

## Case Study of St. Kangmei's Financial Fraud Based on GONE Theory

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**Abstract:** In recent years, fraud cases have frequently occurred in listed companies. Through Kangmei Pharmaceutical's financial fraud cases, this article aims to provide practical advices to reduce the occurrence of fraud cases, protect investors' interests, and strengthen market supervision. This article analyses reference literatures, and uses the method of induction and summary to analyze the causes of financial fraud from the four levels of GONE theory, and express views on the four levels.

### 1. Overview of GONE Theory

The "GONE" theory is the most widely distributed theory in the United States. The theory holds that corporate accounting fraud is composed of four factors: Greed, Opportunity, Need, and Exposure. They interact and are indivisible, and together determine the degree of corporate fraud risk. That is, when a fraudster is greedy and needs money and self-esteem, he will definitely commit fraud as long as he has the opportunity and thinks it will not be exposed in the future.

### 2. ST Kangmei Case Overview

#### 2.1 Basic situation of Kangmei Pharmaceutical Company

##### 2.1.1 Company Profile

Kangmei Pharmaceutical Co., Ltd. is a company engaged in the production and wholesale sales of pharmaceuticals and biological products. Its main business is chemical medicine and Chinese medicine decoction pieces [1-2]. In addition, Kangmei Pharmaceutical also involves real estate and building materials related businesses. 2019 In May, Kangmei Pharmaceuticals, which has continuously received the inquiry letters from the Shanghai Stock Exchange, received the annual report inquiry letters from the Shanghai Stock Exchange, and took the initiative to wear a cap to become "ST Kangmei".

##### 2.1.2 Equity Structure

The actual controller of Kangmei Pharmaceutical Co., Ltd. is Ma Xingtian. As of January 2020, the controlling shareholder is Kangmei Industrial Investment Holding Co., Ltd., the shareholding ratio is 32.75%, Xu Dongjin holds 1.4% of the shares, and the top ten shareholders individually account for less than 5%. In Kangmei Industrial Investment Holdings Co., Ltd., Ma Xingtian holds 99.68% and Xu Dongjin holds 0.32%.

##### 2.1.3 Financial Situation

According to the quarterly report of Kangmei Pharmaceutical, the total operating income of the first three quarters of 2019 was 4.902 billion, 3.231 billion, and 2.215 billion, which were 0.18%, 31.47%, and 54.68% lower than the first three quarters of 2018. The first three quarters of 2019, net profit were 450 million, 218 million and -136 million, respectively. Compared with the first three quarters of 2018, the first quarter increased by 145%, and the second and third quarters decreased by

13.83% and 160.71%, respectively. From the quarterly report, it can be seen that in 2019, Kangmei Pharmaceutical's operating income fell sharply, and its net profit was unstable and showing a downward trend.

## **2.2 The Beginning and end of the Fraud Incident**

On April 29, 2019, Kangmei Pharmaceutical issued a correction announcement, claiming that in the 2017 annual report data, due to accounting errors, inventories decreased by 19.5 billion yuan and cash increased by 29.9 billion yuan. All walks of life have paid close attention to this phenomenon, and the Shanghai Stock Exchange issued three letters to ask related questions. On the afternoon of May 17, 2019, the China Securities Regulatory Commission informed the progress of Kangmei Pharmaceutical's investigation [3]. According to the Securities Regulatory Commission, the 2016-2018 financial report disclosed by Kangmei Pharmaceutical is initially determined to be materially false. One is to use false bank documents to increase bank deposits; the second is to increase business income through false business credentials; and the third is to use related party transactions to purchase company shares and manipulate stock prices.

## **3. Cause Analysis of Financial Fraud in Kangmei Pharmaceutical Based on GONE Theory**

### **3.1 Greed Factor**

After years of training, Kangmei Pharmaceutical has become well-known in the minds of ordinary people. It is considered to be "white horse stock". However, Ma Xingtian, the actual controller of Kangmei Pharmaceutical, has the same problem as other bosses, that is, they want to expand their business scope [4]. So, he started to get involved in the real estate industry known as the profiteering industry. Before the incident, Kangmei Pharmaceutical is expected to provide huge investment for the project in the next few years, but at the time, Kangmei's book value was insufficient and it wanted to solve this problem through financing. However, Kangmei Pharmaceutical has used improper means to safeguard its own interests. According to relevant media reports, as of April 2019, Kangmei Pharmaceutical has been involved in bribery cases five times in four years, and the total amount of bribes violated by the law reached 6.1 million Hong Kong dollars in cash, the object of bribes is mainly for the directors of relevant departments of the Drug Administration and local government officials. In order to open up the relationship between the various projects of Kangmei Pharmaceutical and make the financial statements more beautiful, false increase in deposits and so on are sufficient to reflect Kangmei Pharmaceutical's Greed [5].

### **3.2 Chance Factor**

#### **3.2.1 Unreasonable Equity Structure**

The shareholding structure mainly reveals the internal power distribution of listed companies, and the irrational shareholding structure will lead to a situation that can block the sky and provide operable space for fraud. The largest shareholder of Kangmei Pharmaceutical is Kangmei Industrial Holdings Co., Ltd., which holds 32.75% Equity, the top ten shareholders hold less than 5%, and the actual controller of Kangmei Industrial is Ma Xingtian, which holds 99.68%. Ma Xingtian's wife also holds 1.4% of Kangmei Pharmaceutical and 0.32% of Kangmei Industrial. This means that the two of them hold a total of 34.15% of the shares and have actual control and voice over Kangmei Pharmaceutical.

#### **3.2.2 Internal Control Failure**

The failure of the internal control of Kangmei Pharmaceutical also provides an opportunity for financial fraud. The status of independent directors of Kangmei Pharmaceutical is minimal. The independent director system was originally designed to form a system of checks and balances of power. As the actual controller of the company, Ma Xingtian plays a decisive role in the nomination of independent directors. For the sake of their own interests, the elected independent directors must

be in his favor. According to the 2018 annual report published by Kangmei Pharmaceutical, it can be seen that the three independent directors attended every meeting on time, but never raised objections, so it can be seen that this system does not play a good role in restraining.

### **3.2.3 Inadequate External Audit Supervision**

The external audit is performed by an independent third-party agency as a third party, and independence is a prerequisite for its practice. Kangmei Pharmaceutical has cooperated with Guangdong Zhengzhong Zhujiang Certified Public Accountants for 19 years. During this period, Kangmei Pharmaceutical's, the issue of double deposits and loans has been questioned constantly, but the firm has always expressed unqualified opinions in its audit opinions. The qualified opinions were issued only in 2018. In addition, auditors lack professional skepticism and due attention. Currency Funding projects are the focus of audit, but Kangmei Pharmaceutical's cash accounts for nearly 30 billion yuan. Such a huge number cannot be ignored, which shows that the lack of external audit supervision also gives Kangmei Pharmaceutical an operable possibility.

### **3.3 Demand Factor**

From the data released by Kangmei Pharmaceutical, it will be found that the net profit of Kangmei has always been at a relatively high level in the industry. However, before the incident, Ma Donghua, the actual controller of Kangmei, reportedly led the company's crazy expansion. In the first three quarters of 2018, the company's net cash outflow reached 4.597 billion yuan. At the same time, it is expected that investment projects and amounts will increase in the next few years, reaching 44.391 billion yuan. However, at the time, Kangmei did not have sufficient financial support on its books. Financing was a practical means. As a private enterprise, Kangmei had difficulty in financing. It was a common situation. Therefore, for better financing, good cash flow and stable stock prices are important for Kangmei Pharmaceutical, which has led to a series of financial fraud by Kangmei Pharmaceutical.

### **3.4 Exposure Factors**

#### **3.4.1 The Possibility of Fraud Exposure is Small**

For Kangmei Pharmaceutical, first of all, the government, Kangmei Pharmaceutical involved five bribery incidents in four years, and the people in dispute were mainly government unit personnel, which provided convenience for covering up fraud. In addition, Kangmei Pharmaceutical is a large local taxpayer, and government units are also keeping their eyes open and closed on some things. On external audit, Zhengzhong Zhujiang Certified Public Accountants has long cooperated with it, and Kangmei Pharmaceutical has also paid high fees. The firm may lose its independence, issue false audit reports, and have a low probability of exposure.

#### **3.4.2 Small Punishment for Fraud Found**

According to the newly amended Securities Law in 2014, the company's financial fraud fines reached a maximum of 600,000. This is a huge waste for companies with a large amount of financial fraud. In the case of Kangmei Pharmaceutical fraud, the Securities and Futures Commission ordered Kangmei Pharmaceutical to correct it, issued a warning, and imposed a fine of 600,000 yuan. The 600,000 fine was not a good idea for the nearly 30 billion "missing off" caused by the fraud of Kangmei Pharmaceutical.

## **4. Inspiration of Kangmei Pharmaceutical's Financial Fraud**

### **4.1 Improve the Legal and Moral Awareness of Management and Establish the Concept of Corporate Integrity Management**

Greed is the source of all fraud. To curb greed, we must first curb the greed of management. Management is the most powerful voice for an enterprise. The moral level of management and the

degree of awareness of the law will affect the cultural construction of an enterprise. The company's good reputation is conducive to gaining the trust of the people and winning the market competitive position. The company must strictly control the recruitment of personnel, pass relevant assessments and conduct follow-up education, and establish employee integrity files, especially those who have a direct relationship with management and accounting staff, to keep the moral bottom line and suppress greed.

#### **4.2 Improve the Internal Control System of the Enterprise and Improve External Auditing Capabilities**

Not giving the company a chance to be fraudulent requires internal and external supervision and control. Enterprises need to be aware of the importance of equity diversification and avoid the situation of one-handed cover. If the equity is not dispersed, the board of supervisors and independent directors are set up as a fake. An enterprise without checks and balances greatly increases the probability of fraud. At the same time, the board of directors and the board of supervisors must also play their roles actively, perform their duties, implement the internal control system, strengthen the supervision function of internal control, and reduce the probability of fraud. In addition, external Audit institutions must maintain independence, and the Institute of Certified Public Accountants must strengthen management and follow-up education to reduce the chance of fraud from both internal and external sources.

#### **4.3 Implement a Strict Listing Delisting System and Strengthen Investment and Financing Management**

Generally speaking, financial fraud is driven by benefits, it may be for listing and financing, and it may be fraud to avoid delisting. No matter what the reason, there is fraud. Therefore, from listing to delisting, we must formulate and abide by a set of strict standards and strictly control the quality of listed companies. Meanwhile, the relevant regulatory authorities must enforce laws, establish an effective open information transparency system, and improve the follow-up compensation mechanism to protect the relevant interests of investors, whether it is listed or withdrawn. Companies in the city will not risk financial fraud due to misfortune.

#### **4.4 Improve the Mechanism of Fraud Detection and Punishment**

Strengthen the combination of external audit and internal audit, external audit must be fair and impartial, and internal audit must be independent of various departments. Give full use of the supervision role of the general public, news public opinion is a powerful monitoring method, and many cases of financial fraud are exposed by the media. We must attach importance to the management of the media's professional ability and broaden the channels for public supervision. Strengthen the management of local governments and establish a special punishment mechanism for local officials to cooperate with counterfeiting. Government management departments must increase the punishment and raise the cost of fraud. It is argued that the amount of fraud should be divided into a corresponding proportions to fine. In addition, the supervisory department can not only be limited to fines, but also can be held responsible for the corresponding criminal liability. This will make enterprises afraid of fraud and can't afford fraud!

### **5. Conclusion**

Frequent financial fraud cases are the result of a combination of factors, therefore, the current listed companies and social regulatory authorities must pay great attention. From the inside of the enterprise, it is necessary to improve the management's legal and moral awareness, establish a credible business philosophy to curb the greed, improve the internal control of the enterprise, and avoid covering the sky with one hand. For regulators, we must implement a strict listing and delisting system, establish an effective open information transparency system, increase penalties, and increase fraud costs. Intermediaries should also strengthen professional ethics and improve credibility. Only

through the joint efforts of many parties can we have an open and transparent market and promote the further development of listed companies.

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