

The Impact of China's Independent Director System on Corporate Financial Fraud: The Case of Kangmei Pharmaceutical Fraud

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Abstract: The case of financial fraud of Kangmei Pharmaceutical is known as one of the most serious fraud cases ever in A-share. This paper analyzes the cause, course, and result of the financial fraud of Kangmei Pharmaceutical. Data analysis of the share price of Kangmei Pharmaceutical is conducted to investigate the impact of this incident on the market. The case study method, information asymmetry theory, and principal-agent theory are used to illustrate the impact of independent directors in the financial fraud case and the insights from the fraud case of Kangmei Pharmaceutical.

Keywords: Financial fraud; independent directors; Kangmei Pharmaceutical; Case study

1. Introduction

In recent years, the vicious incidents of financial fraud of listed companies have been repeatedly prohibited, such as Luckin Coffee, LeTV and also Kangmei Pharmaceutical. These cases of financial fraud have had a bad social impact, causing huge losses to investors and damaging the capital market environment. The huge fines imposed on the five independent directors of Kangmei Pharmaceutical after the fraud case exposed the long-standing problems of the independent director system in China. China's independent director system does not have a long history. In 2001, the China Securities Regulatory Commission formally introduced the independent director system among listed companies. In the past two decades, although Chinese listed companies have set up independent directors in accordance with the regulations, most of them are just procedural and do not really play a restraining role for listed companies. Compared with European and American countries, the system of independent directors in China is not yet mature, and there is much room for improvement. This paper will focus on the system of independent directors in China and analyze the role played by the system of independent directors in the internal control of listed companies, taking Kangmei Pharmaceutical as a case study.

This paper will use case analysis as the research method, Kangmei Pharmaceutical fraud case as the research object. The fraud case of Kangmei Pharmaceutical is the most serious financial fraud case in the history of A-shares, and the social impact is very bad. This case exposes the problems of the independent director system in China in practical application, and the independent directors of the company are virtually useless and do not play a real supervisory role. This case is selected as the

object of study, which is representative. On the one hand, this paper will analyze the motive of fraud, the means of fraud, the consequences and the impact of fraud in the Comet fraud case. On the other hand, as the most important part of this paper, this paper will focus on the behavior of the independent directors of Kangmei Pharmaceutical since its listing in 2001 (including the hiring of independent directors and the meeting of independent directors), so as to focus on the impact of the independent director system in the financial fraud in China.

This paper will be broadly divided into six parts. The second part of the article will review the classic literature, such as the previous studies discussing "the impact of independent directors on internal control" and "Analysis on Kangmei fraud". The third part of the article will introduce the research method used in this paper, the case study method. The fourth part of the article will focus on the fraud case of Kangmei Pharmaceutical and analyze the behavior and impact of independent directors. The fifth part of the article will discuss the important role of independent directorship in internal control in China. Finally, the sixth part of the article will conclude with a conclusion and a discussion of the limitations of this research.

2. Literature review

As is acknowledged to all, there is a strong link between the behavior of independent directors and the performance of the company. Armstrong et al. (2014) state that in general, companies with a high percentage of independent directors have a higher level of corporate transparency and correspondingly better internal controls. [1] In Reguera-Alvarado & Bravo (2017), not only the number of independent directors is important, but also the tenure and some other characteristics of independent directors have an impact on the company's performance.[2]

In addition, the behavior of independent directors is also closely linked to financial fraud. The abnormal turnover of outside directors is a significant signal to financial fraud. [3] Examining the characteristics of outside directors and boards at these fraud firms, Gao et al. (2016) find strong evidence that board size, number of meetings, and fraction of financial experts are related to abnormal turnover in fraud firms during the fraud committing period. The study also shows that abnormal director turnover is significantly higher for fraud that is considered more egregious. [3]

Furthermore, our research is also closely related to the large number of articles related to financial fraud. By reviewing the literature on financial reporting misconduct from the perspective of law, accounting, and finance, Amiram et al. (2018) provide comprehensive and insightful answers to important questions related to financial fraud, such as the motivations for financial fraud, the penalties for financial fraud, and even the influence of culture in financial fraud.[4] Similarly, Free et al. (2015) study financial reporting fraud from the perspective of Co-offending and examine the reason why Co-offending appears so frequently in fraud cases.[5]

3. Methodology

The study will adopt the case study method to study the financial fraud case of Kangmei Pharmaceutical, focusing on the motive of fraud of Kangmei Pharmaceutical and the impact of the independent director system in this case. By studying this case, I will explore the impact of China's independent director system in the financial fraud of listed companies and give regulatory suggestions.

In addition, we will apply the asymmetric information theory. Asymmetric information theory (Akerlof, 1970) suggests that in the financial market, different people have different levels of information, and the group with more information is often in a more advantageous position. [6] The internal employees or managers of a company have more information about the company's real business and income situation, which can have a negative impact in the competitive market economic activities. But in reality, this information asymmetry cannot be completely eliminated, but only

through severe and effective regulatory measures. Therefore, we need to establish a system of independent directors in listed companies to regulate the company internally.

4. Results and findings

4.1. Review

Kangmei Pharmaceutical is one of the large-scale pharmaceutical private enterprises integrating the supply and marketing of drugs, Chinese medicine tablets, Chinese herbal medicines and medical devices. It was listed on the Shanghai Stock Exchange in 2001. However, in the course of its operations, it has experienced major financial fraud incidents. On the evening of December 28, 2018, Kangmei Pharmaceutical announced that Kangmei Pharmaceutical received the "Notice of Investigation" from the China Securities Regulatory Commission. On May 17, 2019, the CSRC notified Kangmei Pharmaceutical of fraudulent financial reports, suspected of misrepresentation and other violations of laws and regulations. On August 16, 2019, the CSRC imposed penalties on Kangmei Pharmaceutical and others and the person in charge of the ban on entering the market, and the actual hammer fraud behavior. On May 14, 2020, the CSRC issued a penalty and prohibition decision on Kangmei Pharmaceutical, and decided to order Kangmei Pharmaceutical to make corrections, give a warning, and impose a fine.

4.2. Abnormal Returns

In order to study this financial fraud, we decided to start with the share prices of Kangmei Pharmaceutical. First, we obtained data on the share price of Kangmei Pharmaceutical from the wind database from the beginning of 2018 to the present. Using October 16, 2018 (i.e., the release date of the analysis report disclosing the financial fraud of Kangmei Pharmaceutical) and April 30, 2019 (i.e., the day Kangmei Pharmaceutical issued an accounting error announcement) as the cut-off time points, we calculated the daily and monthly abnormal return before and after the two time points. The tables below show the daily stock returns of Kangmei Pharmaceutical from July 16 to January 16, 2019, before the release of the report on October 16. If the value is negative, the stock price today has moved downward compared to the starting price, and if the value is positive, it has moved upward. The following table depicts the daily abnormal return in the stock prices for the six months before and after October 16, 2018(from April 16,2018 to April 16,2019). It is easy to see from the table that Kangmei's share price reached a peaked in June, then growth slowed, but its abnormal return has remained positive. After October 16, it fell sharply in the short term after the exposure, and continued to fall over the six months. Its share price also fell from ¥22.00/share to ¥11.34/share.

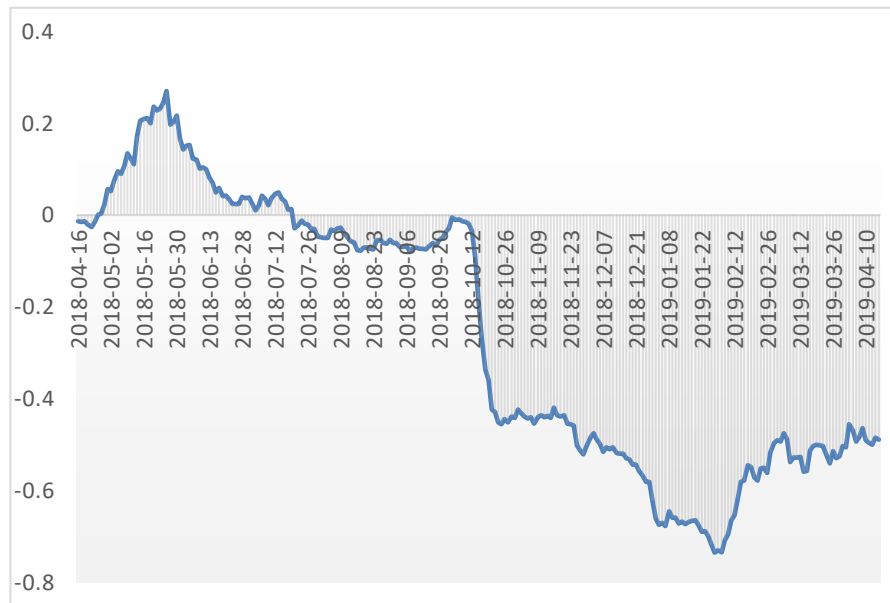


Figure 1: Abnormal return of Kangmei Pharmaceutical from April 16 to April 16 (the next year).

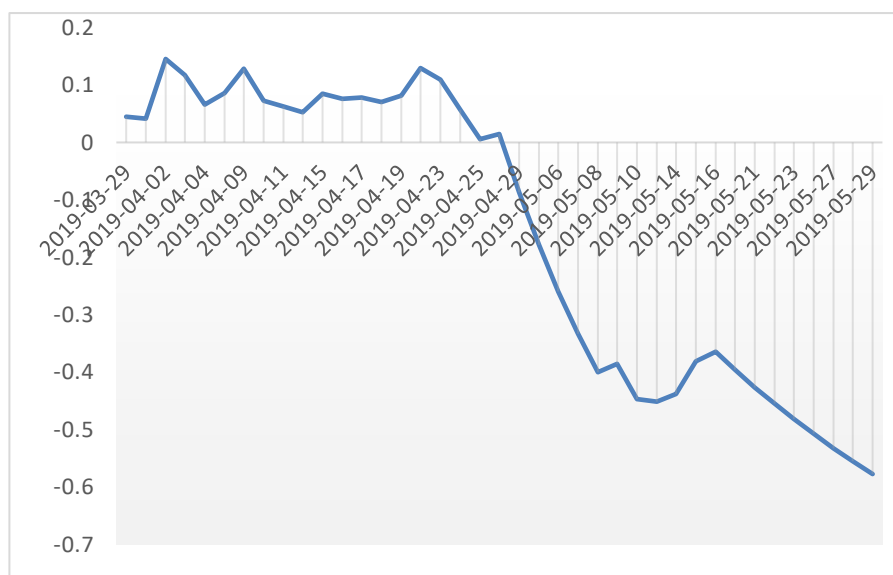


Figure 2: Abnormal return of Kangmei Pharmaceutical from March 30 to May 29 (2019).

We used the exactly same approach to examine the stock prices around April 30, 2019. On that date, Comet Pharmaceuticals issued an announcement admitting to an accounting error in its previous earnings report, and the stock price, which had been in the doldrums for a long time, plummeted again. The stock price fell from 10.92 per share to 4.21 per share. Combined with the two charts above, it is easy to see that the financial fraud case has dealt a devastating blow to the share price of Kangmei Pharmaceutical and has caused great harm to consumers.

4.3. Volatility

In business analysis, by studying variance, we can determine volatility as well as market safety. The mathematical formula for variance is:

$$\sigma^2 = \frac{\sum(X-\mu)^2}{N} \quad (1)$$

In order to make the statistics more accurate, we first apply a normalization to the daily stock prices. That is, the daily stock price is divided by the average of the stock prices during the time period under study. The variance of the standardized stock price is then found, and the variance provides a measure of the volatility of the stock price over the time period. The graph below represents the variance for the one month and three months before and after October 16.

Table 1: Variance of Kangmei's stock price.

Date range	September 16 to October 16	October 16 to November 16	July 16 to October 16	October 16 to January 16 (the next year)
variance	0.027	0.152	0.031	0.177

Analyzing the two graphs above we can see that the variance of the stock price in the month after before and after October 16, 2018 is 0.0273191 and 0.151710914. the latter is almost five times higher than the former. And analyzing the three months before and after, we can see that the share price variance for the first three months is 0.31089268, while the variance for the second three months is 0.176726033. By comparing the before and after, we can see that in the months after October 16, 2018, Comet's share price fluctuated very severely and became less stable.

4.4. Impact on the resignation of independent directors of listed companies :

On November 12, 2021, the first trial verdict of Kangmei Pharmaceutical landed, and five then independent directors were punished with joint and several liability of 369 million yuan. Since then, according to statistics from wind, as of November 19, only a week, a total of 19 A-share listed independent directors chose to resign. As of 30 November, a total of 39 A-share listed companies issued 42 independent director resignation announcements, and the number of resigned independent directors was 43. Only on November 12, three companies announced the resignation of independent directors. In this "resignation wave" of independent directors, the earliest ones were ST Huading, ST Guang Yi and Xin Wangda, which disclosed their announcements on November 12. The announcement disclosed that Mr. Zhou Youmei, an independent director of the Company, applied for resignation as an independent director and other corresponding positions for personal reasons, and will not serve in the Company after his resignation. Xin Wangda announced that Zhong Mingxia, an independent director of the company, applied for resignation as an independent director and other related positions because her term of office was about to expire, and she would not hold any position in the company after resignation.

5. Discussion

5.1. Summary of events

Through the analysis of the stock price, we can know that the financial fraud incident of Kangmei Pharmaceutical has caused serious impact on itself. And after the result of its first trial, it triggered a large number of resignations of independent directors of listed companies in China. This illustrates the relationship between the failure of independent directors and financial fraud, and also shows that there are many problems with the system of independent directors in China. In the following, we will

discuss why independent directors are unable to be "independent" in China and what the financial fraud case of Kangmei Pharmaceutical has taught us.

5.2. Factor analysis

5.2.1.External factors

After analyzing the case, we divided the causes into internal and external causes, which we will discuss in detail below. External causes include the following two reasons. First, Independent directors have not been developed in China for a long time and are still not mature enough. Looking back at the history of the emergence of this system, in 1940, the SEC began encouraging public companies to have audit committees composed of independent directors, and the Investment Company Act of 1940 required that The Investment Company Act of 1940 requires that at least 40% of the board of directors be independent. The China Securities Regulatory Commission (CSRC) issued a decree in 2001, specifying that listed companies should establish an independent director system. Although it has been 20 years so far, the history of the independent director system in China is still relatively short compared to that of European and American countries, which is one of the reasons for the deficiencies of the independent director system in China.

Second, independent directors are paid little and work for a short period of time. According to the survey, the average annual salary of independent directors in China is only ¥85,000. The vast majority of independent directors work on average less than 20 days per listed company per year on average, and after deducting the time to attend the shareholders' meeting and the board of directors, 77.33% of the independent directors work on average less than 8 days per year in each listed company. If an independent director works for too short a time, it is difficult for him to make an accurate judgment on the real financial situation of the company and cannot travel his supervisory role. As well, the average salary of an independent director is only \$85,000, but in the case of Kangmei Pharmaceutical, over \$100 million in joint and several liability damages were awarded to the independent director. The contrast between the low salary and the huge compensation is one of the reasons that caused the resignation of independent directors en masse. This is also the reason why it is difficult for independent directors in China to play a real supervisory role.

5.2.2.Internal factors

The first two points are external reasons, and this next point is internal reasons. The weakness of internal control of more Chinese listed companies themselves has led to financial fraud. Looking at the corporate structure of Kangmei Pharmaceutical, the Ma Xingtian's family holds 90% of the equity. The internal control of its company is extremely weak. By studying the behavior of the independent directors of Kangmei Pharmaceutical, we find that the independent directors of Kangmei Pharmaceutical almost never express an opposing view during their tenure. All decisions regarding the company are unanimously approved, which is clearly unreasonable.

6. Impact and inspiration of the incident

6.1. Strengthening professional ethics education for independent directors.

The Chinese law provides that: independent directors have a duty of honesty and diligence to listed companies and all shareholders. Independent directors should perform their duties conscientiously in accordance with the requirements of relevant laws and regulations, such guidance and the articles of association of the company, and safeguard the overall interests of the company, with special attention to the legitimate rights and interests of small and medium shareholders from being harmed. However,

the vast majority of independent directors of listed companies in China have failed to do so, and they choose to remain silent in the face of all the signs of financial fraud, resulting in weak internal control of the company and no protection of the interests of small and medium shareholders. Therefore, we should strengthen the professional ethics education for independent directors.

6.2. Enhance the supervision of various departments.

With the maturity and development of China's capital market, there are more and more financial studies for listed companies, and at the same time, a large number of fraudulent events are exposed. From these fraud events we can easily see a commonality: the management and practitioners of these companies have insufficient respect for laws and regulations and professional ethics, and most of them understand the hazards, but still take the risk. Therefore, we need to strengthen external supervision. Supervision should include both social and legal supervision. From the perspective of social supervision, accounting firms are independent and should evaluate the authenticity and integrity of the audited unit's financial situation from an impartial and objective perspective, which is the meaning of their existence. The financial fraud of Kangmei Pharmaceutical is inextricably linked to its accounting firm, Zhengzhongzhujiang Accounting Firm. The annual reports of Kangmei Pharmaceutical for three consecutive years, 2016, 2017 and 2018, contained false records such as inflated revenue and inflated monetary capital. and Zhengzhongzhujiang issued standard unqualified audit opinions for the financial statements of Kangmei Pharmaceutical in 2016 and 2017 respectively; on April 28, 2019, Zhengzhongzhujiang issued a qualified opinion for the financial statements of Kangmei Pharmaceutical in 2018. It was found that the aforementioned audit report issued by Zhengzhongzhujiang accounting firm was falsely documented. From a legal perspective, we need to introduce tougher laws to stop financial fraud from happening. If the penalty is not strong enough, the company and the firm will take the chance that they will not wear out the incident, or choose the way with the least loss after weighing the pros and cons. Therefore, the only way to prevent fraud from happening is to increase the intensity of supervision and punishment.

7. Conclusions

Through the above study, we sorted out the cause, course, and result of the financial fraud of Kangmei Pharmaceutical, and analyzed the whole case from the perspective of the independent director system. The movement of the stock price was studied, data analysis was conducted, the case study method, information asymmetry theory, and principal-agent theory were applied, and finally conclusions were drawn. First, we believe that the failure of independent directors is one of the important reasons why listed companies can successfully commit financial fraud. Financial fraud is only possible when independent directors cannot perform their duties well and the company's internal controls are weak. Second, the financial fraud incident of Kangmei Pharmaceutical has had a great impact in China, exposing the problems of the independent director system in China, and this paper also discusses the causes and the implications for the future. We believe that the problems of the independent director system in China should be solved mainly by enhancing the internal control of companies, strengthening the professional ethics education of independent directors, and enhancing the supervision and punishment.

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