

Analysis of the Financial Fraud Incident of Kangmei Pharmaceutical: Exploring the Motivation and Mechanism of Regulatory Inquiries

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Abstract: With the development of China's capital market, regulatory inquiries become an essential tool to ensure the market's stability and protect investors. This article delves into the underlying motivations, operational mechanisms, and ramifications of regulatory inquiries. To explain these concepts, it uses the financial fraud incident of Kangmei Pharmaceuticals as an example. The study also shows that regulatory inquiries improve the quality of information disclosure and market transparency because they force companies to explain and elaborate on certain matters. In the case of Kangmei Pharmaceuticals, regulatory inquiries over time led to the revelation of the company's elaborate schemes in the use of financial frauds which led to the involvement of the Securities and Futures Commission (SFC) in the investigation and prosecution of the case. However, there are still some issues that have to do with regulatory inquiries such as lack of enforcement and therefore there is a need to improve the mechanism and corporate governance. The purpose of this study is to offer policy suggestions that will help to improve the efficiency of regulation and strengthen the stability of the Chinese capital market in its entirety.

Keywords: Regulatory inquiries, Information disclosure, Financial fraud, Corporate governance.

1. Introduction

With the development of China's capital market, regulatory inquiries have become one of the most important regulatory tools that have been increasingly important for maintaining market order and protecting investors' interests [1]. For the listed companies, the accuracy, reliability, and relevance of information are not only the concern of investors but also have an impact on the market order. The regulatory inquiries help to improve the quality of information disclosure, increase the level of transparency in the market, protect the rights of investors and establish certain standards of the company's activity as it requires the listed companies to explain and respond to certain issues [2]. The recent occurrences of financial fraud have continued to raise concerns about market trust, which is an indication that there are gaps in the information disclosure regulation. Previous studies on the regulatory inquiry system have covered the theoretical framework, the structure of the system, the actual implementation outcome, and the changes in the behavior of the listed companies.

From the theoretical perspective, the use of regulatory inquiries has its theoretical background in the theory of information asymmetry and the principal-agent theory. Akerlof introduced the theory of the "lemon market", according to which the party with more information can take advantage of the other party and pass some information to him/her [3]. Managers have the truth while investors are only able to access public information about the firms [4]. Legal interventions have been seen to affect the market's perception of corporate information, for instance, accuracy and truthfulness hence, eliminating information asymmetry.

As for the institutional practice, through the "Comment Letter" system, foreign regulatory authorities like the U.S. Securities and Exchange Commission (SEC) may raise questions in response to the potential problems in the financial reports of the listed companies [5]. Brown et al. pointed out that the revealing effect of the inquiries made by the SEC is significant and the market can enhance its ability to identify high-risk companies [6].

At home, since 2013, the Shanghai and Shenzhen exchanges have stepped up the number of inquiries on the annual report review, major asset restructuring, and IPO information [7]. According to Li and Zhou, there has been a shift from the passive response to the inquiry system to an active supervisory system [8]. Zhang and Wang have discovered that through empirical analysis, firms receiving inquiry letters have improved in terms of disclosure integrity and financial soundness, and the market response is more sensitive [9].

Regarding the effects of inquiries, the difficulties that have been reported include poor implementation, redundancy of the content of inquiries, and low efficiency of feedback [10]. Investigative actions often act only as a recall of the event, thus hampering the ability to prevent such occurrences. Therefore, the effectiveness of the inquiry mechanism depends on its ability to quickly detect risks, set up a pressure transfer mechanism, and then investigate further [11].

2. Review of the financial fraud incident of kangmei pharmaceuticals

2.1. Background of the incident and the counterfeit trail

Kangmei Pharmaceutical Co., Ltd. was established in 1997 and it is the first listed company in the traditional Chinese medicine industry chain. The business of the company is related to the cultivation of Chinese herbs, manufacturing of Chinese medicine, and trading of pharmaceuticals. It was listed on the Shanghai Stock Exchange in 2001 and was once known as an industry standard for the financial data it has reported over the years including the 2017 financial report which indicated that its book money funds stood at 34.1 billion yuan. However, the above picture is not the real picture; the company has a well-orchestrated counterfeiting plan. To cover up the problem of the broken capital chain, the company inflated more than 30 billion yuan of revenue, forged bank vouchers, and fabricated fixed assets. The first signs of these frauds were identified in 2015 when the company's monetary assets and its cash flow patterns were suspected by the observers in the market. This was succeeded by increased regulation in 2018 due to media articles that revealed some financial malpractice. The climax of the crisis was in May 2019 when the company was exposed to accounting fraud and the monetary funds were reduced by 29.9 billion yuan.

2.2. Staged evolution of regulatory inquiries

There is a clear escalation of the kind of regulatory questioning as demonstrated by the shift from the regulatory compliance scope examination of the issues to the risk questioning technique. The first concerns were raised regarding the technical aspects, for instance, before 2018, the SSE mainly dealt with the issues concerning the lack of proper disclosure of monetary funds and the huge disparity between the interest income and the size of the fund. However, as the number of risk indicators increased, the nature of questions asked gradually shifted towards systematic forms of responsibility.

This is evident in the "Question Letter on Explanation of Correction of Significant Accounting Errors" released in 2019 due to the 29.9 billion yuan funds' deficiency. This letter directly forced the company to answer questions on the existence of financial fraud, negligence of the auditing organization, and mandatory disclosure of the direction of the funds and evidence of the transfer of interest by related parties. What is more important to mention is the fact that the frequency of inquiries and the degree of exposure to the company's financial risks are positively related. Five regulatory inquiry letters were received from 2018 to 2020, four of which were received in 2019 when the risk was on the outbreak of the period, which indicates that the regulatory layer enhances the risk of investigation by increasing the density of inquiries.

2.3. Market reaction and regulatory linkage effect

The capital market reacted sensitively to the occurrence of the incident, which was disclosed, through a drop in the stock price. The stock price dropped from its highest level of RMB 26.28 in 2018 to its lowest level of RMB 3.07 in 2019, which is a decline of over 88%. At the same time, the market value decreased by over 100 billion yuan. A class action lawsuit was initiated by over 50,000 investors because of the loss of misrepresentation, which involved 4.8 billion yuan, and this became a record for civil compensation in A shares. From the SFC's letter of inquiry, the case was initiated immediately after an investigation of some key facts such as inflated income and forged documents. The market ban is also directed to 21 individuals and the auditing agency ZhengZhong ZhuJiang Accounting Firm and the revocation of license penalties. It is worthy of note that the accountability of intermediaries created a chain market effect, whereby other companies listed on the same stock exchange saw their share prices drop by an average of 9.7% within five days of the penalty announcement, thus a reputational collateral disciplinary effect.

3. Analysis of the logical relationship between the inquiry and the discovery of financial counterfeiting

The counterfeiting behavior of financial documents by Kangmei Pharmaceuticals is not random; it is a well-orchestrated process that is secretive and systematic. The exposure process of financial counterfeiting behavior of CombiPharma shows the interaction of regulatory inquiries and risk identification, which can be divided into the following core links based on the logical connection:

3.1. Risk trigger mechanism: abnormal financial data triggers inquiries

The analysis of the financial statements of Kangmei Pharmaceuticals from 2016 to 2018 showed that there is a sharp difference between the deposits and loans, which has become the key factor in the development of risk. The company's book money funds have been abnormally high for quite some time, reaching 34.1 billion yuan in 2017, while the interest income is only in the tens of millions of dollars, and the annualized yield is less than 0.1%, which is significantly lower than the average 3% level of wealth management income in the market during the same period. Of particular interest is the fact that in the first half of the year 2018, the financial expenses stood at 1.886 billion yuan. However, the company did not use a large part of the money funds to pay high-interest expenses, and thus formed a "deposit, while borrowing money" paradoxical situation. In this regard, the exchange has been sending a letter of inquiry to ask the following questions: Are the monetary funds genuine? How is the interest income accounted for? Is the financing reasonable? In their responses to the regulators, CombiPharma used such phrases as "funds for strategic reserves", "interest calculation differences" and others that are hard to understand. Nevertheless, these responses failed to address the regulator's concerns about possible financial fraud, which led to the investigation of the data and the nature of the business.

3.2. Transmission of market pressure: publicization of inquiries accelerates risk exposure

The release of the regulatory inquiry letter to the public led to a domino effect within the market. Mainstream financial media began to conduct a detailed expose of Kangmei Pharmaceuticals, revealing its main problems such as double high deposits and loans and connected transactions. This led to a market panic in the country. These inquiries caused the capital market to be volatile, and Kangmei Pharmaceuticals' stock price plummeted. The company's stock price which was 26.28 yuan in 2018 reduced to 11.67 yuan in 2019, thus having a cumulative drop of 55.6%. This led to a market value reduction of more than 100 billion yuan. This sharp drop acted as a market pressure that forced Kangmei Pharmaceuticals to announce on April 30, 2019, that the overstatement of the currency funds was 29.944 billion yuan in 2017. This self-disclosure behavior is not only the outcome of the market pressure transmission but also the cause of the full exposure of financial fraud. This goes a long way to show how regulatory inquiries and market supervision complement each other.

3.3. Regulatory linkage effect: inquiries and enforcement synergies form a closed loop

The exchange then used a multiple approach to investigate to obtain the main abnormal data, which included the main evidence such as overstatement of revenues and fake bank statements. This set of findings offered the SFC all the links it needed to investigate the May 2019 filing of the company. The investigation of the letters of inquiry also showed the following issues: the difference between the interest income and the size of the capital was rather large, and more than 50% of the fund revenue was occupied by related parties. These helped the SFC to quickly pinpoint systematic frauds, major ones that have been as follows: operating revenue of 30 billion yuan was overstated and fixed assets of 8.6 billion yuan were fabricated. However, the time taken from the time the issue was raised in 2016 to the time the case was filed in 2019 shows the depth of the problems with the regulatory synergy mechanism. The limited communication between the exchanges and the SEC coupled with the low cost of violations has resulted in a delay in the management of risks and continuous loss of investors' money. Such a time gap calls for a cross-sectoral response team to be formed and implemented as a way of combating the vice.

3.4. Internal control deficiencies magnify risks: inquiries reveal governance failure

The regulatory investigations have revealed that Kangmei Pharmaceuticals has a weak internal control system that reveals a major problem in its governance structure. The company's previous fraudulent activities of inflating funds through forging bank deposit slips and business vouchers also show that there is no proper financial approval system in the company and the current document management system is also insufficient. Of most concern is the fact that the occupation of related-party funds has gone beyond the regulatory threshold of 50% of the revenue, but the statutory disclosure requirements have not been met. This egregious failure directly reveals the governance weaknesses that allow the real controller, Ma Xingtian, to abuse his authority. The following internal control failure features were identified in the course of the inquiry letter: First, the "one share" under the equity structure meant that the real controller had uncontested power; second, the absence of independent directors; third, the audit committee failed to perform its function due to the virtualization of systemic vices; and fourth, the real controller was able to get hold of the company and use it as a systematic counterfeiting tool.

4. Revelations

4.1. Build a risk-oriented regulatory framework to enhance the precision and linkage of inquiries

The regulatory authority needs to set up a dynamic risk early warning system, which mainly covers the key risk indexes including high deposits and loans, abnormally large connected transactions, and the gap between cash flow and financing cost. It should also conceal possible fraud clues through several rounds of progressive questions. At the same time, the Exchange is also expected to strengthen the co-regulatory relationship with the SFC, public security, taxation, and other related departments. This enhancement entails the creation of a real-time data-sharing system and the immediate commencement of collaborative investigations on risky activities including suspicious transfer of funds and the use of forged documents. It is believed that the Exchange will need to put in place a sequence of activities such as the transfer of clues, investigations, enforcement, and disciplinary actions. The closed-loop management system is one of the measures that will be put in place in the course of this process. Thus, by decreasing the gap between the identification of risks and their elimination, the social losses due to systematic counterfeiting are minimized.

4.2. Strengthening corporate governance and internal control systems to curb the root causes of power abuse

Publicly traded corporations should rebuild their internal controls, with a focus on the approval of significant financial transactions, related party transactions, and financial information. The use of blockchain technology in business documents and the application of bank water for the entire verification process is critical for the identification of transactions. At the same time, the improvement of the governance structures should be conducted to allow independent directors to obtain the necessary financial information directly, thus preventing the real controller from dominating the key decisions. As for the "one-share" enterprises, it is necessary to require the disclosure of equity control maps and set a restriction on the voting rights of related parties. This is important to avoid cases of financial fraud since the possibility of transfer of interest is removed.

4.3. Technology-enabled innovation of regulatory tools and activation of market-based constraints

The application of big data and artificial intelligence technology has made it possible to create an intelligent questioning system that includes financial report data, public opinion dynamics, and industry standards. This system is also able to generate a question bank on its own and it also provides measurements of Abnormal Interest Income and Warning Indicators for Inventory Turnover Deviation among others. The use of this system has the ability to increase the efficiency and professionalism of questioning processes. At the same time, a market-driven mechanism has been introduced to require brokers to state opposite points of corporate inquiries in their research notes, enable investors to file class-action lawsuits based on inquiries, and include the content of inquiries in the ESG rating system. The combination of 'regulatory inquiries, market pricing and judicial accountability' ensures that there is a constant pressure against violation of the law.

5. Conclusion

This paper aims to discuss the function, position, and role of regulatory inquiries. In this regard, it carries out research in three areas. The study, through quantitative text analysis, identifies the high-frequency risk areas that are the subject of inquiries and establishes their link with corporate fraud

and financial malpractice. The study reveals that there is a positive relationship between the content of inquiry letters and fraudulent means and the effectiveness of risk identification increases with the number of rounds of inquiry. Taking Kangmei Pharmaceutical as an example, this study disassembles the process of multiple rounds of questioning in the form of 'questioning-response-questioning' to force enterprises to disclose evidence of fraud. The regulator gradually establishes systemic fraud through the comparison of interest income with the size of money funds, the ratio of related party transactions, and other tangible measures. The event study method was used to establish that large inquiries lead to an average of 25% reduction in the target company's share price and a 1.2 percentage point increase in the cost of financing. However, at the same time, about 30% of enterprises avoid accountability by giving vague answers, which indicates the inefficiency of the current mechanism in determining violation costs and promoting cross-departmental cooperation.

The inquiry letter has a 78% risk capture accuracy in industries that are most vulnerable to fraud such as the pharmaceutical and agriculture industries, but it cannot give early warning on emerging technology firms. For instance, Kangmei Pharmaceuticals has been highlighted to have 88% of its currency funds inflated and connected transactions contributing more than 50% of its revenue, which has become a significant breakthroughs for the regulators to identify the anomalies. Substantive inquiries caused a chain reaction in the market through public disclosure, for example, in Kangmei Pharmaceuticals, where the stock price dropped by 42% within 30 days after the first inquiry, and the auditing institution was investigated; while formalized inquiries were not sensitive enough to the market, and some companies escaped the regulatory pressure through "evasive" answers. The case of Kangmei Pharmaceuticals took over three years from the first inquiry in 2016 to the filing and investigation in 2019; the system has the following deficiencies: slow flow of information between the exchanges and the SFC and the low cost of non-compliance. Such problems have made it difficult to turn the 'risk detection' function of regulatory inquiries into 'prior deterrence' effectiveness.

In this regard, improving the effectiveness of regulatory inquiries as one of the key elements of the "gatekeeper" in the capital market requires the use of technology, institutional cooperation, and market regulation. This paper disaggregates the case of Kangmei Pharmaceuticals to support the argument that the inquiry mechanism is beneficial in the exposure of risks and the correction of market prices. But it also shows the weaknesses, like "lagging warning" and "lack of punishment". Further research studies should be conducted to establish the correlation between the textual characteristics of inquiry letters and the types of fraud and the viability of using intelligent regulatory tools in risk detection. When the registration system is fully implemented, the inquiry mechanism will be promoted from the "risk identification tool" to the "market regulation framework," which will ensure the sustainable and healthy development of the capital market.

Authors contribution

All the authors contributed equally and their names were listed in alphabetical order.

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