

# A Case Study of Fraud in Xinjiang Ready Health Industry Co.,Ltd. Based on Fraud Triangle Theory

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**Abstract:** Since the case of Kangmei Pharmaceutical Co.,Ltd., financial fraud in the pharmaceutical industry has received increasing attention from all parties in society, and financial fraud in listed companies has an important impact on the sustainable and healthy development of the capital market. Taking the four-year-long financial fraud of Xinjiang Ready Health Industry Co.,Ltd. as an example, this paper analyzes the pressure, opportunities and excuses of financial fraud of this enterprise by applying the fraud triangle theory, and finally puts forward governance suggestions from four aspects: improving corporate governance structure of the company, enhancing the function of auditors and strengthening the effectiveness of regulatory departments to punish financial fraud.

**Keywords:** Financial fraud, Fraud triangle theory, Xinjiang Ready Health Industry Co.,Ltd..

## 1. Introduction

Xinjiang Ready Health Industry Co.,Ltd. was listed in the shell with the pressure of performance promise, however, the operating results were not as good as expected, and fraud was used to fulfill the performance promise in order to avoid compensation. Amidst the lack of ethics of its managers and changes in its business model, the company practices fraudulent means in numerous ways. The content of the penalty book issued by CSRC shows that the company is involved in four major violations: (1)Inflating profits by 3.202 billion yuan through fictitious sales and procurement business, inflating sales and management expenses, falsifying bank returns, and inflating income from other businesses. (2)Failing to disclose in a timely manner the connected transactions of 2.592 billion yuan in non-operating appropriation of funds by controlling shareholders and related parties. (3)Failing to truthfully disclose the company's

fundraising funds of 770 The deposit and actual use of RMB 770 million. (4)Failure to disclose in a timely manner matters related to the provision of guarantees for controlling shareholders and related parties and material litigation. Therefore, the analysis of the motives of the fraud cases of company can lead to relevant countermeasures to strengthen the supervision of financial frauds of listed companies.

## 2. Case Review

In May 2016, Xinjiang Ready Health Industry Co.,Ltd. was restructured and listed on the shell of Xinjiang Hops Co.,Ltd. The main business is the wholesale sale of drugs, health care products and medical devices. Company fraud issue was first brought to public attention when it received a notice of investigation from the CSRC, and ended with delisting after 24 delisting risk warnings, and the whole process of events is shown in Table 1.

**Table 1.** Case Background

Time	Content
Sep. 4, 2018	Received inquiries from SSE for revenue increase without profit increase, restructuring commitment, etc.
Apr. 2, 2019	Received inquiry from SSE on termination of the project of pharmaceutical security traceability system and remaining fund raising, etc.
May. 20, 2019	Received inquiry from SSE on 2018 annual report.
Dec. 12, 2019	Received an inquiry from the SSE regarding the acquisition of Sichuan Belcon Pharma.
Apr. 28, 2020	Received a notice of investigation from the Securities Regulatory Commission.
Jun. 29, 2020	Received negative opinion on internal control and unavailable opinion on financial statements from the firm.
Jul. 3, 2020	Received inquiries from the SSE regarding illegal appropriation of funds, significant changes in performance, other business income, etc.
Nov. 2020 - Jan. 2021	Resignation of 3 directors, 2 supervisors, 1 independent director and 1 employee representative supervisor.
Apr. 30, 2021	Negative opinion on internal control and unable to express an opinion on financial statements issued by the firm.
May 28, 2021	Received inquiries from the SSE regarding accounts receivable, provision for bad debts and other receivables.
Oct. 24, 2021	Received "Prior Notice of Administrative Punishment and Market Prohibition" from CSRC.
Jun. 24, 2022	The CSRC officially announced the "CSRC Administrative Punishment Decision".
Jun. 30, 2022	Termination of listing after 24 delisting risk warnings.

### 3. Analysis of Fraud Motivation Based on Fraud Triangle Theory

In 1995, the fraud triangle theory was proposed by Albrecht, who found that in accounting activities, pressure factors, opportunity factors and rationalization reasons formed the three major motivating factors of fraudulent activities[1]. The following is the analysis of fraud motivation of Xinjiang Ready Health Industry Co.,Ltd. according to the three aspects of fraud triangle theory.

#### 3.1. Pressure

Pressure is the most direct motivation for behavior, a drive for profit, including pressure to maintain economic performance, pressure caused by the need to maintain the

personal image of the company's senior management or beneficial owners.

##### (1) Performance commitments

In 2015, Xinjiang Hops Co.,Ltd. purchased 100% of Readay Medicine Co.,Ltd. by issuing shares and cash payments for a total of 6.127 billion yuan, switching to a pharmaceutical distribution company, with Hubei Tongjitang Investment Holding Co. becoming its controlling shareholder and the company changing its name to Xinjiang Ready Health Industry Co.,Ltd.. Company successfully listed by the shell of Hops. Among them, the restructuring company and Hubei Tongjitang Investment Holding Co. signed a performance commitment, promising that Readay Medicine Co.,Ltd. net profit attributable to shareholders of the parent company for the years 2016, 2017 and 2018 will be no less than 460 million yuan, 529 million yuan and 561 million yuan, respectively.

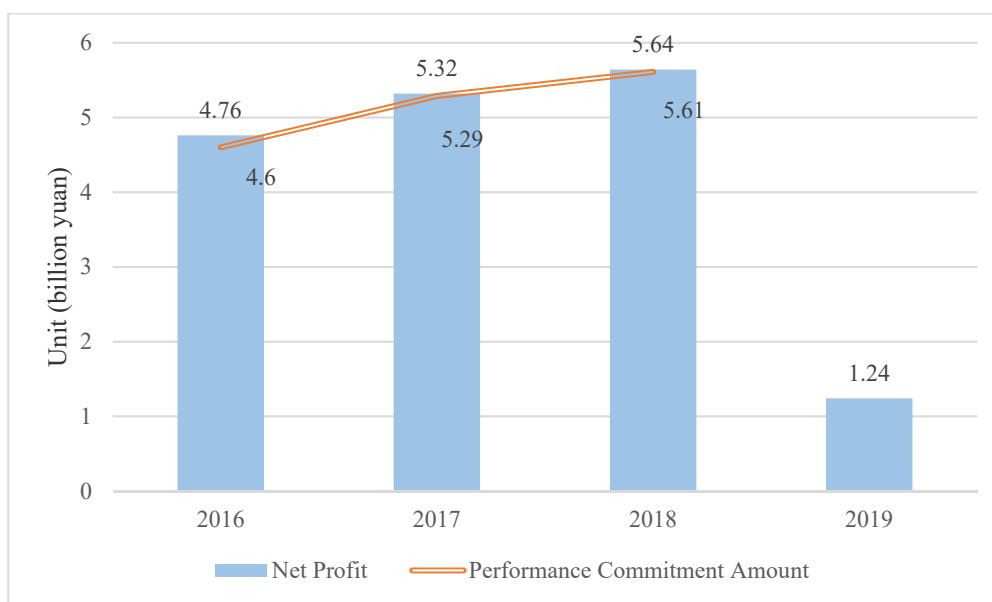


Figure 1. Performance commitment completion

From Figure 1, it can be seen that the company completed the performance promise exactly in the first three years, and in the first year after completing the promise, the net profit fell precipitously to 124 million yuan, a 77% decrease from the previous year. The explanation given by the company is that in order to strengthen the management of funds and receivables, the company adjusted its business model by way of concessions, and therefore the revenue recognized by the net method fell.

However, it is really important to pay attention to the case that the operating performance changes immediately after completing the performance promise, and many existing fraud cases are related to the performance promise, for example, the case of Aerospace Communications Holdings[2]. The high return of performance promises corresponds to high risk, and companies that are unable to fulfill their promises are likely to avoid compensation by falsifying them, and stakeholders should be cautious about such cases.

##### (2) Financing needs

In 2018, the "China' two invoices system" of pharmaceutical reform was officially promoted and

implemented, and in order to seize the opportunity of the implementation of the "China' two invoices system", the company broadened the market by continuously increasing the credit line of customers and inventory goods, which led to the increase of receivables, prepayments, purchase payments and deposits[3]. In 2018, accounts and notes receivable increased to 3.635 billion yuan, up 1.227 billion yuan from the previous year, and prepayments increased to 525 million yuan, up 291 million yuan from the previous year. In addition, in order to solve the capital problem, the company has also raised debt several times in recent years, and the amount of borrowing has been rising year by year. As seen in Figure 2, by 2019, the company's short-term borrowings increased to 725 million yuan and another 313 million yuan of borrowings were overdue that year. Finally, the company also postponed the 2015 project several times and used the funds raised for daily operations. As a result, the company is under financial pressure and has the necessary financing needs. The financing opportunity was obtained by fabricating false data if the financing conditions were not met.

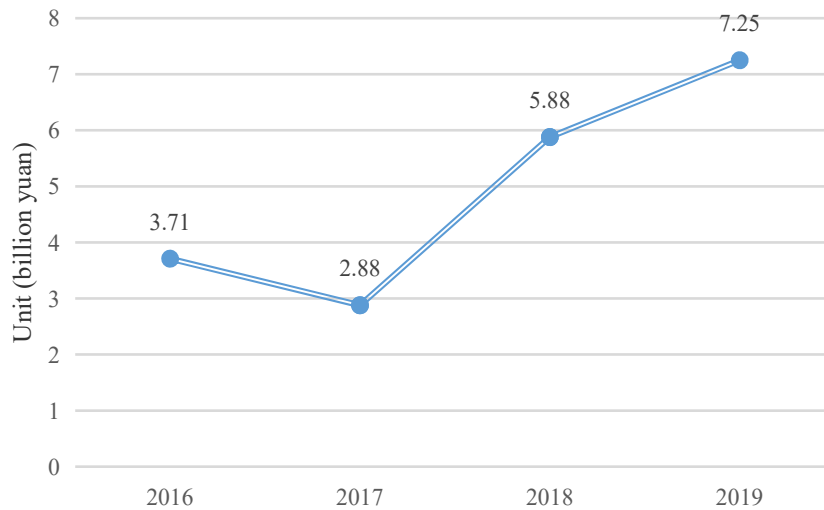


Figure 2. Short-term borrowing

### 3.2. Opportunity

Opportunity refers to the chance to cover up the fraud and escape from the regulatory authorities. Opportunities exist to enable fraudulent motives, including deficiencies in internal control, information asymmetry, inadequate accounting and auditing systems, inadequate penalties, quality of work not easily assessed, ignorance or incompetence.

#### (1) Internal factors

First, the absolute control of "Ownership Structure" leads to poor equity checks and balances in the company, which provides opportunities for financial fraud[4]. As shown in

Figure3, Hubei Tongjitang Investment Holding Co. directly holds 31.72% of the company's equity, and indirectly holds 7.67% of the company's equity through Derui Wanfeng, holding a total of 39.38% of the company's equity, which is the controlling shareholder of the company. Meihua Zhang and Qing Li (wife) jointly hold 92.33% of Hubei Tongjitang Investment Holding Co., making them the controlling persons of the company. In addition, Meihua Zhang is also the chairman of the company and Qing Li is the vice chairman and general manager. It can be seen that the husband and wife have high control over the company and are in charge of the company's management and major decisions.

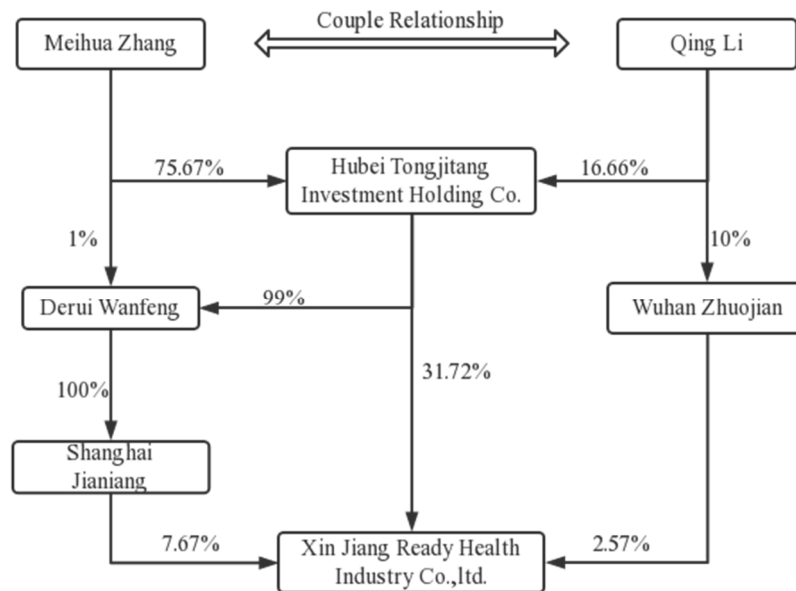


Figure 3. Holdings in 2016

Second, the internal control failed. 2019-2020, the company's internal control audit report was issued with an unavailable opinion, pointing out that the company and its subsidiaries had significant deficiencies in funding activities, procurement and sales operations, asset management and accounting, and financial reporting. Meanwhile, there were cases of non-operating capital appropriation by controlling shareholders and abnormal capital transactions, indicating that the company did not disclose or deliberately did not

disclose related party capital transactions in a timely manner and the matters were not approved by the shareholders' meeting and board of directors' consideration procedures. In addition, seven directors of the company have left one after another since 2020, which can be guessed that the company has serious internal problems.

#### (2) External factors

One of them is the auditors' failure to perform their duties. The company started fraud from 2016, and the SSE has asked

the company several times about the increase of revenue but not profit and the completion of performance promise. The auditor should have been cautious about this and further focused on verifying the relevant information. However, after conducting a series of audit procedures, the auditors agreed with the explanations given by the company as well as the responses. It was only after the CSRC intervened in the investigation in 2020 that the firm issued an unavailable opinion on the 2019 annual report. Before that, the auditors, who are the most familiar with the company's situation, did not find any problems at all.

Second, the penalty is low. The new securities law has strengthened the penalties, but compared to the amount of corporate fraud is still too small. Just look at the company's inflated profits of 3.202 billion yuan, while the total amount of punishment is only 0.14 billion yuan. In addition, the company was also illegally occupied by the controlling shareholder, which did bring the controlling shareholder far more than the amount of the fine. Therefore, the low penalties of the Securities Law provided the company with opportunities for fraud.

### **3.3. Excuses**

Excuses refer to finding many seemingly reasonable reasons to justify fraudulent behavior. Excuses align fraudulent behavior with its moral values and codes of conduct.

The company and its effective controller both have low moral quality and weak legal awareness. Starting from 2016, the company's financial frauds amounted to four years, with cumulative inflated operating income, other business income and profit of 20.735 billion yuan, 386 million yuan and 3.202 billion yuan, respectively. Failure to disclose financial transactions with related parties as required, and providing non-operating funds to related parties for 2.592 billion yuan. The amount is so large and the proportion is so heavy that it is mind-boggling. The company, through three subsidiaries, fictitiously created sales and procurement operations, inflated sales and administrative expenses, and forged bank returns. The sudden rise of the company in the past few years is only an illusion created by the controller for his own selfish desire.

## **4. Prevention and Suggestions**

### **4.1. Improve the corporate governance structure**

First, to improve the degree of equity checks and balances, to break the "Ownership Structure" absolute control. Many fraud cases in China have the manipulation of the major shareholders, "Ownership Structure" of the right to speak so that the company's board of directors, the supervisory board as a virtual. Therefore, it is urgent to break the dilemma of "Ownership Structure". It is also worthwhile to pay attention to those companies that have this problem and remain cautious. Strategies such as introducing strategic investors and employee stock ownership can be properly adjusted and effectively decentralize power. Not only is it conducive to establishing an internal governance structure with mutual checks and balances, but it can also bring more opportunities and resources to the company. employees can also have the opportunity to express their opinions and participate in corporate governance, as well as have a greater sense of belonging.

Second, improve internal control and strengthen internal

supervision. Clarify the checks and balances and independence of the governance and management, with clear separation of power and responsibility. In particular, the function of independent directors should be consolidated, not only to clarify the obligations of independent directors, but also to protect their power from persecution. Internal audit, as the supervising party, needs to have sufficient power and be independent enough. A good communication system and information system should be established to ensure that information from all parties can be effectively communicated and the quality of information can be guaranteed so that the internal control system can be properly implemented.

### **4.2. Improve the overall level and quality of auditors**

As an external supervisor who is familiar with the company's situation for several years without finding the company's problems, it can be seen that the professional quality of auditors does need to be improved. Auditors should not only participate in continuous training, but also focus on developing critical thinking and independent thinking skills, constantly reflecting and summarizing their operational work experience, and looking for ways to improve in order to enhance the quality and efficiency of their audit work. Most importantly, auditors need to establish the right values, uphold the principle of independence and stick to their bottom line.

### **4.3. Strengthen the effectiveness of regulators**

Securities Law of the People's Republic of China (revised in 2019) did increase the various penalty bars, but the benefits of violating the law are simply too high. The regulators should continue to actively participate in and promote the implementation, formulation and revision of relevant laws and regulations to further ensure the timeliness and effectiveness of regulation. Increase penalties, increase criminal penalties, focus on punishing those responsible, and raise the cost of violations. Strengthen the application of regulatory technology tools and make full use of big data, artificial intelligence, blockchain and other technical means to improve the accuracy and efficiency of regulation. Broaden the scope of regulation and strengthen the coordination and cooperation between regulation and other departments and institutions.

## **5. Conclusion**

Xinjiang Ready Health Industry Co.,Ltd. has problems such as huge amount of inflated profits, large amount of funds being occupied by controlling shareholders, non-disclosure of the use of fund-raising funds and irregular guarantee. This paper does research on the fraud motive of Xinjiang Ready Health Industry Co.,Ltd. from the starting point of fraud triangle theory. The main reasons are high pressure of performance commitment, inadequate internal control and external audit failure. Through the analysis of this fraud case, we propose suggestions and recommendations for the identification and prevention of corporate financial fraud. It contributes to the prevention of fraud in advance, which can effectively reduce the loss of relevant stakeholders and maintain the order of capital market.

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