

Original Paper

Will the Exposure of the Kangmei Pharmaceutical Incident Teach a Lesson to A-Shares?

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Abstract

The financial fraud of Kangmei Pharmaceutical was exposed, and the scale of financial fraud reached the largest in the history of A-shares, which is shocking. On November 17, 2021, the Intermediate People's Court of Foshan City, Guangdong Province publicly pronounced its judgment on the case of 12 people including Kangmei Pharmaceutical's former chairman and manager of the China Securities Regulatory Commission, Ma Xingtian, for manipulating the securities market. There has been extensive discussion in the industry. This article adopts the case study method. Firstly, it will sort out the whole story of the financial fraud incident in Kangmei Pharmaceutical, and analyze the means of financial fraud in Kangmei Pharmaceutical; secondly, it will focus on the audit failure and the failure of independent directors in the financial fraud case and the reasons; Finally, some suggestions are put forward from three aspects: Strengthen the internal governance, improve the external governance and the independent director system.

Keywords

Kangmei Pharmaceutical, Financial Fraud, Corporate Governance

1. Introduction

1.1 Summary of Kangmei Pharmaceutical's Financial Fraud

On October 16, 2018, Kangmei Pharmaceutical suddenly fell by the daily limit in the session, and fell down again on October 17, and its market value was quickly halved on October 23. The market about Kangmei financial fraud voice, in December 2018, because of suspected information disclosure violations, Kangmei pharmaceutical was officially placed under investigation. Under pressure, on April 29, 2019, kangmei pharmaceutical issued the announcement about early error correction, because financial data accounting errors in 2017 into 8.898 billion yuan, operating costs of 7.6 billion yuan,

sales expenses and management expenses less in 500 million yuan and 200 million yuan, sales goods more in 10.2 billion yuan, monetary funds in 29.9 billion yuan, financing activities related to cash projects in 300 million yuan.

The CSRC conducted a detailed investigation into Kangmei Pharmaceutical's nearly 30 billion yuan of "missing". On May 17, 2019, the CSRC issued an investigation progress to confirm that the financial report disclosed from 2016 to 2018 was significantly false. In the evening, Kangmei Pharmaceutical voluntarily applied for the implementation of "other risk warning", and the company's stock abbreviation was changed from "Kangmei Pharmaceutical" to "ST Kangmei". According to the investigation results of CSRC, Kangmei Pharmaceutical reported 22.58 billion yuan in 2016; 2017 annual report reported 29.94 billion yuan; 2018 reported 36.19 billion yuan. Kangmei pharmaceutical so big fraud strength has become the largest financial fraud case in the history of A shares.

1.2 Punishment Result

In August 2019, the CSRC issued the "Prior Notice of Administrative Punishment and Market Ban", and the actual controller Ma Xingtian and his wife were respectively fined 90 0,000 yuan and banned from entering the securities market for life. On May 14, 2020, CSRC announced that it would make administrative punishment and market ban on Kangmei Pharmaceutical in violation of laws, and transferred the suspected criminal acts of Kangmei Pharmaceutical and relevant personnel to judicial organs. On November 17, 2021, Ma Xingtian, the former chairman of Kangmei Pharmaceutical, and others were sentenced to the first instance of manipulating the securities market. Ma Xingtian was sentenced to 12 years in prison and fined 1.2 million yuan for the crimes of securities market manipulation, illegal disclosure, failure to disclose important information and bribery; 11 Xu Dongjin, former vice chairman and executive deputy general manager, and others were sentenced to prison and fined for participating in related securities crimes.

In addition, due to the failure of the basic audit procedures, the audit institution Zhongzhong Zhujiang Accounting Firm and its direct responsible person shall bear 100% of the joint liability for compensation. The five independent directors involved in the A-share market were also held liable for 123 million yuan to 246 million yuan, the first time in China's A-share market.

2. Analysis of Financial Fraud Means

2.1 Inflated Currency Funds

Kangmei Pharmaceutical through financial bookkeeping, false bookkeeping, forged, altered large certificates of deposit or bank statements, with operating income fraud forged sales collection, the highest amount of 36.2 billion yuan. Kangmei Pharmaceutical intercepted the inquiry letters and tampered with them, and provided forged bank statements or statement data to accounting firms. Combined with the audit defects of Zhongzhong Pearl River Accounting Firm, Kangmei Pharmaceutical was able to "create" such an amazing monetary fund in its account.

2.2 Inflated Income

From 2016 to 2018, the net cash ratio of Kangmei Pharmaceutical kept declining, and even fell to negative in 2018, that is, the net profit of 1 yuan caused the cash outflow of enterprises, this phenomenon is far from the general performance of A-share listed companies.

According to the CSRC, Kangmei Pharmaceutical forged business vouchers, cooperated with false certificates of deposit, confirmed the revenue extension recognition fees in advance to complete the false increase of revenue and monetary funds, reached the same growth of income and monetary funds, and further whitewash the statements.

2.3 Inflated Fixed Assets, Construction in Progress, Investment Real Estate

Questions about Kangmei's false investment began decades, accused of falsely investing projects, increasing projects under construction and transferring them to fixed asset accounts for several years. Between 2012 and 2014, corporate fixed assets multiplied, causing controversy.

In the CSRC announcement, some of the investment projects of Kangmei Pharmaceutical have been identified as not meeting the conditions for accounting confirmation and measurement. Kangmei Pharmaceutical's 2018 financial report included a number of unfinished projects into fixed assets, inflated fixed assets by 1.189 billion yuan, 401 million yuan under construction, and investment real estate by 2.015 billion yuan.

2.4 Related Party Transactions Occupy Funds to Buy and Sell Stocks

Kangmei Pharmaceutical occupies corporate funds through transactions with related parties. The first is to transfer huge amounts of money to the affiliates to buy the company, and then to attract investors 'money and raise the company's stock price. Take the right time to sell stocks bought at a low price to make a big profit. After the stock price falls after the shareholders, and then take the opportunity to use funds to buy the company's shares at the low point, repeat the above process, manipulate the stock market, and obtain huge returns.

3. Problems Existing in the Independent Directors

3.1 Responsibilities of Independent Directors

According to the CSRC, listed companies need to set up independent directors within the board of directors. As the external manager of the enterprise, the independent directors play a certain positive role in the operation and management of the enterprise, and promote the effective improvement of the internal control system of the enterprise to a certain extent. The independent director shall bear the following responsibilities:

3.1.1 Provide Professional Decision Guidance to Avoid Decision Risks

Most listed companies in China will choose certified public accountants as independent directors, because they have quite rich professional knowledge and practical experience, and can provide professional guidance and review for the finance of listed companies. When the company makes decisions, the independent directors should provide the company with professional financial, financial, legal and other aspects, put forward suggestions for the company's strategic goals, help the company to

make more correct and effective business strategies, and improve the company's comprehensive competitiveness. On the contrary, when the company makes decision mistakes or financial crisis, the independent board should raise objections to the risk and reduce the possibility of risk.

3.1.2 Supervise the Company's Decision-Making and Safeguard the Rights and Interests of Mnority Shareholders

In a dominant company, the concentration of equity of major shareholders will often encroach on the interests of minority shareholders for their own interests, resulting in the interests of minority shareholders can not be guaranteed. Independent directors can vote to express their independent opinions and audit and supervise the compliance of the company's finance, so as to reduce the operating risks of the company and safeguard the interests of minority shareholders and creditors.

In addition, the independent directors, as outside directors, do not associate with the owners of the company, and the interests of the independent directors are not associated with any shareholders. Under this condition of independence, the independent directors can better supervise the company's decision-making and management while expressing the company's decision-making opinions from a professional and independent perspective.

3.1.3 Introduce Knowledge and Talents to Promote the Sound Development of the Company

Independent directors as industry celebrities and experts in a field, in the use of their own expertise on the company related issues constructive opinions at the same time with strong human capital and social capital, bring more connections and resource channels, investment cooperation opportunities, broaden the company business development and expand the company's visibility in the industry.

3.2 *The Flaws of the Independent Directors of Kangmei Pharmaceutical*

3.2.1 The Participation of Independent Directors Is Low and They Do Not Play a Good Supervisory Role

Jiang Zhenping, the longest-serving of the five independent directors on the ticket, is the deputy chief accountant of Zhongrui Accounting Firm Co., Ltd. With rich working experience, he did not play his supervisory role during the financial fraud. The remaining four part-time independent directors from universities had low participation, but they did not raise objections in the specific performance of their duties, all voted in favor of the annual report review, and did not play their due supervision function.

3.2.2 Excessive Concentration of Equity, and the Close Relationship between the Independent Directors and the Major Shareholders

Kangmei Pharmaceutical has stable shareholding structure, one dominance and family characteristics. In May 2017, Ma Xingtian and Xu Dongjin, the two major shareholders of Kangmei Pharmaceutical, began to increase their holdings frequently. Meanwhile, the controlling shareholder of Kangmei Industrial and its related party, Ms. Xu Dongjin, promised not to reduce their shares within one year from the date of increasing their holdings. Through the frequent increase behavior of the major shareholders, the major shareholders and actual controllers of the listed company can directly and indirectly hold a large number of shares of the listed company. Shareholders with a large shareholding

ratio can actually control the decision-making rights and management rights of listed companies.

Two of the punished independent directors were from South China University of Technology. Li Dingan, a retired accounting professor at the School of Business Administration at South China University of Technology, has already served as an independent director of Kangmei Pharmaceutical as early as 2003. Han Zhongwei, who once served as the independent director and deputy general manager of Kangmei Pharmaceutical, is also originally from South China University of Technology and once served as the vice dean of the School of Business Administration of South China University of Technology. Ma Xingtian, the former chairman of Kangmei Pharmaceutical, had a master of business administration and later became a graduate tutor. This shows the deep relationship between South China University of Technology and Kangmei Pharmaceutical, and the close relationship between the independent directors and the board of directors. Although Kangmei Pharmaceutical has set up independent directors, it is only an empty shell and has no practical effect.

4. Key Factors of Audit Failure

4.1 The Auditors Shall not Perform the Audit Procedures Properly

4.1.1 Auditor's Improper Implementation of Audit Procedures

Zhongzhong Pearl River Accounting Firm has a problem in identifying the risk of major misstatement in the audit of Kangmei Pharmaceutical. The amount of monetary funds from 2016 to 2018 was equivalent to the amount of interest-bearing debt it held, But while Kangmei Pharmaceutical pays the huge financial expenses each year, Interest income is minimal, This is clearly counterintuitive; besides, At the beginning of 2019, Kangmei Pharmaceutical issued the accounting error correction announcement and corrected the inventory amount of 15.7 billion yuan at the end of 2017 to 35.2 billion yuan, And the 2018 audit report released by Zhongzhong Pearl River Accounting Firm, after this announcement, However, these subjects are not fully covered in aggregated areas of significant risk, significant risk at identified financial statement levels, and planning of further audit procedures for important accounts and transactions, This is obviously a dereliction of duty in the Pearl River.

4.1.2 Problems in the Testing Procedures for the Internal Control of Kangmei Pharmaceutical Industry

In the audit work, Zhongzhong Zhujiang Accounting Firm did not accurately identify the difference between the new SCM3.0 architecture supply chain system and Kingdee EAS system used by Kangmei Pharmaceutical. Moreover, it did not judge the cause of the difference and the impact on the collection of audit work evidence, but directly abandoned the application of jiecoco system data, resulting in the lack of certain rationality and completeness of the audit evidence obtained.

At the same time, in the middle of the pearl River to Kangmei pharmaceutical letter certificate procedure implementation is not in place. In response to the possible risk of fraud in monetary funds, the bank statement was obtained by the audit project manager from Huang Sheng, an employee of Kangmei Pharmaceutical. Moreover, the letter attendant Huang sent by Kangmei Pharmaceutical replaced the letter with the false credit certificate prepared in advance, leading to the failure of the audit

process, but the auditor did not find it. It can be seen that Zhongzhong Pearl River does not effectively control the correspondence certification process in the site correspondence certificate.

4.2 Loss of the Independence of Audit Firms

Zhongzhong Pearl River has been the audit work of Kangmei Pharmaceutical's annual report for 19 consecutive years, and also the internal control audit work of Kangmei Pharmaceutical. During this period, Kangmei Pharmaceutical paid more than 30 million yuan of audit fees to Zhongzhong Zhujiang. Under the close interest link of long-term cooperation, even though Kangmei has been questioned by the outside world because of the abnormal phenomenon of double high deposit and loan, during the more than ten years of cooperation, Zhongzhong Pearl River Accounting Firm has issued a standard unqualified audit report on the annual report of Kangmei Pharmaceutical. In 2019, Kangmei Pharmaceutical was reported as having a financial fraud, and the CSRC investigated Kangmei Pharmaceutical. In such an embarrassing situation, Zhongzhu Zhujiang accountant still issued an audit report for the 2018 annual report of Kangmei Pharmaceutical in early 2019. This makes it difficult not to question whether Zhongzhong Pearl River Accounting Firm has maintained its due independence in the long-term cooperation between the two sides, and whether the familiarity and understanding of Kangmei Pharmaceutical has relaxed its vigilance and produced the path dependence of audit methods, so as not to effectively identify the risk points in the audit work.

5. Suggestions

5.1 Strengthen the Internal Corporate Governance

5.1.1 Optimize the Shareholding Structure

The major shareholder of Kangmei Pharmaceutical is Ma Xingtian and his wife. The total number of shares of the couple is too high, causing the "dominant" situation, which is easy to cause dictatorship. Therefore, to solve the problem of equity concentration of Kangmei Pharmaceutical, it is necessary to optimize its equity structure, disperse the equity, divide the control of the company to multiple people, prevent the emergence of dictatorship, and play a check and balance role.

5.1.2 Strengthen the Internal Control

Kangmei pharmaceutical chairman and general manager overlap and independent directors of negligence, is not conducive to corporate governance level of checks and balances and supervision, so the company needs to divide governance structure, strengthen internal control, need to separate ownership and management, hire professional managers to manage the operation of the principal, agent relationship, improve the corporate governance structure, make the functions of the general meeting, the board of directors, the board of supervisors, three can achieve effective supervision and mutual restraint, contribute to the company's long-term governance and development.

5.2 Improve Corporate External Governance

5.2.1 Strengthen the Sense of Responsibility of Intermediary Agencies

Zhongzhong Pearl River Accounting Firm should shoulder the important responsibility of supervising

and preventing the fraud of listed companies, but it lost its professional vigilance in the case of Kangmei Pharmaceutical, which greatly encouraged the fraud of enterprises. Drawing lessons from the Kangmei case, in order to improve the quality of third-party auditors, more attention should be paid to and guarantee the independence of auditors. In addition, third-party institutions can be introduced as a cooperation bridge between enterprises and firms, trying to avoid the interest bundling relationship between enterprises and accounting firms.

In addition to Zhongzhong Zhujiang Accounting Firm, Kangmei also found the dereliction of duty of Guangfa Securities as an intermediary in the case. For example, it did not uphold a fair and objective attitude in the relevant investment banking project occupation, did not review the full aspects of the financial information of the invested enterprises, and did not perform its supervision duties. For the dereliction of duty of intermediary agencies, the accountability should be strengthened. At the same time, strengthen the qualification examination of the intermediary personnel from the root cause, strengthen their sense of responsibility, guard the market door, and safeguard the interests of small and medium investors.

5.2.2 Increase the Illegal Cost of Financial Fraud

For most financial fraud cases, the final price of listed companies is often minimal compared with the benefits derived through fraud. The new Securities Law, which came into force in 2020, has further increased penalties, but the cost of breaking the law is still too low compared with a financial fraud case of 10 billion yuan like Kangmei Pharmaceutical. American penalties, by contrast, are even more deterrent: for executives involved in financial fraud, up to \$5 million, or even 20 years in prison.

In addition, for the financial fraud enterprises that constitute major illegal acts, the delisting system should be more strictly implemented to prevent the enterprises from avoiding the delisting risks by exploiting the loopholes in the law. For example, for all the listed companies identified by the CSRC with financial fraud and cause serious consequences, they should be required to force delisting.

5.3 Improve the Independent Director System

5.3.1 Further Regulations on the Qualifications of Independent Directors

Independent directors should not be employed in companies that have business contacts or may be related in the future. The qualifications of independent directors should also be considered from their professional and professional background. They should not only have professional knowledge but also have corresponding practical experience, so as to provide valuable and practical suggestions to the company. The CSRC or a third party can establish a talent pool to include the information of independent directors together. When selecting independent directors, they should be found from the talent pool according to the needs, and the wishes of independent directors should also be determined. Only the qualified and willing are the appropriate independent directors.

5.3.2 Establish a Sound Laws, Regulations and Guarantee Mechanism

Drawing on western countries, the punishment mechanism is divided into formal system and informal system. The formal system includes the legal litigation mechanism of civil liability and the regulatory

punishment of regulatory agencies in the securities market. The informal system includes the shareholder voting system, resignation and reputation mechanism. From the legal level, the independent director system rights, obligations, functions and so on various aspects to improve the laws and regulations, for support in shareholder vote, from the current company and sustained adverse effects on subsequent office of independent directors, investors and regulators can file civil litigation and regulatory punishment, the market at the same time. In terms of industry, it can also clearly stipulate the practice principles of independent directors through supervision institutions to regulate the behavior of independent directors.

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