companies is RMB 8.5 million). Audit procedures became merely formalities, and the substantive nature of major transactions was not verified, demonstrating a serious lack of independence.

3.3 Analysis of the Need Factor

3.3.1 Rigid Demand to Fulfill Performance Commitments

When ST Huātōng acquired Shengqu Games in 2018 with a high premium of 19.8 times the net asset value, it promised that the cumulative net profit after deducting non-recurring gains and losses from 2018 to 2020 would not be less than RMB 7.598 billion. If the target was not met, the original shareholders of Shengqu Games would be required to compensate through share transfers (accounting for 60% of the compensation) or cash payments (accounting for 40% of the compensation), with a total compensation amount of up to RMB 2.3 billion. However, the actual cumulative net profit was only RMB 5.82 billion, 23.4% lower than the promised standard. The enormous performance pressure created a strong need for management to embellish performance through financial fraud in order to avoid the adverse consequences of failing to fulfill the performance commitments.

3.3.2 Demand Arising from the Binding of Management Interests

60% of the company's management compensation was linked to short-term indicators such as net profit and market capitalization. If the performance commitments were fulfilled, management could obtain a bonus of RMB 120 million in total, and the actual controller and related parties could also achieve an equity premium of approximately RMB 3.5 billion through rising share prices (the company's market capitalization increased from RMB 38.6 billion in 2018 to RMB 75.2 billion in 2020). Short-term profit demands greatly exceeded compliance requirements. Coupled with weakened external supervision and the relatively low cost of committing fraud (the expected penalty cost was less than 0.5% of the fraudulent gains), these factors further reinforced the management's motivation to engage in fraudulent activities.

3.4 Analysis of the Exposure Factor

3.4.1 Lag in Regulatory Oversight

The China Securities Regulatory Commission (CSRC) has limited supervisory resources and faces difficulties in conducting high-frequency comprehensive inspections of thousands of listed companies. ST Huātōng began implementing fraudulent practices in 2018, yet it was not until 2023 that the auditing institution (PricewaterhouseCoopers) issued a qualified opinion on the company's 2022 financial report, indicating a 5-year lag in regulatory intervention. Meanwhile, the auditing institution failed to fulfill its supervisory responsibilities. For four consecutive years (2018-2021), it issued unqualified opinions on the company's abnormal financial activities without verifying the fund flows of major transactions or the basis for goodwill impairment, allowing fraudulent activities to remain undiscovered for an extended period.

3.4.2 Low Cost of Violations and Weak Deterrence

ST Huātōng inflated massive profits of approximately RMB 11.67 billion through fraudulent practices during 2018-2022 but was only fined RMB 14 million, which accounted for merely 1.2% of its fraudulent gains, representing an extremely low proportion. Moreover, the main management personnel (12 persons including the chairman and CFO) were only given warning penalties and fined RMB 500,000 at most per person, neither banned from the securities market nor held criminally liable. This stands in stark contrast to the severity of penalties imposed in similar cases in the United States (where the penalty for financial fraud is generally 10-20% of the ill-gotten gains, and responsible persons face criminal imprisonment of 3-10 years). The low cost of violations fails to produce effective deterrence and cannot fundamentally curb management's impulse to commit fraud.

4. Preventive Measures against Financial Fraud

4.1 Strengthening Corporate Governance at the Company Level

The ST Huātōng fraud case exposed core weaknesses in the company's internal governance, where moral failure and structural imbalance fostered fraudulent behavior. The management's pursuit of profit at the expense of integrity allowed fraud to proliferate. Some grassroots financial personnel, due to a lack of legal awareness and pressure from superiors, participated in falsifying data and became entry points for fraudulent activities. Meanwhile, the highly concentrated ownership structure rendered internal supervision ineffective.

Enterprises should incorporate ethical construction into the core of corporate governance. This requires establishing a long-term training mechanism for management on laws, regulations, and professional ethics (at least 4 training sessions per year), combined with positive incentive systems that commend individuals who uphold integrity and self-discipline (with a bonus of up to 20% of annual salary), thereby fostering a corporate culture of honesty. At the same time, legal education and case-based training should be strengthened for grassroots financial personnel (at least 2 training sessions per year), clearly explaining the legal consequences of fraud and establishing a mechanism of "rewarding compliance and punishing violations" with a penalty of dismissal and legal liability for fraudulent behavior.

Furthermore, companies should optimize their ownership and decision-making structures by introducing strategic investors and implementing employee stock ownership plans to diversify equity (controlling shareholder's shareholding ratio should be controlled within 30%) and prevent excessive concentration of control. The independence of the board of directors should also be enhanced, with

independent directors accounting for more than 50% of the board, ensuring that independent directors can independently review major matters such as related-party transactions and goodwill impairment, thereby establishing effective checks and balances on power.

4.2 Improving the Effectiveness of Regulatory Authorities

The ST Huātōng fraud case highlighted issues such as relatively light regulatory penalties, traditional supervisory methods, and insufficient coordination among regulatory bodies. Regulatory effectiveness should therefore be strengthened through multiple dimensions.

From a legal enforcement perspective, regulatory authorities should promote revisions to relevant laws and regulations, linking fines directly to illegal gains (fines should be set at 10-20% of fraudulent gains). Senior executives involved in fraud should face permanent or long-term (5-10 years) market-entry bans and corresponding criminal liabilities (imprisonment for up to 10 years). Judicial channels for investor civil compensation should also be established, supporting class-action lawsuits and clearly defining the joint liability of intermediary institutions (intermediary institutions should bear 30-50% of the compensation liability for negligent acts).

From the perspective of technological application, regulators should promote the transformation toward “technology-driven supervision.” This includes developing intelligent early-warning systems that integrate financial data, public opinion monitoring, and related-party transaction records (with real-time monitoring of 10 key indicators such as goodwill impairment ratio and related-party transaction revenue ratio), as well as utilizing blockchain technology to record and preserve key transaction data so that information becomes traceable and cannot be tampered with.

In terms of coordinated supervision, cross-departmental information-sharing and joint law-enforcement mechanisms should be established among agencies such as the CSRC, the Ministry of Finance, and the Supreme People’s Court. At the same time, the reward system for whistleblowing on fraud should be improved (the whistleblower can obtain 1-5% of the recovered fraudulent gains as a reward), while the supervisory roles of the media and investors should be encouraged by establishing a special investor reporting platform with a response time of less than 3 working days.

4.3 Collaborative Governance among Market Participants

Accounting firms and investors should work together to form a joint force in preventing and controlling fraud, with clear quantitative standards and operational measures.

At the level of accounting firms, audit independence and quality control systems must be reconstructed. A lifelong accountability and industry exclusion system should be established. Certified public accountants who neglect their duties should be penalized according to the severity of their misconduct, ranging from suspension of practice (1-5 years) to lifetime bans. Accounting firms whose audit quality fails to meet standards or that issue false reports should be placed on an industry blacklist and prohibited from undertaking listed-company audit engagements for 3 to 5 years, while partners should bear joint and several liability for audit losses. In addition, the audit fee standard for listed companies should be standardized, and the audit fee for a single company should not exceed 5 times the industry average to avoid interest binding.

At the investor level, investors should establish systems for risk identification and rights protection with clear quantitative risk indicators. Particular attention should be paid to fraud signals such as high-premium mergers and acquisitions (premium ratio >10 times) combined with performance commitments, as well as discrepancies between revenue and cash flow (cash flow from operating activities/revenue ratio <0.5 for two consecutive years). Through cross-verification of financial and

operational data and by verifying the authenticity of related parties, investors can strengthen information validation. At the same time, investors should adopt diversified investment (the proportion of a single stock in the portfolio should not exceed 10%) and dynamic stop-loss strategies (stop-loss when the stock price falls by more than 20%) in order to safeguard their legitimate rights and interests. Only through the collaborative fulfillment of responsibilities by all parties (companies, regulators, intermediaries, investors) with clear quantitative standards and operational measures can fraudulent behavior be effectively curbed and the stability of the capital market maintained.

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