

A Study on Financial Fraud at Kangmei Pharmaceutical Based on the GONE Theory

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Abstract: In light of the frequent occurrence of financial fraud, this paper takes the financial fraud case of Kangmei Pharmaceutical as a research case. Drawing from relevant studies by domestic and international scholars and considering the prevalent occurrences of financial fraud at home and abroad, this paper employs case analysis and financial information comparative analysis methods. Using the actual case of Kangmei Pharmaceutical's financial fraud as an example, it summarizes the main fraudulent methods employed by Kangmei Pharmaceutical, including inflating revenue, forging accounting documents, establishing an unreasonable equity structure before financing, and fabricating profits through "related-party transactions." This paper also analyzes the motives for Kangmei Pharmaceutical's financial fraud in detail from four aspects of the GONE theory: Greed, Opportunity, Need, and Exposure. Additionally, it proposes governance measures and insights for countering financial fraud from these four perspectives. Finally, specific recommendations are presented based on the analysis results. This paper aims to provide innovative approaches and means for publicly listed companies to seek effective governance of financial fraud, regulate market operation, cultivate an ecosystem conducive to the healthy development of all parties, and protect the rights of investors in compliance with legal requirements.

Keywords: Kangmei Pharmaceutical, financial fraud, GONE theory

1. Introduction

On October 16, 2018, Pay Yanlong and Lin Ximing published an article publicly raising questions about Kangmei Pharmaceutical's financial data and alleging the possibility of fraudulent activities. These allegations sparked widespread market attention. In response to public concerns, the China Securities Regulatory Commission (CSRC) urgently formed an investigation team on the same evening to conduct a formal investigation into Kangmei Pharmaceutical.

The investigation team meticulously reviewed Kangmei Pharmaceutical's financial reports and found that from 2016 to 2018, Kangmei Pharmaceutical had artificially inflated its operating income by approximately CNY 30 billion and its bank deposits by approximately CNY 20 billion through the fabrication of business transactions and fictitious receipts. Furthermore, the investigation revealed issues such as the fabrication of accounting documents, an unreasonable equity structure before financing, and concealment of related-party transactions by Kangmei Pharmaceutical.

This incident has raised widespread public concerns about the authenticity of financial reports of publicly listed companies and emphasized the importance of regulatory authorities conducting rigorous examinations of financial reports. Simultaneously, for investors, it has become even more crucial to approach the financial reports of publicly listed companies cautiously to avoid suffering losses due to information asymmetry.

Table 1: Timeline of Financial Fraud at Kangmei Pharmaceutical

Time	Progress of case investigation	Details
28th Dec 2018	The Securities and Futures Commission (SFC) opened a case for investigation	The Securities and Futures Commission opened an investigation into Kangmei Pharmaceuticals for suspected violations of credit disclosure laws and regulations.
30th April 2019	SSE Issues Regulatory Letter	Due to the errors in accounting account funds of Kangmei Pharmaceuticals, resulting in an overcount of currency funds of 29.944 billion yuan. SSE issued a supervisory work letter on matters related to the correction of accounting errors in its previous period.
5th May 2019	SSE Issues Enquiry Letter	The SSE issued a letter of enquiry requesting Kangmei Pharmaceutical to verify and make additional disclosure on the manner of depositing the overstated monetary funds, the main account, the restrictive situation, whether there is any violation of the use of funds and the main destination of the funds.
9th May 2019	Kangmei Pharmaceutical's auditing organisation is under investigation	The SFC opened an investigation into Guangdong Zhengzhong Zhujiang Accounting Firm, the auditor of Kangmei Pharmaceuticals.
17th May 2019	Kangmei Pharmaceuticals has been issued a risk warning	With effect from 21 May 2019, the short name of Kangmei Pharmaceutical's A-share stock will be changed to "ST Kangmei".
17th May 2019	SFC notifies Kangmei Pharma of progress in case	The SFC introduced that the 2016 to 2018 financial reports disclosed by Kangmei Pharmaceuticals were materially false, firstly, the use of false bank documents to falsely increase deposits, secondly, revenue falsification through forged business vouchers, and thirdly, the transfer of part of the funds to the accounts of related parties to buy and sell the Company's shares.

Table 1: (continued).

21st May 2019	Relevant debt credit rating downgraded.	Kangmei Pharmaceuticals has been put on other risk warning, and China Chengxin International has downgraded the credit ratings of the main body of Kangmei Pharmaceuticals and the related debt.
16th August 2019	Kangmei Pharmaceuticals has been punished.	The SFC has served a prior notification letter to Kangmei Pharmaceuticals and the parties involved in the case, and intends, in accordance with the law, to impose administrative penalties on the company and 22 parties, including Ma Xingtian, and to take measures to prohibit entry into the securities market for six parties.
10th May 2020	Kangmei and its executives have been warned.	Due to the violation of the letter disclosure, Kangmei Pharmaceutical and its executives received the "Decision on the Measures of Issuing a Warning Letter to Kangmei Pharmaceutical Company Limited, Ma Xingtian, Zhuang Yicheng and Tang Xu" from Guangdong Securities Regulatory Bureau.
14th May 2020	Kangmei Pharmaceutical's related personnel suspected of criminal acts have been transferred to the judicial authorities.	The SFC decided to order corrections, give a warning and impose a fine of 600,000 yuan on Kangmei Pharmaceuticals, impose fines ranging from 900,000 yuan to 100,000 yuan on 21 responsible persons, and take measures of banning from 10 years to lifelong entry into the securities market on six key responsible persons. Meanwhile, the SFC has referred the suspected criminal acts of CombiPharma and related personnel to the judicial authorities.
5th June 2020	Decision letter issued by Guangdong Securities Regulatory Bureau	The Guangdong Securities Regulatory Bureau ordered Kangmei Pharmaceuticals to publicly explain the reasons, among others, that led to multiple significant changes in the company's disclosed operating results, and to hold the relevant responsible persons internally accountable.
9th July 2020	The then-actual controller was taken coercive measures.	The family of then-actual controller Ma Xingtian said that Ma Xingtian was subject to mandatory measures by the public security authorities for the offence of illegal disclosure and non-disclosure of important information.
22nd July 2020	Suspension of stock trading	Kangmei Pharmaceutical's controlling shareholder, Kangmei Industry, is planning a major matter that may lead to a change of control of the company, and the stock of Kangmei Pharmaceutical has been suspended from trading for two consecutive trading days since the opening of the market on the morning of 23 July 2020.

Table 1: (continued).

29th July 2020	Continued suspension of stock trading	Kangmei Pharmaceuticals said that this major matter may involve trusteeship and subsequent reorganisation, and the related work will take a long time, involve a large scale of debt, and have a wide range of repercussions. The company applied to the SSE to continue to suspend trading and resume trading on 3 September 2020 at the latest.
3rd September 2020	Resumption of trading	Kangmei Pharmaceuticals said that trading in the company's shares will resume from the opening of the market on 3 September 2020, and the controlling shareholders and de facto controllers will be changed.
29th January 2021	The SSE issued a regulatory letter	The SSE requires Kangmei Pharmaceuticals to do a good job in production and operation, fully prompt the debt, operation and other significant risks, and do a good job in accounting treatment and disclosure of relevant revenue recognition in strict accordance with the provisions of accounting standards.
20th February 2021	Zhengzhong Zhujiang Accounting Firm was fined] [Zhengzhong Zhujiang Accounting Firm was fined	The SFC ordered Guangdong Zhengzhong Zhujiang Accounting Firm (Special General Partnership) to make corrections, confiscated business income of 14.25 million yuan and imposed a fine of 42.75 million yuan; warned Yang Wenwei, Zhang Jingli and Su Chuangsheng and imposed a fine of 100,000 yuan each; and warned Liu Qing and imposed a fine of 30,000 yuan.
12th November 2021	Compensation of 2.459 billion yuan to investors by the original controller of Kangmei Pharmaceuticals	The Guangzhou Intermediate People's Court made a first-instance judgement on the nation's first securities class action lawsuit.
13th November 2021	The former real controller of Kangmei Pharmaceuticals and others compensated investors 2.460 billion yuan	It ordered Kangmei Pharmaceuticals to compensate securities investors for losses of RMB 2.459 billion, with Ma Xingtian and five directly responsible persons, Zhengzhong Zhujiang Accounting Firm and directly responsible persons assuming full joint and several liability, and 13 relevant responsible persons assuming partial joint and several liability.

2. Analysis of Financial Fraud Methods

(1) Inflating Operating Income

In 2017, Kangmei Pharmaceutical inflated its operating income by CNY 8.898 billion, resulting in an adjustment of CNY 17.579 billion in operating income, a decrease of 34%. The side effect of

this inflation led to a rapid increase in accounts receivable. Kangmei Pharmaceutical's accounts receivable surged from CNY 2.239 billion in 2015 to CNY 4.351 billion in 2017, representing over 100% of net profit [1].

(2) Forging Accounting Documents

In 2014, Kangmei Pharmaceutical's "other receivables" remained at a relatively low level, just CNY 58 million. However, in the following three years, this figure dramatically rose to a staggering CNY 9.2 billion, raising widespread public concern and suspicion. Kangmei Pharmaceutical artificially inflated the balance of "other receivables" by using fraudulent bank documents, seriously violating the principles of accuracy and authenticity in financial reporting. Such behavior severely damaged the interests and rights of investors and undermined market fairness and transparency.

More significantly, Kangmei Pharmaceutical did not disclose the specific contents of "other receivables" in its financial reports. This not only violated the principles of transparency and fairness in financial reporting but also prevented investors from accurately understanding the company's true financial condition. Kangmei Pharmaceutical's lack of honesty in financial reporting has drawn widespread attention and condemnation from various sectors of society. People have expressed strong dissatisfaction and anger about this dishonest financial reporting behavior. This serves as a reminder that investors need to be more cautious when selecting investment targets and demand that companies adhere to principles of honesty and fairness in financial reporting.

(3) Establishing an Unreasonable Equity Structure Before Financing

As of December 31, 2018, Kangmei Pharmaceutical Industrial Investment Holding Co., Ltd. held a 32.91% stake in Kangmei Pharmaceutical. The company's ownership structure is dominated by Ma Xingtian and his wife Xu Dongjin, who hold 99.68% and 0.32% of the shares, respectively. Compared to other shareholders, none of whom holds more than 5%, the Ma Xingtian couple possesses absolute control and decision-making power over Kangmei Pharmaceutical [2]. In this scenario, when Ma Xingtian makes any unreasonable decisions, other executives and shareholders cannot effectively balance him, leading to the potential for incorrect decisions by the company's actual controlling entity. This situation has created vulnerabilities for future financial fraud issues within the company.

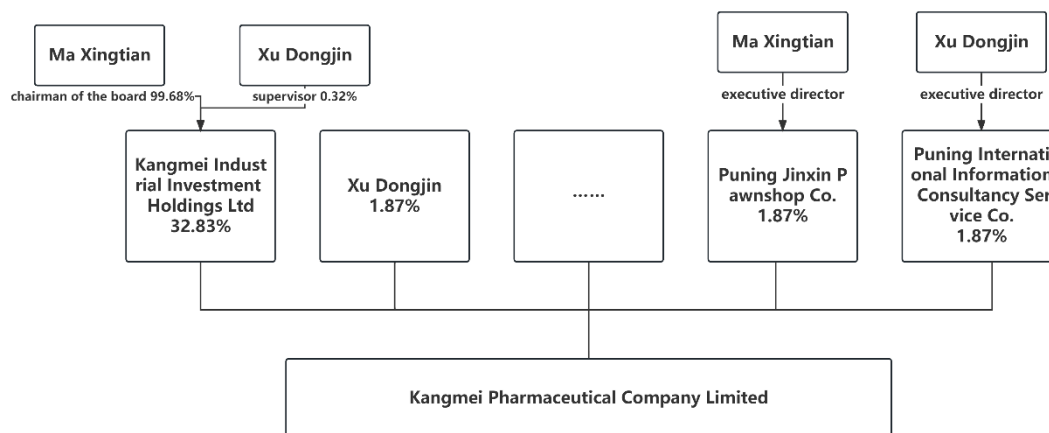


Figure 1: Kangmei Pharmaceutical's Ownership Structure
Source: Kangmei Pharmaceutical Announcements

(4) Fictitious Profits through "Related-Party Transactions"

From 2016 to 2018, Kangmei Pharmaceutical provided non-business funds to its subsidiaries without the necessary legal approval processes, amounting to a substantial CNY 11.619 billion. These funds were used to replace subsidiary companies' payments, interest, and advances, among other expenses. These subsidiary companies include Kangchun Pharmaceutical Co., Ltd. and Kangdu

Pharmaceutical Co., Ltd., among others. According to the 2018 financial statements, these subsidiary companies had instances of occupied accounts receivable.

Kangmei Pharmaceutical's actions clearly contravened normal business operation rules. Not only did they bypass the legal approval processes, but the amounts involved were significant, severely impacting the company's financial stability and operational integrity. This behavior not only damaged the company's reputation but also harmed the interests of a vast number of investors. Therefore, rigorous investigation and action must be taken to maintain market fairness and justice.

Furthermore, Kangmei Pharmaceutical's actions exposed severe internal management issues. When a company makes significant decisions, it must follow legal approval processes to ensure the legality and compliance of the decisions. Kangmei Pharmaceutical's behavior clearly violated this principle, posing significant risks to investors. Therefore, we must pay attention to Kangmei Pharmaceutical's actions, strengthen regulatory efforts, and protect the interests of investors and market order stability.

3. Theoretical Foundation

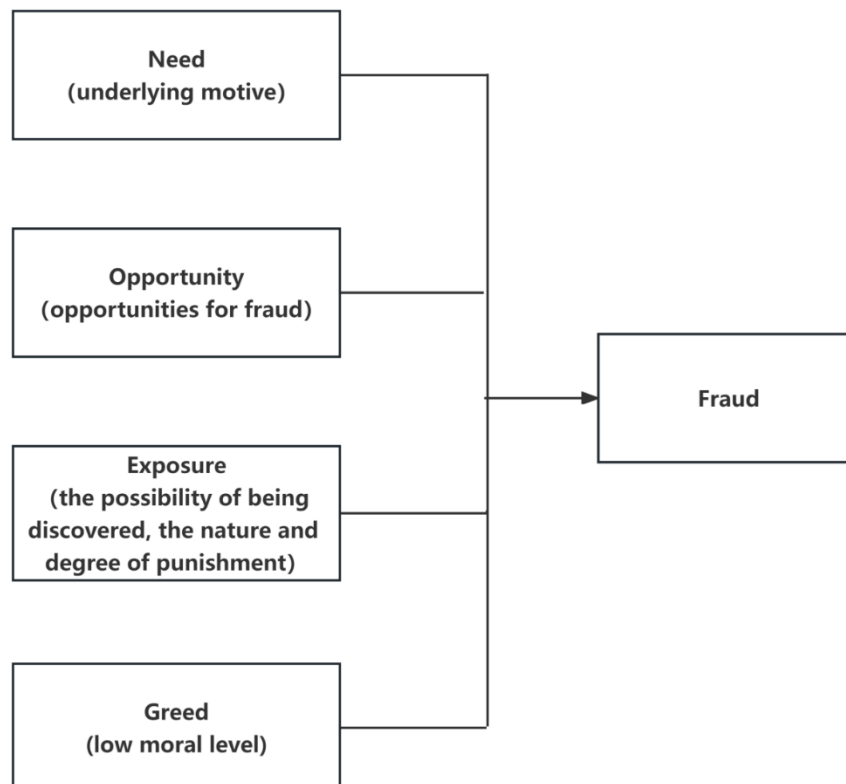


Figure 2: GONE Theory Analysis

The GONE theory, short for "GONE," is a well-known theory in the field of corporate accounting fraud and anti-accounting fraud. This theory posits that corporate accounting fraud is comprised of four key factors, G, O, N, and E, which interact closely and are inseparable. No single factor is considered more important than the others, and together, they determine the extent of the risk of corporate fraud. Specifically, the four factors in the GONE theory represent:

1. G (Greed): This factor approaches the subjectivity of financial fraud from a human perspective. It explains the subjective factors behind fraudulent behavior, namely an excessive desire for wealth and benefits on the part of individuals. This greed may be rooted in an individual's values, ethical

beliefs, and economic pressures, among other factors. For example, some executives may choose to engage in financial fraud out of greed in pursuit of greater wealth and benefits.

2. O (Opportunity): This factor is further divided into internal and external opportunity factors. Internal opportunity factors primarily arise from the unreasonable or flawed internal control systems, governance methods, or equity structures within a company. For instance, a highly concentrated equity structure can lead major shareholders to sacrifice the interests of minority shareholders in pursuit of personal or organizational profit maximization. External opportunity factors involve oversight by third-party independent audit organizations, regulatory authorities like the China Securities Regulatory Commission (CSRC), and securities market laws and regulations, among others. For instance, some companies may exploit internal control deficiencies for financial fraud, and external audit organizations or regulatory bodies may exhibit negligence or loopholes, providing these companies with opportunities for fraud.

3. N (Need): This factor primarily focuses on financial fraud behaviors driven by personal and corporate interests. For example, companies may choose to engage in financial fraud due to economic pressures, expansion demands, or other interest-driven factors in order to secure additional funding and support. Such needs may be rooted in market competition, performance pressures, financing requirements, or other factors.

4. E (Exposure): This factor mainly examines the potential opportunities for financial fraud arising from unsound systems, both internally and externally, from a company's perspective. For example, some companies may have deficient internal management systems, lacking effective supervision and control mechanisms, which could provide employees or executives with opportunities for financial fraud without fear of punishment or exposure. Additionally, external regulatory authorities or audit organizations may also exhibit negligence or loopholes, making it difficult to detect or expose the financial fraud activities of some companies.

4. Analysis of Kangmei Pharmaceutical's Financial Fraud Motives Using the GONE Theory

(1) Need Factor (Need)

According to the 2018 financial report, Kangmei Pharmaceutical experienced a significant net outflow of cash of CNY 4.597 billion, a surprising figure. The projected capital requirements for future projects would amount to nearly CNY 45 billion, imposing enormous pressure on Kangmei Pharmaceutical. In order to gain the trust of investors and creditors, Kangmei Pharmaceutical decided to employ various deceptive financial fraud methods to conceal its financial difficulties. They cleverly packaged themselves as a "blue-chip" stock seemingly with substantial potential and excellent performance, with the aim of attracting investors from the A-share market[3]. Kangmei Pharmaceutical's strategy achieved remarkable success; through deceptive financial statements and other fraudulent means, their stock price multiplied, meeting the substantial financing requirements of the group. However, this behavior is undeniably short-sighted, as such dishonest practices will eventually expose their true nature, leading to greater losses for the company and its investors.

(2) Opportunity Factor (Opportunity)

Kangmei Pharmaceutical has been accused of inflating data to an astonishing total of nearly CNY 120 billion in recent years. Despite having significant bank deposits, the company has engaged in multiple rounds of financing, leading to questions about its internal control systems and top management functions [4]. In fact, this situation vividly reveals significant issues within Kangmei Pharmaceutical's internal mechanisms. On one hand, it is evident that Kangmei Pharmaceutical's internal control systems have substantial flaws. The act of inflating data suggests that there is a problem within some part of the company, making it difficult for the management to detect and control errors in a timely manner. This may indicate that the company's internal control systems have

not been adequately designed and executed to effectively prevent and detect errors. On the other hand, Kangmei Pharmaceutical's equity structure and operational control are highly concentrated in the hands of the Ma Xingtian couple. This situation implies that the decision-making power and influence of the company are primarily concentrated in the hands of a few individuals, increasing the risk of decision-making errors. As Ma Xingtian and his wife have a deep understanding of the company's operations and financial conditions, it is challenging for other shareholders or external regulatory bodies to detect any misconduct if they intentionally engage in inappropriate behavior.

(3) Exposure Factor (Exposure)

Individuals like Ma Xingtian have already gained substantial illegal benefits from long-term financial fraud activities. Even though they face widespread public condemnation after being exposed, the actual impact on Kangmei Pharmaceutical is limited. The China Securities Regulatory Commission (CSRC) imposed a fine of only CNY 600,000 on Kangmei Pharmaceutical, which is insignificant compared to the inflated income of CNY 30 billion and profits of CNY 4 billion from 2016 to 2018. This fine amounts to only 0.002% of the inflated income and 0.015% of the inflated profits [5]. This fine is clearly negligible.

(4) Greed Factor (Greed)

The management of Kangmei Pharmaceutical adopted unethical means such as bribery and speculative real estate investments to increase the company's profits. These actions flagrantly violated ethical and legal standards, damaging the company's reputation and credibility. As leaders of the company, they should lead by example, adhere to moral and legal boundaries, and uphold the company's positive image. The behavior of Kangmei Pharmaceutical's management not only harmed the company's reputation and credibility but also eroded the trust and support of its employees. Employees are a crucial force for a company's development, and management should focus on communication and interaction with employees, earning their trust and support through integrity and professionalism, thus driving the company's growth and progress to achieve its long-term goals. Kangmei Pharmaceutical's management should seek legal, ethical, and sustainable means to increase profits, emphasizing the company's sustainable development, considering its long-term interests and social responsibility to earn more respect and recognition and realize the company's long-term development goals.

5. Countermeasures and Recommendations

(1) Eliminating the Motivation for Financial Fraud in Listed Companies

The primary task is to expand the company's financing channels, leveraging the unique nature of the stock market to create diverse and comprehensive financing methods. This can address the issue of financing difficulties for listed companies. Secondly, it is essential to establish clear delisting rules and criteria for significant illegal and non-compliant activities, and optimize the related delisting regulations to enhance the implementability of the delisting system. This will help combat enterprises that employ financial fraud as a means to severely disrupt market stability.

(2) Reducing Opportunities for Financial Fraud in Listed Companies

Reducing the occurrence of financial fraud events hinges on the dual role of internal control and external regulation. On one hand, we can employ the method of involving institutional investors to improve equity arrangements. In the case of Kangmei Pharmaceutical, the concentration of equity led to a "one-share dominance" situation. By introducing institutional investors to optimize the equity structure, it can promote equity diversification and enhance the supervision of major shareholders [6]. On the other hand, it is crucial to improve internal checks and balances mechanisms. This can be achieved by enhancing the autonomy of internal oversight bodies within the company, optimizing internal control procedures, and strengthening the supervision capabilities and independence of the company's audit committee.

(3) Enhancing the Discovery Mechanism for Exposing Financial Fraud

Firstly, dealing with financial fraud should be stricter. The current maximum fine limits stipulated in the Securities Law are insufficient to effectively deter financial fraud by listed companies, resulting in an imbalance between the costs and benefits of violating information disclosure regulations. Therefore, we recommend increasing the fines to raise the cost of fraud, which will help reduce its occurrence. Additionally, we should seek to establish a mechanism that rewards reporting financial fraud, with the bonus deducted from the fines. Secondly, the level of scrutiny by audit firms should be raised. Specialized audit firms can effectively prevent financial fraud by listed companies. Specific measures include enhancing the independence of audit personnel, maintaining necessary professional skepticism and judgment, and optimizing communication mechanisms between the company's internal audit committee and external audit firms to enhance audit efficiency and reduce the likelihood of financial fraud by listed companies.

(4) Curbing the Greed of Management in Listed Companies

Implementing corporate ethical culture and legal knowledge training can enhance and perfect the company's internal management ethics and legal system, thereby correcting the misconceptions of the management level and allowing them to fully exercise their supervisory and managerial roles. In addition, companies should actively develop a corporate culture that aligns with their practical needs, strengthening the company's cultural "soft power." Simultaneously, establish a comprehensive system for social responsibility management, enabling the management level of the company to fully understand their legal obligations and social responsibilities and ensure the effective execution of social responsibilities.

6. Conclusion

The extensive and far-reaching impact of the Kangmei Pharmaceutical financial fraud case has caused significant economic losses to numerous investors while severely damaging the market's credibility. This case has hindered the healthy development of the capital market and had a profound impact on the trust system of society as a whole. To prevent the recurrence of similar events, it is imperative to conduct a thorough analysis of the methods and reasons behind this fraud case. Through detailed research, we can discern that this case reflects many issues related to corporate governance structure, internal controls, and regulatory systems. These issues provided Kangmei Pharmaceutical with opportunities to engage in fraud by manipulating financial data and concealing real information, deceiving a wide range of investors. Therefore, we need to optimize and improve relevant systems and regulations, such as enhancing supervision over corporate governance structures to ensure that boards of directors, supervisory boards, and senior management can effectively carry out their duties. Furthermore, we must strengthen regulatory and law enforcement efforts to harshly combat any violations of laws and regulations. Additionally, there is a need to enhance corporate integrity and ethical standards. The integrity and ethics of companies serve as a cornerstone for maintaining the healthy development of the capital market. Only those companies that adhere to integrity and ethics can achieve long-term success in market competition. In summary, it is only through a multi-faceted approach, including the optimization and improvement of relevant systems and regulations, increased supervision and law enforcement, and the enhancement of corporate integrity and ethical standards, that we can ensure the healthy and stable development of the capital market. Only in this way can we create long-term value for society and contribute to the economic development of the country.

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