

Identification and Audit Response of Financial Fraud in Listed Companies in Pharmaceutical Industry

-- Based on Shuang Kang Incident

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Abstract: Financial fraud is the conscious misstatement and neglect of financial information by enterprises, which is often difficult to be detected due to the asymmetric nature of information. In recent years, frequent lightning in the capital market, especially the high incidence of financial fraud in listed companies in the pharmaceutical industry, has greatly jeopardized the market order. Therefore, the article discusses the common fraudulent means and differences that the two companies have in conjunction with the financial reports and related announcement information of Kangmei Pharmaceutical and Kangdexin, dissects the abnormal characteristics of identifying financial fraud risks, and proposes corresponding audit response ideas and methods to safeguard the capital market order and investors' interests.

Keywords: Financial fraud, Fraud identification, Audit response.

1. Introduction

In recent years, the phenomenon of fraud has become "rampant", with numerous cases of financial fraud by Kangmei Pharmaceutical, Kangdexin, Zangger Group, Fu Ren Pharmaceutical, etc. The fraudulent means mainly include fictitious transactions, inflated profits, under-recording of costs and expenses, and failure to disclose or false disclosure of relevant financial information as required, which misleads investors and seriously hinders the healthy and stable development of the capital market. This has seriously hampered the healthy and stable development of the capital market. Although the new Securities Law has significantly increased the penalty cost of fraud and to some extent increased the expected cost of financial fraud, there is still a big gap compared with the expected benefit of fraud. In order to provide a strong deterrent to management and shareholders of listed companies, a two-pronged approach is needed, which focuses on increasing the probability of financial fraud detection while increasing fraud penalties. Therefore, this paper selects two typical financial fraud cases of Comet Pharmaceuticals and Kangdexin as cases to study how to take effective means and measures to detect and control fraud in a timely manner. The article discusses the identification of financial fraud in two dimensions: financial information and non-financial information, and proposes corresponding audit response measures, hoping to provide reference for protecting investors' rights and interests as well as promoting the smooth development of the stock market.

2. Case Analysis

2.1. Case Background

2.1.1. Kangmei Incident

The CSRC opened a case against Kangmei Pharmaceuticals on December 28, 2018 for "alleged violation of information disclosure regulations"; on April 30, 2019, Kangmei Pharmaceuticals released its 2018 annual report with an unqualified opinion issued by Guangdong Pearl River Co. adjustments were made; Kangmei Pharmaceutical Co.

changed its name to ST Kangmei on May 20, 2019; and the CSRC issued an administrative penalty against Kangmei Pharmaceutical on August 16, 2019. According to the CSRC's investigation, Kangmei Pharmaceuticals Inc. inflated its monetary funds by a total of 88.7 billion yuan in the three years from 2016-2018, a record high for its illegal amount. The CSRC ordered Kangmei Pharmaceuticals to immediately rectify the situation, issued a warning, fined 600,000 yuan, and handed over the relevant personnel to judicial authorities.

2.1.2. Kangdexin Incident

On January 22, 2019, Kangdexin was investigated by the CSRC for failure to repay "short-term debts" when due, and on the same day, the shares of Kangdexin were included in ST Kangde; Ruihua Accounting Firm issued an unavailable audit report on May 6, 2019, and ST Kangde was renamed as * ST Kangde; On July 5, 2019, Kangdexin was subject to administrative penalties by the CSRC and was suspended from listing. According to the CSRC's investigation, Kangdexin inflated its profits by a total of 11.9 billion yuan in four consecutive years from 2015-2018. In addition, Kangdexin was also alleged to have failed to disclose in its annual report irregularities such as the irregular appropriation of company funds by the company's controlling shareholder, the provision of guarantees for the company's controlling shareholder and the untruthful disclosure of the use of funds raised. The above-mentioned acts led to the existence of false records and material omissions in the relevant annual reports disclosed by Kangdexin. The CSRC imposed top penalties on Kangdexin and the persons responsible for them, and imposed a lifetime market ban. The above two incidents are significant violations, and the financial fraudulent practices are typical and representative, so this paper uses these two financial fraudulent incidents as case studies.

2.2. Analysis on Similarities and Differences of Typical Frauds

2.2.1. Fictitious Transactions with Inflated Assets

ST Kangmei first increased its business revenue by falsifying contracts with customers and other forms, while

increasing its accounts receivable. After digesting the accounts receivable by forging and altering bank deposit slips, the accounts receivable actually paid later was not recorded in the accounts. In the audit process, the company also issued false bank inquiry letters and bank statements to muddle through and create the illusion that the accounts were in line with the reality. Kangdexin used false contracts, fake overseas customers, imitated foreign customers' signatures and fabricated foreign sales to increase revenue and inflate operating costs, sales and R&D expenses, resulting in a total of 11.9 billion yuan of inflated profits.

2.2.2. Information Disclosure Violations

Listed companies should disclose material events occurring during the year or disclose events occurring after 31 December that would have a significant impact on investors' decisions. However, some listed companies concealed matters such as material overdue debts, material litigation, external guarantees, connected transactions, non-operating capital appropriation by related parties, and freezing of bank accounts and major assets. Both Kangmei Pharmaceuticals and Kangdexin failed to make the required disclosure of material matters to conceal the fact of financial fraud.

2.2.3. Take Advantage of Related-party Transactions

ST Comet first transferred funds to related parties by falsifying related party transactions, and later transferred back funds in the form of sales revenue. The related parties took advantage of internal information to manipulate the share price and drive up the share price so that the major shareholder and the related parties made profits. It is suspected of sitting on the market and manipulating the market, which is bad in nature and damages the legitimate rights and interests of investors. The related party of Kangdexin is Kangde Group, and Kangde Group once signed an agreement with the Bank of Beijing that the income of Kangde's subsidiaries would be centralized through its bank account to the head office bank account of Kangde Group, and when funds were needed, they would be transferred from the head office bank account in Beijing down to each subsidiary company, however, the actual situation was that the bank statement of Beijing only showed the net amount after the consolidation and transfer, does not list specific transactions between the relevant accounts, and between the two years of 2017 and 2018, the funds of Kangdexin and other subsidiaries were accounted for up to 15 billion yuan yet only 100,000 yuan is listed.

2.2.4. Abuse of Accounting Policy

How accounting policies are chosen can have a direct impact on the data in a company's financial statements, and companies often make changes in accounting policies and

accounting estimates to control profits. For example, improperly recognizing revenue, changing inventory valuation methods, arbitrarily accruing and reversing asset impairment provisions, and arbitrarily adjusting the net salvage value or depreciation and amortization lives of fixed assets. Comet Pharmaceuticals included in its statements engineering projects that did not meet the conditions for accounting recognition or measurement, resulting in an inflated fixed asset.

3. Characteristics of Financial Fraud Abnormality Identification

3.1. Comprehensive Analysis of Financial Statements

If there is a large difference between a company's net cash flow and net profit or if the difference persists for a long time, it indicates that there is a high probability of fraud in profit-related items. Comet Pharmaceuticals net cash flow from operations is much lower than net profit and the company may be fraudulent. From 2013-2018, Comet Pharmaceuticals earned net profit of 15.477 billion yuan and net cash flow from operating activities of 3.569 billion yuan, with a net present ratio of 23.06%, especially in 2018, the net present ratio was negative. Likewise, there is a huge difference in the fact that Kangdexin had a negative net present ratio in 2016, while it was a steep 125.76% in 2017.

3.2. Analysis of Financial Statement Items and Indicators

3.2.1. Monetary Funds and Liabilities

As an important asset of a company, money capital plays an important role in operations, and the proportion of money capital to total assets varies from industry to industry, usually ranging from 15% to 25%. Too small a proportion of money capital will increase liquidity risk and weaken the company's solvency, too large a proportion indicates that the company is well capitalized and has low operational risk, but it will increase opportunity costs and lack of capital gains. A gearing ratio between 40%-60% is conducive to the balance of risk and return, with most firms in the 30%-50% range. From Table 1, it can be seen that the proportion of money capital of Kangmei Pharmaceutical and Kangdexin from 2015-2017 is close to 50%, and the proportion of interest-bearing liabilities is around 30%, and Kangmei Pharmaceutical is as high as 47.96% in 2018. The financial management of Kangmei Pharmaceutical and Kangdexin is not in line with normal business logic, and there is a typical problem of "double high deposit and loan", which is an effective feature to identify financial fraud.

Table 1. Double high deposit and loan of Kangmei and Kangdexin

Year	Kangmei		Kangdexin	
	Monetary capital/ Total assets (%)	Interest bearing liabilities/Total assets (%)	Monetary capital/ Total assets (%)	Interest bearing liabilities/Total assets (%)
2015	41.51	39.38	44.87	28.87
2016	49.84	37.65	58.23	26.23
2017	49.69	35.91	54.01	33.96
2018	2.46	47.96	44.71	31.53

3.2.2. Inventory Item Analysis

As shown in Table 2, Comet's inventory ratio exceeded 20% from 2015-2017, especially as high as 45.84% in 2018, the ratio is much higher than the proportion of about 12% in the pharmaceutical industry, yet the inventory turnover ratio is lower than the industry average. In contrast, the proportion of Kangdexin's inventory in total assets is decreasing year by year, at 2.27% in 2016 and 1.77% in 2018, which is far from the same industry level. The inventory mismatch between Comet Pharmaceuticals and Kangdexin is too high and

suspected of being fictitious. As shown in Table 8, Comet's inventory ratio exceeded 20% from 2015-2017, especially as high as 45.84% in 2018, the ratio is much higher than the proportion of about 12% in the pharmaceutical industry, yet the inventory turnover ratio is lower than the industry average. In contrast, the proportion of Kangdexin's inventory in total assets is decreasing year by year, at 2.27% in 2016 and 1.77% in 2018, which is far from the same industry level. The inventory mismatch between Comet Pharmaceuticals and Kangdexin is too high and suspected of being fictitious.

Table 2. Comparison of inventory between Kangmei and Kangdexin

Year	Kangmei			Kangdexin			Industry
	Stock (100mn)	Stock/Total assets (%)	Inventory turnover rate	Stock (100mn)	Stock/Total assets (%)	Inventory turnover rate	Inventory turnover rate
2015	97.95	25.71	1.54	5.32	2.36	2.41	3.54
2016	126.19	23.02	1.35	6.01	2.27	4.43	3.95
2017	157.00	22.85	0.45	5.83	1.70	1.81	3.90
2018	342.10	45.84	0.54	6.06	1.77	2.80	3.68

3.2.3. Income Growth Rate and Gross Margin Analysis

Gross profit margins vary widely from industry to industry, and pharmaceutical companies generally have higher gross profit margins. If a company's gross profit margin of a certain type of main business changes significantly compared to previous years, or far exceeds the industry level, or contradicts the trend of changes in the same industry, then it is highly likely to have falsification. As shown in Fig.1 and

Fig.2, Kangdexin's gross margins from 2015-2018 were generally higher than the industry level, while Kangmei Pharmaceutical's gross margins rose sharply in 2017, posing a financial risk. Moreover, in terms of financial logic, revenue growth rate changes in roughly the same direction as gross margins. The revenue growth rate and gross margin of Kangmei Pharmaceuticals and Kangdexin even show an inverse growth.

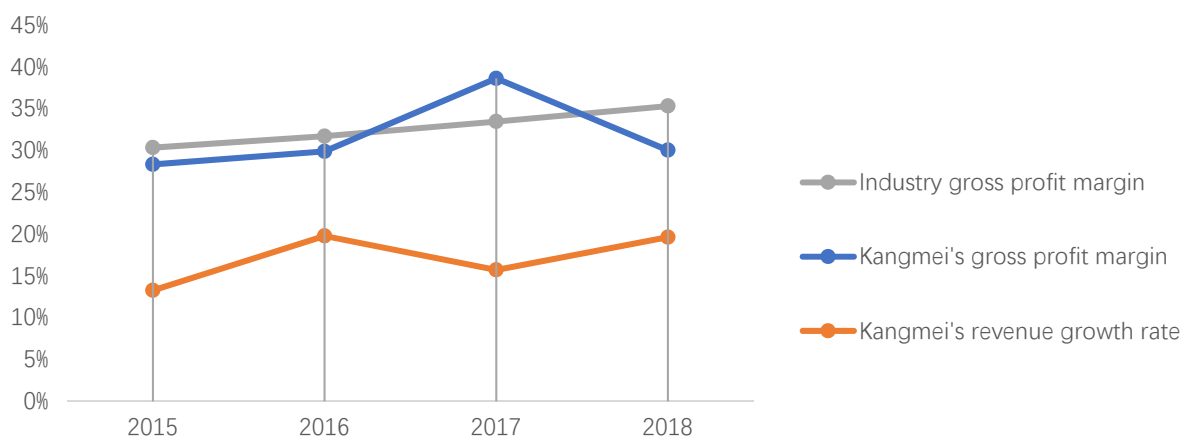


Figure 1. Kangmei's Revenue Growth Rate and Gross Profit Rate

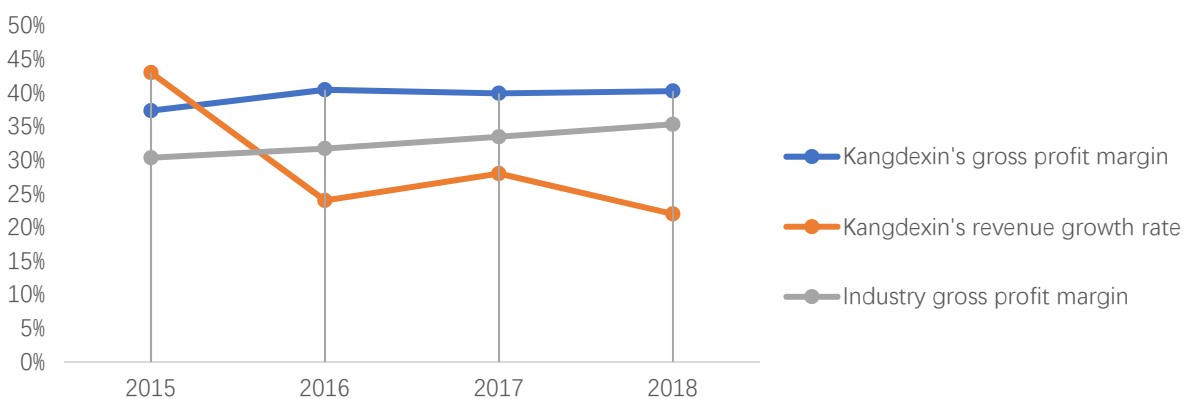


Figure 2. Kangdexin's Revenue Growth Rate and Gross Profit Rate

3.3. Non-financial Information Analysis

3.3.1. Vendor and Customer Exception

The commercial substance and sound business logic of an enterprise's transactions with significant suppliers and customers are key control activities. The presence of related parties or hidden related parties in the top five customers, frequent changes in major customers and suppliers are unusual characteristics. Taking Kangmei Pharmaceutical as an example, from the perspective of suppliers, the top 5 suppliers of Kangmei Pharmaceutical's Chinese herbal medicine trading business in 2018 are all individuals, while the top 5 suppliers of raw materials for Chinese herbal medicine are all enterprises, while the inventory of Chinese herbal medicine in both cases has different procurement channels. Moreover, individual suppliers are more difficult to collect and grant credit, relatively fragmented in distribution and more difficult to track, but the amount of transactions between Kangmei Pharmaceutical and individual suppliers is much higher than that of corporate suppliers. On the other hand, from the perspective of customers, the top 5 customers of the inventory of Chinese herbal medicines in the inventory goods are also individuals, while in the information disclosed in the announcement of Kangmei Pharmaceuticals, it is stated that these stocks are mainly directly wholesaled and retailed to pharmaceutical manufacturing enterprises, Chinese herbal beverage enterprises and individual end customers, which is not consistent with the representation of the sales policy in reality. In addition, the gross profit rate of the large amount of Chinese herbal medicine trading business, where both the customers and suppliers are individuals, is much higher than that of the same industry. The reasonableness of this business needs to be further confirmed as to whether there is commercial substance and whether it is in line with the characteristics of the industry and the internal control requirements of the enterprise.

3.3.2. High Proportion of Equity Pledged or Frozen by Controlling Shareholders

In the case of a controlling shareholder pledging a high percentage of the company's shares, it is necessary to maintain the stock price in order to prevent the stock from bursting. The prerequisite for ensuring a stable share price is that the company has a good financial position and business expectations, which is most intuitively reflected in the financial statement data. At this point, fraud becomes the most direct and effective way to "spruce up" the financial statements. On the other hand, in the case of insufficient capital, the major shareholders are likely to cooperate through financial fraud to realize the act of emptying the company's capital. The controlling shareholders of Kangdexin and Kangmei Pharmaceuticals are the promoters of the companies, and they always hold the decision-making power of the companies in important matters and play a pivotal role in the daily operation of the companies. The controlling shareholder of Kangdexin appropriated nearly 15 billion yuan of the listed company's funds, while the controlling shareholder of Kangmei Pharmaceuticals acquired the company's shares for 9 billion yuan through the funds of its affiliated companies. The controlling shareholders of the two companies treated the listed companies as cash machines, lost their bottom line of integrity, touched the edge of the law, and the internal controls of the companies were virtually null and void. Kangdexin's controlling shareholder, Kangde Group, had its 2,835,200

shares in the company frozen in late August 2018 due to a contract dispute. By this point, the pledged shares of Conde had reached 91.53%, and on January 3rd of this year, it reached 99.45%. At the end of January 2018, the percentage of shares held by the controlling shareholder of Kangmei Pharmaceuticals had reached 90.08%, while on November 29, 2018, its pledge ratio reached 99.53%. The controlling shareholders of the two major companies had improper strategies, blindly expanded and fell into difficulties, thus taking risks and illegally appropriating the funds of the listed companies privately or by instructing their interested parties.

4. Countermeasures Against Financial Fraud

4.1. Remain Professionally Skeptical

Auditors need to maintain professional skepticism at all times in the process of performing audit procedures, and treat the economic matters of the audited entity with a more prudent attitude compared to general enterprises, especially key matters affected by the characteristics of the pharmaceutical industry. To pay attention to abnormal figures and indicators in a timely manner, carry out multi-dimensional linkage verification, determine whether the reasons for the appearance of abnormal phenomena are commercially reasonable, whether they are in line with the enterprise internal control system and related management system; focus on the cross-verification of financial data and non-financial data, and pay attention to whether there is a collision relationship between abnormal financial data and business data. For huge write-offs, especially large impairments of assets, a questioning mindset should be adopted, and matters with fraud signals should be checked backwards. In the actual audit, information dissemination in the news media can be used to reduce the information gap with the auditees. Be alert to insider trading, corruption, etc., provided by public opinion about listed companies and critically evaluate the appropriateness and adequacy of the evidence considered as audit evidence.

4.2. Attach Importance to the Analysis of Industry Characteristics and Expected Value Data

As required by auditing standards, comparing expected value results using financial data trend analysis and ratio analysis are the most common methods of risk assessment analysis. Therefore, how to set accurate and comparable expected values is the core issue of audit implementation, of which how to choose industry classification and industry characteristic indicators is the primary key issue to be solved. If the industry classification criteria are not set properly, the selection of expectations will be biased, resulting in "technical anomalies" rather than "material anomalies" in financial indicators, which will increase the risk of inspection. Therefore, it is necessary to select more detailed industry categories and to position more precisely the comparison of listed companies in order to determine the expectations of industry data.

4.3. Improve Financial Fraud Detection

Against the background of continuous innovation in business practices and fraudulent means, the change of digital auditing is necessary for effective screening of financial fraud.

On the one hand, CPAs can analyze the early warning information or signs of financial fraud of the audited entity from multiple perspectives, such as industry business, financial taxation, corporate governance, internal control and digital characteristics, from existing financial fraud identification systems or tools, so as to formulate corresponding risk response strategies in a targeted manner. On the other hand, advances in information technology can be used to empower independent audits. With the help of information technology such as big data and artificial intelligence, a more detailed database of industries and business industries can be constructed as far as possible to obtain more information resources, thus laying a solid data foundation for the development of risk-oriented auditing and enhancing the ability of CPAs to perform audit procedures and detect fraud, thereby reducing the occurrence of audit failures.

4.4. Establishing and improving the Mandatory Audit Rotation System

The CICPA does not currently impose a limit on the number of years of continuous service of an accounting firm. However, as two parties in the audit tripartite relationship, accounting firms and auditees are linked for long periods of time, which can easily have a negative impact on independence. In addition, the current method of paying audit fees makes the firm have a strong financial dependence on the audited entity, and the interests of both parties are closely related, affecting audit quality. All these will increase the inspection risk of auditing. Therefore, it is necessary to establish a sound system of mandatory audit rotation to ensure audit independence and objectivity, thereby improving audit quality. On the one hand, legal provisions should be made for the number of years of mandatory audit rotation for firms, and a rotation time suitable for the enterprise and market conditions should be established. On the other hand, the internal and external supervision of the mandatory audit rotation system should be strengthened. Relevant departments such as the supervisory boards and internal audit bodies of listed companies should strengthen the supervision of the selection and rotation of accounting firms and regular assessment; external supervisory bodies such as the Securities Regulatory Commission and the stock exchange should establish a perfect supervisory mechanism and impose strict penalties on firms and listed companies that do not strictly implement the system, so as to raise the cost of violation and regulate the implementation of the system.

4.5. Strengthen the Supervision of Audit Quality

The regulatory authorities should strictly review the audit operations of accounting firms and set reference standards for audit fees to avoid audit collusion between firms and audited entities. In addition, to increase the cost of non-compliance of firms, the important role of financial non-compliance information disclosure in social audit regulation should be emphasized on the one hand. The regulatory authority can maximize the efficiency of audit supervision by improving

the ways and means of disclosing information on financial irregularities in China, and disclosing the non-compliant audit practices of accounting firms that fail to audit, so as to improve the quality of auditing; on the other hand, imposing strict disciplinary measures of fines and suspensions on accounting firms that fail to audit, and imposing different disciplinary measures on practitioners who disregard professional ethics depending on the severity of On the other hand, strict disciplinary measures such as fines and suspensions are imposed on accounting firms with audit failures, and different penalties are imposed on practitioners who disregard professional ethics depending on the seriousness of the case, and those who cause serious adverse impact on society are directly banned from the industry.

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