

## Research on Audit Failure of Listed Companies

### -- Based on the Case Study of Kangmei Pharmaceutical Industry

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#### Abstract

Based on the recently disclosed financial fraud cases of Kangmei pharmaceutical industry, this paper analyzes the causes of financial fraud from four aspects by using the theory of GONE, and then combines with the right points. According to the actual situation of Zhujiang's audit of Kangmei Pharmaceutical Co, Ltd., it is found that the reasons for audit failure are lack of professional skepticism and due diligence, unreasonable design of physical examination, inadequate analytical procedures, implementation audit methods incorrectly, the audit quality control mechanism. Therefore, we should reduce fraud opportunities, strengthen supervision and increase punishment; improve audit independence, maintain reasonable professional skepticism, make full use of analytical review, improve the quality of accountants in order to prevent audit failure.

#### Keywords

audit failure, financial fraud.

#### 1. Introduction

As an important defense against corporate fraud, CPA audit plays an important role in maintaining the economic order of China's capital market, reducing information asymmetry and improving the credibility of listed companies' financial statements. With the continuous optimization of CPA practice environment and the increase of capital market supervision, the quality of CPA practice in China has been continuously improved and generally recognized by the public. However, in recent years, there are still some cases of CPA audit failure in the capital market of our country.

In 2018, after GP Certified Public Accountants (special general partnership) audited the 2017 financial statements of Kangmei Pharmaceutical, it issued a standard unqualified audit report and published its financial report to the public. Then the relevant departments found that the assets of Kangmei pharmaceutical industry increased by nearly 30 billion yuan. By December 28, 2018, the CSRC had filed an investigation on Kangmei pharmaceutical Co. Ltd.

On April 29, 2019, Kangmei Pharmaceutical issued an announcement on correction of previous accounting errors. This paper elaborates on 14 accounting errors of the company's 2017 annual report. These mistakes involve key projects such as profit, income and cash. According to its announcement, the company has serious data errors in accounts receivable, operating revenue, operating cost, inventory and other important accounting subjects. It sounds unbelievable that more than 29,944 billion yuan of monetary capital was recorded. It inflated 30 billion yuan of monetary capital, and then evaporated overnight. However, Kangmei Pharmaceutical said that it was a miscalculation. If it's a mistake, it should be the biggest "accounting mistake" in Chinese history.

On May 14, 2020, China Securities Regulatory Commission issued a letter of decision on administrative punishment for financial fraud of Kangmei Pharmaceutical. It is subject to a fine of 600,000 yuan, and a fine of 100,000 to 90,000 yuan for 21 persons in charge as well as a ban on entering the bond market for 10 years to life for 6 persons in charge.

From December 28th 2018 to May 14th 2020, China Securities Regulatory Commission took investigation and filed a case for investigation to punish it, which lasted for a year and a half, and finally put an end to the financial fraud.

## 2. Fraud Motivation Analysis

### 2.1. Greed Factor

First, Kangmei Pharmaceutical industry for their own interests, using the bribery means repeatedly to achieve their own goals. Not only play up to investors, but also bribe the government and regulators. In March 2019, HK \$200,000 was bribed to the local party secretary in order to invest in Langzhong City, Sichuan. Over the past 15 years, Kangmei Pharmaceuticals has paid different amounts of bribes to regulators such as the Securities and Exchange Commission and the Drug Enforcement Administration.

Second, Ma Xingtian, the boss of Kangmei Pharmaceuticals, likes to speculate and make a profit. China's real estate industry has always been a windfall industry. Kangmei Pharmaceuticals has seen the real estate industry's windfall, in 2012 began to dabble in the real estate industry. Before being investigated, Kangmei Pharmaceuticals had claimed to invest \$16.55 billion in the real estate industry in 2019. This is undoubtedly a huge amount of money, to get this part of the funds you need to have good-looking report data.

### 2.2. Need Factor

Although there were \$30 billion on the account, \$2 billion in debt could not be repaid in February 2019. This shows that the quality of these book funds is not high. Since the listing, the amount of equity financing is about 16 billion yuan, the bond financing is 52.65 billion yuan, and the loan financing is 12.395 billion yuan. These circumstances show that Kangmei Pharmaceuticals is in urgent need of money. Under the huge demand for funds, Kangmei Pharmaceuticals has a motive for fraud.

In addition, in order to avoid a forced de-listing, Kangmei Pharmaceuticals must keep the shell of listed companies. The study found that Kangmei's net cash flow was less than half of net profit, and its gross margin was much higher than that of the industry. This means that the company's profits have skyrocketed and it has made a lot of paper wealth. This could help Kangmei keep the listed company's brand and not be forced out of the market.

### 2.3. Chance Factor

The internal controls of Kangmei Pharmaceuticals are ineffective. According to the information it disclosed, the internal control audit report is advised in 2018. This shows that there is a big problem with its internal control. In addition, expert's research found that the shareholders' meeting of Kangmei is essentially a walk-in meeting. Mr. Ma also recognize that there are serious corporate governance problems at Kangmei Pharmaceuticals, and that management and actual controllers are completely above internal controls, so it is not surprising that financial fraud is caused.

### 2.4. Exposure Factor

First, there is little likelihood of exposure to financial fraud. Kangmei Pharmaceuticals has put on a "rationalization" cloak for its own fraud. Although the means of fraud is not very high, but because of Kangmei Pharmaceutical's corporate governance, internal control there are many defects, the actual controller's rights completely affect the internal control, coupled with the

external audit body's independence is not enough, audit supervision is not in place and the audit institution's inherent defects, such as audit time, cost and benefit, reasonable assurance and other inherent defects will make fraud more difficult to find. As a result, the cost of fraud in The Kangmei Pharmaceuticals is very low.

Second, the penalty after financial fraud is light. In this case, the \$30 billion deposit and the penalties imposed on businesses are simply incomparable. Our penalty for fraud has always been too light. This leads to the rules of the right to do industrial enterprises cannot make a lot of money, and those who go through the evil path of fraud is overnight rich. In this environment, it is difficult for enterprises to do business with peace of mind, but easy to embark on the road of fraud. Because the temptation of wealth is too great, the punishment after exposure is not painful.

### **3. Audit Failure Analysis**

#### **3.1. Lack of Professional Skepticism and Due Diligence**

The standard audit opinion issued by GP Certified Public Accountants in 2017 raises questions as to whether the auditors have used confirmations. Although there is a deposit of 30 billion yuan on the account of Kangmei Pharmaceutical, but if this is forged by Kangmei Pharmaceutical, then the auditor can identify the authenticity through the bank third-party agencies by confirmations.

Also, whether auditors have doubted about the inventory and monitored. If auditors maintain the skepticism that they should have, then they should use effective methods to monitor, not simply entrust the so-called experts to do it. Monetary funds have always been the object of key audits. Such a big problem illustrates the auditor's serious negligence. Not even the most basic skepticism.

#### **3.2. Unreasonable Design of Physical Examination**

The monitoring of tangible assets is an important substantive audit procedure. When CPAs face up to 78% of the inventory items in stock and the beginning balance is significantly higher than the ending balance of last year, they did not identify it as having special risks, but rather developed a general inventory monitoring plan.

This approach lacks doubt and verification of the existence and completeness of inventory counts provided by Kangmei Pharmaceutical, and questions remain as to the appropriateness of the unannounced draw ratio. On the other hand, for the changes in inventory between the inventory count date and the balance sheet date, the CPA only reviewed the purchase, sale and inventory situation, checked the outgoing and outgoing inventory orders by sampling. It was not possible to determine whether the inventory changes between the inventory count date and the balance sheet date had been properly recorded, resulting in the audit failure.

#### **3.3. Inadequate Analytical Procedures**

The relationship between inventory and sales revenue, as well as impairment provisions and turnover of inventory, were not taken into account. In this correction, the main business revenue was reduced by 8.898 billion, and the main business cost was reduced by 7.662 billion yuan, thus estimating the gross profit margin of the adjusted business to be 13.9%. However, looking at Kangmei's financial data in recent years, except for the small sales of food and Chinese herbal medicine trade, no business sector gross profit margin is less than 20%, far above the industry average. Such a drastic adjustment is clearly not the result of a single operational calculation error. No matter how many business sectors involved, the high gross margin of these sectors should be unveiled.

### 3.4. Implementation Audit Methods Incorrectly

Kangmei has more than 34 billion yuan of money, which is not only far more than other enterprises in the same industry, but even more than the total assets of many enterprises. And its proportion of total assets is as high as 49.7%. At the same time, Kangmei Pharmaceutical has a short-term loan of 11.37 billion yuan. According to the principle of analytical procedures, this phenomenon of "double high" of deposits and loans should have aroused the high vigilance of CPA and focused on it as a high-risk project for the audit of monetary funds.

However, GP Certified Public Accountants has only carried out routine verification procedures for the high-risk project and has not confirmed the authenticity of the bank's reply, which leads to the invalidation of the correspondence procedure.

### 3.5. The Audit Quality Control Mechanism

Good internal operation mechanism and perfect internal quality control system can effectively guarantee the risk control of accounting firms. By comparing with the organizational structure of Ruihua and Tianjian, we can identify the defects and deficiencies in the design of audit quality control mechanism in GP Certified Public Accountants.

On the one hand, in terms of the number of professional committees set up, there are only 5 in the GP Certified Public Accountants, and Ruihua accounting firm and Tianjian Association are 8. It can be seen from the integrity of the organizational structure that the GP Certified Public Accountants is relatively deficient.

On the other hand, in addition to the risk control committee, Ruihua also set up a partnership conduct supervision committee to prevent partners from colluding with listed companies for fraud, and set up a technical and standard department and a quality supervision department accordingly at the departmental level to further extend the audit quality control to the business execution level. In contrast, GP Certified Public Accountants has only set up a risk and quality control committee, and no specific executive department related to quality control. It can be seen that its control mechanism for audit quality is relatively single, only stays at the partner level of supervision and review, and does not clearly control the audit quality specific responsibilities. When audit quality problems may not be resolved in time, resulting in audit failure.

## 4. Relevant Countermeasures

### 4.1. Prevent Financial Fraud

#### 4.1.1. Reduce Fraud Opportunities

In order to improve the internal control system, the regulatory authorities should review the internal control system of Kangmei pharmaceutical and regularly evaluate the implementation of the system. In addition, to strengthen the supervision of internal audit, we need to identify and evaluate the company's risks more comprehensively and accurately. The internal audit department should adapt to the changes of internal audit environment, build a systematic big data audit practice framework, design an audit whole process operation platform driven by functional research and risk management, use convenient audit analysis tools to quickly locate the company's risks in audit, operation and other aspects, identify the defects in business, internal control and other processes, so as to establish a set of effective The audit monitoring system provides the possibility for the prevention and detection of management fraud.

#### 4.1.2. Strengthen Supervision and Increase Punishment

First, CSRC should strengthen supervision. China Securities Regulatory Commission should focus on the inspection of listed companies to effectively prevent the fraud of listed companies.

China Securities Regulatory Commission should adhere to the problem-based and risk-based approach, and apply limited regulatory resources to prominent issues.

Second, improve the social supervision system. Establish a comprehensive enterprise credit evaluation mechanism across the whole society, and take the enterprises and firms that have been *punished by the CSRC for fraud as the key inspection and supervision objects of the CSRC*.

## **4.2. Prevent Audit Failure**

### **4.2.1. Improve Audit Independence**

There is no guarantee for the quality of soul audit. Now there are many companies like Kangmei pharmaceutical that haven't changed their offices in 19 years. Enterprises should change their cooperative offices after a certain period of time. If we do not change the firm for a long time, even if the auditor finds that the company has fraud, it is difficult to make a correct judgment and deal with it. In order to improve the declining trend of audit independence, the relevant departments should formulate more stringent measures to prohibit the relationship between the firm and the enterprise that is detrimental to the independence. First, separate the assurance business from the non-assurance business. In order to avoid the impact of non-assurance services on the independence of assurance services, the two services should not be undertaken by the same firm. First, the firm may establish independent departments engaged in two aspects. Second, the firm can set up a completely independent agency by independent non assurance services. But if we want to separate these two businesses, we need to have relevant laws in order to achieve corresponding results. Secondly, the chief auditor should be changed frequently. To a great extent, the independence of audit is decided by the chief accountant. If the audited unit does not change the chief accountant for a long time, it is easy to generate the inherent thinking. This is not good for finding the problems of the audited unit.

### **4.2.2. Maintain Reasonable Professional Skepticism**

GP Certified Public Accountants is lack of professional skepticism and due diligence. Throughout the audit period, auditors should always be skeptical. Auditors should be skeptical of the financial information provided by enterprises and the audit evidence from different parties, so as to effectively prevent risks. Auditors are skeptical of the audit data, and can quickly find out the existing problems, which will greatly improve the efficiency of the work.

### **4.2.3. Make Full Use of Analytical Review**

Although the audit quality is the first, we should also consider the amount of investment cost, because audit resources are limited after all. If the firm wants to get a huge profit while ensuring the quality, it can only make full use of audit resources to reduce the cost and get profit. The application of analytical review can greatly improve the efficiency of audit, reasonably allocate audit resources, and achieve the balance of quality and income.

### **4.2.4. Improve the Quality of Accountants**

Strengthen the moral construction of accountants. Professional ethics has a lot to do with the independence of accountants. The former is the foundation and internal power of the latter. Only when accountants have high standards of professional ethics can they resist the temptation of interests and be respected and trusted. Every accountant in audit field should put honor first. Professional ethics is the guarantee of honor. Therefore, we should establish the moral construction system of accountants and combine self-discipline with heteronomy. Only in this way can we improve the overall quality of Accountants in China.

Kangmei Pharmaceutical's 30 billion yuan of monetary capital "disappeared out of thin air", exposing not only many problems of listed companies themselves, but also the GP Certified Public Accountant which provides audit services for them. In order to avoid the occurrence of similar cases, we need to improve the professional competence of certified public accountants, enhance the supervision of relevant departments. Focus on auditor independence,

professionalism, and maintaining sufficient professional doubt and appropriate professional judgment in the whole audit process, so as to better ensure that users of financial reports can obtain useful information for decision-making.

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