

# Does Kangmei Pharmaceutical Break the Curse of Financial Fraud?

Shaobing Shi<sup>1</sup> and Jianhong Zhu<sup>2</sup>

<sup>1</sup>School of Statistics and Applied Mathematics, Anhui University of Finance and Economics, Bengbu, Anhui 233030, China

<sup>2</sup>School of Accounting, Anhui University of Finance and Economics, Bengbu, Anhui 233030, China

## Abstract

Although the means of financial fraud has changed from simple and crude accounting fraud in the past to more concealed transaction fraud, because the enterprise financial data is a whole and the means are hidden, false profits can not create monetary funds. On the basis of theoretical explanation, taking Kangmei pharmaceutical as an example, this paper tests the asset proportion, sales gross profit margin and capital source data between Kangmei pharmaceutical and the same industry. It is found that Kangmei pharmaceutical is still a "lie supported by counterfeiting, financing, re counterfeiting and re financing". Kangmei pharmaceutical has no ability to break the curse of making profits, but monetary capital will still expose its feet.

## Keywords

Kangmei Pharmaceutical; Profit; Monetary Funds; Cross Check Relationship.

## 1. Introduction

In 2021, the counterfeiting case of Kangmei pharmaceutical industry was dominated by the screen for a long time. From the initial punishment of Kangmei Pharmaceutical by the CSRC to the first instance judgment of Guangzhou intermediate people's Court on China's first securities class action case. From questioning the authenticity of Kangmei pharmaceutical's monetary capital to questioning the authenticity of other assets of Kangmei pharmaceutical. We had a heated discussion on the financial fraud case of Kangmei pharmaceutical from the perspective of Justice (research group of Shanghai National Accounting College, 2022), audit (Wang Shuguang et al., 2020; Yu Ying et al., 2021), independent directors (Guo Fuqing, 2022; Zhang Dunli et al., 2022) and supervision (Liu Jing et al., 2022). We all hope to get a glimpse of the secret of fraud and gain some experience from it. In fact, the fraud type of the company has changed from simple and crude accounting fraud in the past to more covert transaction fraud (Huang Shizhong et al., 2019)[1]. However, no matter how covert, false profits have no monetary capital. If the bank does not cooperate, the enterprise will eventually show its feet in monetary capital, which is the curse of almost all financial fraud companies. Can Kangmei pharmaceutical break this spell?

## 2. What Assets are Used to Undertake Inflated Profits?

Since the origin of Florence, the northern Italian city-state in 1211, accounting has been shining like Newton's three laws shining on physics. In addition, there are two important logical relations in the field of accounting: one is the accounting identity:  $Assets = Liabilities + owner's equity$ , and the other is the well-known profit calculation formula:  $Profit = income - cost$ . The combination of the three makes financial fraud seem easy, but it is not as easy as expected. If the analyst looks at the data separately, any suspicious data can be explained with grand

reasons, but the financial data of the enterprise is a whole. Let's first see why the financial data of an enterprise is a whole.

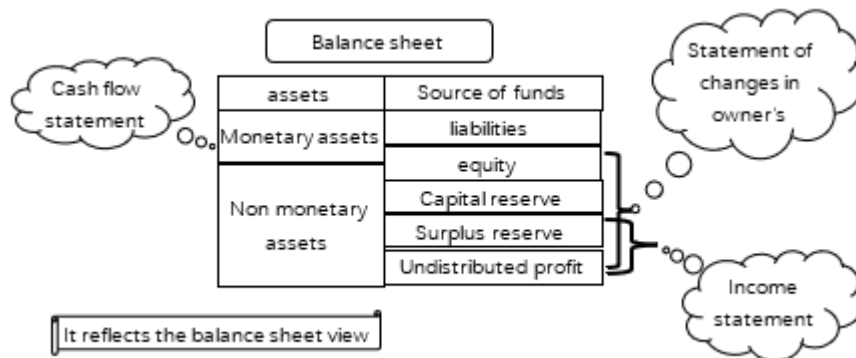


Figure 1. Relationship between four reports

Figure 1 shows the relationship between the four reports outlined by the above-mentioned debit and credit bookkeeping rules and two logical relationships. As long as the enterprise has income or expenditure, at least three statements need to be moved. If it is related to monetary funds, all four statements need to be moved, which can be said to affect the whole body.

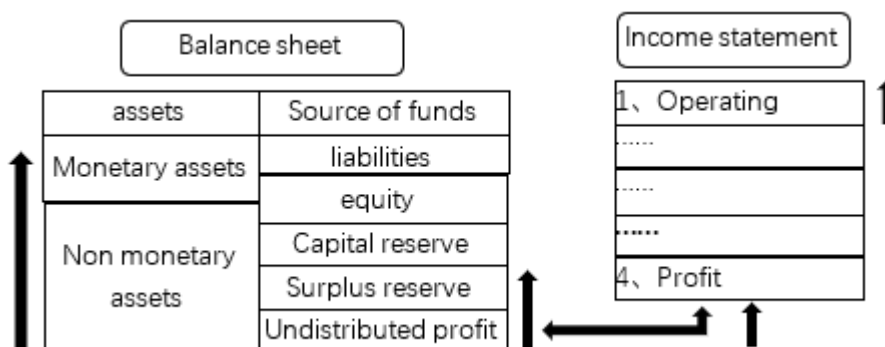


Figure 2. Linkage between income statement and balance sheet

As can be seen from Figure 2, in order to finance more and cheaper funds, enterprises will falsely increase income and profits, but the falsely increased profits will not only stay in the income statement, but will be transferred to the balance sheet. The surplus reserve and undistributed profits entered into the balance sheet will be recorded according to the bookkeeping rule of "borrowing, lending and borrowing must be equal" and the accounting identity of "asset = liability + owner's equity", With the increase of capital sources in the balance sheet, the assets also have to increase, that is, the virtual increase of profits will lead to the virtual increase of assets. This is an invariable law. What changes is how the enterprise quietly and imperceptibly inserts these virtual assets into which or which assets. For example, Yinguangxia falsely increased accounts receivable and inventory, Lantian shares falsely increased fixed assets, Wanfu Shengke falsely increased inventory, fixed assets and projects under construction, Zhangzi Island falsely increased inventory, and LETV falsely increased intangible assets. What assets did Kangmei pharmaceutical falsely increase?

**Table 1.** Assets structure of Kangmei pharmaceutical

year	Proportion of monetary capital	Proportion of accounts receivable	Proportion of other receivables	Proportion of inventory	Proportion of investment real estate	Proportion of fixed assets	Proportion of construction in progress	Proportion of intangible assets	Total proportion of the first eight assets	Total assets (100 million yuan)
2001	30.64%	11.79%	0.16%	15.66%	0.00%	<b>22.12%</b>	12.81%	4.30%	97.47%	5.18
2002	10.86%	10.46%	0.07%	15.80%	0.00%	<b>45.60%</b>	4.85%	10.16%	97.79%	6.30
2003	15.39%	10.20%	0.06%	14.07%	0.00%	<b>42.40%</b>	5.83%	8.63%	96.57%	7.05
2004	10.84%	9.41%	0.10%	14.89%	0.00%	<b>45.12%</b>	2.72%	14.99%	98.06%	8.54
2005	5.98%	10.10%	0.05%	15.64%	0.00%	<b>51.51%</b>	0.00%	15.60%	98.87%	7.90
2006	<b>36.83%</b>	4.85%	0.07%	10.74%	0.00%	20.89%	12.59%	3.63%	89.59%	19.22
2007	<b>47.42%</b>	3.33%	0.13%	8.34%	0.00%	22.49%	4.81%	3.73%	90.25%	32.02
2008	<b>35.22%</b>	3.89%	0.03%	13.44%	0.00%	18.96%	11.39%	12.24%	95.19%	42.09
2009	<b>32.01%</b>	4.48%	0.14%	16.53%	0.00%	14.70%	11.24%	14.01%	93.11%	62.17
2010	<b>33.62%</b>	5.64%	0.40%	13.94%	0.72%	11.79%	10.15%	16.47%	92.74%	82.08
2011	<b>41.50%</b>	4.43%	0.29%	12.51%	0.36%	11.56%	10.46%	12.82%	93.93%	152.37
2012	<b>34.00%</b>	7.41%	0.27%	19.82%	0.28%	14.48%	8.10%	10.45%	94.82%	179.58
2013	<b>38.19%</b>	7.66%	0.39%	17.01%	2.40%	17.30%	3.45%	8.10%	94.50%	222.51
2014	<b>35.82%</b>	8.00%	0.19%	26.43%	1.88%	15.46%	1.63%	3.85%	93.25%	278.79
2015	<b>41.51%</b>	6.69%	0.21%	25.70%	1.78%	12.57%	0.45%	2.76%	91.68%	381.05
2016	<b>49.84%</b>	5.65%	0.26%	23.02%	1.48%	10.80%	0.44%	3.31%	94.79%	548.24
2017	6.44%	7.65%	9.03%	<b>53.98%</b>	1.89%	9.35%	2.63%	3.01%	93.98%	652.93
2018	2.51%	8.30%	14.33%	<b>46.27%</b>	4.35%	11.68%	3.87%	2.92%	94.24%	731.44
2019	0.78%	5.68%	15.56%	<b>48.63%</b>	5.46%	11.91%	5.75%	3.13%	96.90%	645.86
2020	1.53%	6.64%	25.09%	<b>24.96%</b>	9.34%	16.27%	8.97%	3.61%	96.41%	362.13

As can be seen from the above table, the company's fixed assets accounted for a relatively high proportion from 2001 to 2005, monetary funds accounted for a relatively high proportion from 2006 to 2016, and inventories accounted for a relatively high proportion from 2017 to 2020.

**Table 2.** t-test results of Kangmei pharmaceutical and industrial assets

Comparison items	Proportion of fixed assets from 2001 to 2005	Proportion of monetary funds from 2006 to 2016	Proportion of inventories from 2017 to 2020
Industry (C27)	0.2537	0.2136	0.1057
Kangmei pharmaceutical	0.4135	0.3872	0.4346
P value of t-value test	0.0017	0.0004	0.0000

It can be seen from the above table that the front fixed assets, medium-term monetary capital and later inventory of Kangmei pharmaceutical are significantly higher than those of Companies in the same industry, that is, the inflated fixed assets corresponding to the inflated profits of Kangmei pharmaceutical in the early stage, the inflated monetary capital corresponding to the mid-term and the inflated inventory in the later stage. According to the previous theoretical analysis and the data in Table 1 and table 2, Kangmei pharmaceutical may have made a false listing at the beginning.

### 3. Why is Kangmei Pharmaceutical’s Monetary Capital Inflated?

Some people question the high gross profit margin of Kangmei pharmaceutical. In fact, the gross profit margin is not the key to the problem, because the sales gross profit margin is related to the reference. Kangmei pharmaceutical responded to this inquiry in the reply announcement on the inquiry letter on the post audit of the 2018 annual report of Kangmei Pharmaceutical Co., Ltd. of Shanghai Stock Exchange. In the reply, Kangmei pharmaceutical selected certain reference enterprises for comparison in seven sub areas: Traditional Chinese medicine decoction pieces, self-made drugs, shops and houses, traditional Chinese medicine trade, drug trade, medical devices and health food. The result of comparison is that the sales gross profit margin of Kangmei pharmaceutical is lower than that of the reference and higher than that of the reference. If it is not for the experience in this field, practitioners will not be able to examine the authenticity of the data. Kangmei pharmaceutical was once the most complete enterprise in China's traditional Chinese medicine industry chain and the largest company in the pharmaceutical industry at that time because its business involved traditional Chinese medicine decoction pieces, self-made drugs, shops and houses, traditional Chinese medicine trade, drug trade, medical devices and health food. Considering the wide business scope of the company, this paper takes the whole industry as a reference to investigate the gross profit margin of Kangmei pharmaceutical. Although the sales gross profit margin is not the key to the problem, it can provide a lot of information when it is connected with other data.

**Table 3.** Comparison between Kangmei pharmaceutical and interbank monetary funds and sales gross profit margin data

year	Number of Companies in the same industry	Proportion of monetary capital			Gross profit margin of sales		
		Industry 50th quantile	Kangmei pharmaceutical	Kangmei - industry 50th quantile	Industry 50th quantile	Kangmei pharmaceutical	Kangmei - industry 50th quantile
2001	72	18.02%	30.64%	12.62%	37.06%	20.27%	-16.79%
2002	76	16.71%	10.86%	-5.85%	37.13%	25.19%	-11.94%
2003	79	15.53%	15.39%	-0.15%	37.38%	27.80%	-9.58%
2004	92	14.62%	10.84%	-3.78%	37.56%	30.84%	-6.72%
2005	91	13.92%	5.98%	-7.93%	35.80%	31.38%	-4.42%
2006	94	13.13%	36.83%	23.70%	34.47%	29.15%	-5.33%
2007	96	12.44%	47.42%	34.98%	34.79%	26.11%	-8.69%
2008	98	14.87%	35.22%	20.35%	36.05%	26.90%	-9.14%
2009	114	16.36%	32.01%	15.65%	38.16%	33.39%	-4.77%
2010	132	21.08%	33.62%	12.54%	44.35%	36.50%	-7.85%
2011	144	20.74%	41.50%	20.76%	44.93%	30.18%	-14.75%
2012	142	20.34%	34.00%	13.66%	49.28%	25.16%	-24.12%
2013	139	17.56%	38.19%	20.63%	48.75%	26.10%	-22.65%
2014	148	15.57%	35.82%	20.24%	48.21%	26.21%	-22.00%
2015	162	15.66%	41.51%	25.86%	50.23%	28.34%	-21.89%
2016	176	16.34%	49.84%	33.50%	53.57%	29.90%	-23.68%
2017	210	14.25%	6.44%	-7.81%	56.94%	38.63%	-18.31%
2018	215	14.72%	2.51%	-12.21%	59.09%	31.91%	-27.17%
2019	227	14.29%	0.78%	-13.51%	60.54%	13.20%	-47.34%
2020	260	17.34%	1.53%	-15.81%	59.38%	3.95%	-55.43%

It can be seen from table 3 that the gross profit margin of Kangmei pharmaceutical has always been lower than that of the same industry, but the proportion of monetary funds has always been higher than that of the same industry from 2006 to 2016.

**Table 4.** Test results of gross profit margin data of Kangmei pharmaceutical and its peers

Comparison items	Gross profit margin from 2001 to 2020
Industry (C27)	0.4756
Kangmei pharmaceutical	0.2706
P-value of mean t-value test	0.0000
P value of 50th percentile RankSum test	0.0000

It can be seen from table 2 and table 4 that compared with the same industry, Kangmei pharmaceutical's monetary capital proportion in the corresponding period of time is statistically significantly higher than that of the same industry at 1%, while the gross profit margin of sales at 1% is statistically significantly lower than that of the same industry. This scissors gap has some logical problems: low profitability, but there is so much money. Where does the money come from?

#### 4. Where did Kangmei Pharmaceutical's Moner Come From?

**Table 5.** Four types of capital sources of Kangmei Pharmaceutical (unit: 100 million yuan)

Accounting period	Monetary Fund	Operational resources	Financial resources	Resources invested by shareholders	Remaining resources of shareholders	Non current liabilities due within one year	Total long-term liabilities
2001	1.59	0.59	0.94	2.99	0.66	0.170	0.0000
2002	0.68	0.16	2.22	2.99	0.92	0.000	0.5000
2003	1.08	0.51	2.11	2.99	1.43	0.500	0.0080
2004	0.93	-0.23	3.65	3.06	2.06	0.000	0.8500
2005	0.47	0.61	1.55	3.11	2.63	0.000	0.0000
2006	7.08	0.67	6.99	8.17	3.39	1.999	0.0000
2007	15.18	5.04	3.79	19.06	4.13	0.000	0.0000
2008	14.82	-5.24	18.16	22.33	6.83	0.000	6.236
2009	19.90	-5.42	24.87	35.15	7.57	0.000	8.133
2010	27.60	-11.87	44.69	35.13	14.13	1.000	16.147
2011	63.23	-26.59	86.49	69.38	23.08	3.400	36.543
2012	61.06	-15.48	89.23	69.42	36.39	2.000	33.115
2013	84.97	16.56	85.65	69.48	50.79	8.749	26.982
2014	99.85	25.39	86.21	99.23	67.93	2.000	25.007
2015	158.18	48.71	143.96	110.22	77.30	0.045	48.857
2016	273.25	74.11	180.30	192.54	100.06	0.000	48.886
2017	42.07	26.94	340.84	195.56	92.48	25.00	101.07
2018	18.35	4.37	465.91	195.93	67.79	0.000	175.05
2019	5.01	-40.49	479.85	194.95	13.68	51.13	150.30
2020	5.52	-72.27	505.00	195.18	-263.56	93.53	194.16

Note: financial resources = short-term borrowings + long-term liabilities due within one year + long-term borrowings + bonds payable + long-term accounts payable

Operating resources = total liabilities - financial resources

Resources invested by shareholders = share capital + preferred shares + capital reserve

Remaining resources of shareholders = surplus reserves + undistributed profits

By combing the relevant information of Kangmei pharmaceutical and monetary funds, Yuan min (2021) [2] believes that "auditors need to pay attention not only to the balance of monetary funds (making the letter confirmation procedure more effective), but also to the amount of monetary funds (capital flow, transaction essence, etc., and the effective use of analysis procedures), and restore the figures to the economy to gain insight into the business and strategy of the audited unit."The capital sources of Kangmei pharmaceutical are classified according to "the main parts of corporate liabilities and shareholders' equity can be divided into four categories, namely operating resources, financial resources, shareholders' investment resources and shareholders' remaining resources", as proposed by Zhang Xinmin (2015)[3], as shown in Table 5.

It can be seen from table 5 that 2006 was a year of great increase in monetary funds of Kangmei pharmaceutical, but the increased monetary funds mainly came from financial resources and shareholder investment resources, and some were made out of nothing. For example, the non current liabilities due within one year in 2006 provided 199.9 million yuan, but the total long-term liabilities of the previous year were 0. In 2007, monetary funds doubled again, and the main source is still shareholders' investment resources. Since then, the enterprise has been continuously carrying out external financing. In 2017, the assets reached 65.293 billion yuan, the financial resources reached 34.084 billion yuan, and the shareholder investment resources reached 19.556 billion yuan. The operating resources indicating the competitiveness of the enterprise's products and the dominant position in the value chain and the remaining resources of shareholders indicating whether the enterprise can be sustainable shrank in 2017. In 2018, the assets reached 73.144 billion yuan, the financial resources reached 46.591 billion yuan, and the investment resources of shareholders reached 19.593 billion yuan. The operating resources and the remaining resources of shareholders continued to shrink in 2018, only 6.96 billion yuan ( $73.144 - 46.591 - 19.593 = 6.96$ ). Looking at the monetary capital of Kangmei pharmaceutical, it mainly comes from the external capital with high risk and high cost, while the operating liabilities indicating the competitiveness of the enterprise's products and the remaining resources of shareholders indicating the profitability of the enterprise provide little capital. After combing the financing tools provided by the sponsor GF Securities for Kangmei pharmaceutical, song Jianbo and others (2020) found that its financing tools are diverse, including public additional issuance, private additional issuance, allotment of shares, corporate bonds, convertible bonds, preferred shares, etc. in the three years (2016-2018) when the CSRC identified Kangmei pharmaceutical's financial fraud, they completed a fund-raising of about 11.6 billion yuan.

## 5. Conclusion

To sum up, just as it took more than a month for the securities market weekly and the research team of Zhongneng Xingye to complete the investigation and report "Kangmei lies", the article pointed out: "behind the high growth of Kangmei pharmaceutical, it is suspected of financial fraud. Its growth in recent years is likely to be a lie supported by fraud, financing, re fraud and re financing", Therefore, Kangmei pharmaceutical has no ability to break the curse of making profits, but monetary capital will still expose its feet.

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