

# Analysis of Financial Fraud in Kangmei Pharmaceutical: Motivation, Governance and Strategy

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**Abstract:** This paper examines Kangmei Pharmaceutical's financial fraud from 2016 to 2018, a significant case in traditional Chinese medicine. It outlines Kangmei's "big health" business model and reviews the fraud's timeline, media scrutiny, regulatory probes, and legal outcomes. The analysis identifies motives such as liquidity relief, operational pressure, and personal gain for management. The paper suggests governance strategies like steady development plans, diverse evaluation systems, and wider financing. It also assesses Kangmei's post-fraud actions, like management overhaul, business model shifts, performance systems, and partnerships, which helped restore reputation and drive transformation. The study offers insights into financial fraud complexity and lessons for listed companies' financial governance.

**Keywords:** Kangmei Pharmaceutica; Financial fraud; Motivation analysis; Governance; Strategy

## 1. Introduction

Kangmei Pharmaceutical established in 1997 by Mr. Ma Xingtian and listed on the Shanghai Stock Exchange in 2001 as "Kangmei Pharmaceutical (600518)," is a modern pharmaceutical resource-based enterprise that integrates drug production, research and development, and sales. The company operates under the concept of "New Kangmei, Healthy beauty" and is dedicated to enhancing the entire traditional Chinese medicine industry chain, guided by the national strategy to revitalize this field. Kangmei has developed a comprehensive model that includes "big health + big platform

+ big data + big service," with the goal of creating an internationally influential "smart +" precision service brand. Despite its ambitious vision, Kangmei Pharmaceutical became embroiled in one of the largest financial fraud cases in A-share history between 2016 and 2018. This paper aims to explore the motive factors behind the financial fraud, the course of the incident, and propose countermeasures and suggestions for treatment. The research method involves a detailed examination of the timeline and key events of the financial fraud, including media scrutiny, regulatory investigations, and legal repercussions. The paper identifies multiple motivations for the fraud, such as alleviating liquidity shortages, reducing operational pressure, and enabling management to pursue personal gains through share pledges and equity incentives. The significance of this research lies in its empirical analysis of the complexities of financial fraud and its provision of valuable insights and lessons for the financial management and governance of listed companies. By understanding the motivations behind such fraud and the effectiveness of various countermeasures, this paper contributes to the broader discourse on corporate ethics and financial integrity.

## 2. Review of Financial Fraud in Kangmei Pharmaceutical

The financial fraud of Kangmei Pharmaceutical is one of the largest financial fraud cases in A-share history. Specifically, Kangmei Pharmaceutical has made material misrepresentations in its financial reports from 2016 to 2018 and is suspected of violating the law. The significant financial fraud events and time points are listed below as Table1:

**Table 1. Significant Events and Timing of Financial Fraud Incidents in Kangmei Pharmaceutical**

Time	Main events
July 2018	CaiLianPress questioned the large amount of cash hung by Kangmei Pharmaceutical

August 2018	Investors reported to the China Securities Regulatory Commission (CSRC)
October 2018	More media questioned Kangmei Pharmaceutical
End of December 2018	The CSRC officially launched an investigation
April 30, 2019	Kangmei Pharmaceutical announced that it had mistakenly included the value of 30 billion yuan of raw materials into the monetary fund accounting error
May 5, 2019	The Shanghai Stock Exchange required Kangmei to disclose where the money was spent
May 9, 2019	The CSRC launched an investigation into Guangdong Zhongzhong Zhujiang Accounting Firm
Mid-May 2019	The CSRC confirmed that Kangmei Pharmaceutical financial fraud
May 21, 2019	Kangmei Pharmaceutical's corporate bonds were downgraded
August 16, 2019	More than 20 executives, including Ma Xingtian, were given administrative penalties
May 14, 2020	The persons primarily responsible were referred to the judicial authorities
June 5, 2020	The CSRC required Kangmei Pharmaceutical to give explanations on several consecutive major performance changes and other issues, and conducted internal accountability of relevant responsible persons
July 9, 2020	Ma Xingtian, the actual controller at that time, was taken compulsory measures
November 12, 2021	Kangmei Pharmaceutical's original actual controller and other investors compensated 2.459 billion yuan

### 3. Analysis of Fraud Motivation Factors

#### 3.1 Alleviate the Shortage of Working Capital

Share pledge refers to the behavior that the major shareholder of a listed company uses his own shares as collateral to pledge his shares to others so as to obtain liquidity. When listed companies lack liquidity, they can obtain a large amount of working capital in a short period of time by means of equity pledge. The funds obtained from the pledge will be used for the renovation and expansion of production lines, the development of new products and the expansion of new markets. This sends a good signal to the market that the company's business situation is improving, which helps to drive the stock market higher

in a short period of time. [1] In the long run, the main source of working capital required by the operation of an enterprise is operating income. Using equity pledge to obtain funds will make the company's debt ratio higher and higher, which is not a long-term method; Therefore, equity pledge is only a short-term expedient.

It can be seen from Table 2 that the equity pledge rate of Kangmei Pharmaceutical is very high. Frequent equity pledge will mean that the company may face the problem of capital shortage, and long-term reliance on equity pledge financing will weaken the company's ability to resist risks. In addition, if there are multiple equity pledges in the market, it may affect investors' confidence in the market, and then affect capital liquidity and market stability.

**Table 2. Course of Equity Pledge of Controlling Shareholder of Kangmei Pharmaceutical**

Name of Shareholder	Announcement time	Number of shares pledged	Market value of pledged shares	Reason for pledge
Kangmei Industry	2018-11-29	76.68 million	852 million	Additional pledges
Kangmei Industry	2018-11-29	483.22 million	537 million	Additional pledges
Kangmei Industry	2018-04-28	50 million	802 million	undisclosed
Kangmei Industry	2018-03-03	80 million	1,559 million	undisclosed
Kangmei Industry	2018-01-05	38.82 million	803 million	undisclosed
Kangmei Industry	2017-12-28	38.82 million	796 million	undisclosed
Kangmei Industry	2017-12-21	190 million	3,210 million	undisclosed
Kangmei Industry	2017-12-08	36 million	577 million	undisclosed
Kangmei Industry	2017-11-23	108 million	2,264 million	undisclosed
Kangmei Industry	2017-11-08	198 million	4,145 million	undisclosed

Kangmei Industry	2017-11-01	132 million	2,639 million	undisclosed
Kangmei Industry	2017-09-09	100 million	1,478 million	undisclosed
Kangmei Industry	2017-08-31	165 million	2,109 million	undisclosed
Kangmei Industry	2017-08-10	148 million	2,819 million	undisclosed
Kangmei Industry	2017-08-03	140 million	893 million	undisclosed
Kangmei Industry	2017-08-01	232 million	3,045 million	undisclosed
Kangmei Industry	2017-03-30	125 million	1,723 million	undisclosed
Kangmei Industry	2017-03-23	220 million	3,158 million	undisclosed
Kangmei Industry	2016-12-08	144 million	2,422 million	undisclosed
Kangmei Industry	2016-09-09	100 million	1,305 million	undisclosed
Kangmei Industry	2016-07-15	209 million	3,255 million	undisclosed
Kangmei Industry	2016-05-31	150 million	2,628 million	undisclosed
Kangmei Industry	2016-05-11	237 million	3,959 million	undisclosed
Kangmei Industry	2016-03-24	220 million	1,569 million	undisclosed
Kangmei Industry	2015-12-08	144 million	1,009 million	undisclosed
Kangmei Industry	2015-09-15	100 million	976 million	undisclosed
Kangmei Industry	2015-09-15	29 million	345 million	Additional pledges
Kangmei Industry	2015-07-24	150 million	1,016 million	undisclosed
Kangmei Industry	2015-07-24	20 million	275 million	Additional pledges
Kangmei Industry	2015-05-30	36 million	undisclosed	undisclosed
Kangmei Industry	2015-05-09	124 million	852 million	undisclosed
Kangmei Industry	2014-12-04	72 million	425 million	undisclosed
Kangmei Industry	2014-09-18	75 million.	509 million	undisclosed
Kangmei Industry	2014-08-06	2010 million	132 million	undisclosed
Kangmei Industry	2014-07-29	110 million	721 million	undisclosed
Kangmei Industry	2014-06-04	9.0 million	undisclosed	undisclosed
Kangmei Industry	2014-05-07	120 million	670 million	undisclosed
Kangmei Industry	2014-03-15	110 million	876 million	undisclosed
Kangmei Industry	2013-06-27	110 million	677 million	undisclosed
Kangmei Industry	2012-12-22	66 million	475 million	undisclosed
Kangmei Industry	2012-06-28	155 million	954 million	undisclosed
Kangmei Industry	2012-05-22	120 million	720 million	undisclosed
Kangmei Industry	2011-07-20	156 million	795 million	undisclosed

From Table 3, the largest shareholder of Kangmei Pharmaceutical initially only held 30.54% of the equity pledge, accounting for 9.21% of the share capital. From 2010 to 2013, the proportion of equity pledge of the company continued to rise, and the cumulative proportion of pledge exceeded 80% after 2012. Kangmei Industrial pledged a total of 1,629.35 million shares of Kangmei Pharmaceutical in 2018, accounting for

32.76% of the total share capital of the Company, and the total number of shares pledged in total reached 99.53%, almost 100%, which indicates that: Kangmei Pharmaceutical has long had the problem of liquidity shortage, and constantly adopted the way of equity pledge to stabilize the stock price, which laid the motivation for financial fraud.

**Table 3. Proportion Of Equity Pledge of Controlling Shareholders of Kangmei Pharmaceutical**

Year	Cumulative number of pledged shares (million shares)	Cumulative number of pledged shares in proportion to shareholding	Percentage of share capital
2010	156	30.54%	9.21%
2011	250	37.50%	11.37%
2012	552	82.53%	25.11%
2013	602	90.00%	27.38%
2014	577.12	86.28%	26.25%
2015	1,232.79	92.15%	28.03%

2016	1,442.21	93.22%	29.15%
2017	1,438.89	87.72%	28.93%
2018	1,629.35	99.53%	32.76%

### 3.2 Reduce the Operating Pressure of the Company

The fundamental of sustainable development of enterprises lies in operational capacity. In

**Table 4. Operating Capacity Index of Kangmei Pharmaceutical From 2014 To 2018**

Year	2014	2015	2016	2017	2018
Inventory turnover	2.11	1.509	1.354	0.451	0.336
Inventory turnover days	170.6	238.6	265.9	798.7	1070
Accounts receivable turnover	7.381	6.755	6.961	4.098	2.965

The reasonable inventory turnover days in the industry are between 200 and 300 days. As can be seen from Table 4, the inventory turnover days of Kangmei Pharmaceutical from 2014 to 2018 are increasing every year, and the inventory turnover rate and accounts receivable turnover rate are getting lower and lower, even far exceeding the average level of the industry in 2017 and 2018. This means that the inventory takes longer and longer to occupy funds, which will affect the company's capital liquidity and financial flexibility, indicating that the capital chain of Kangmei Pharmaceutical has deteriorated since 2017, and its operating ability is in decline. Under various pressures, if the financial data is not fraudulent, it will inevitably cause irreversible results to the stock price.

### 3.3 Company Managers Pursue Personal Interests to Unlock Equity Incentives

On March 9, 2016, Kangmei Pharmaceutical stipulated the rules for unlocking individual equity in the Equity Incentive Plan Implementation Assessment Management Measures: With the net profit growth rate as the core, the net profit in 2016 can be unlocked for the first time only if the net profit increases by more than 20% compared with the same period in 2015; In 2017, the net profit will increase by more than 40% compared with the corresponding period in 2015 before the second unlocking can be made. In 2018, the net profit can increase by more than 60% compared with 2015 before the third unlocking. If the company's performance assessment index is completed in the previous year, the next unlocking can be determined according to the object to be assessed. Such high-intensity equity incentives provide a breeding ground for

the case of poor operating capacity, the company will have a stronger incentive to commit financial fraud for business purposes or to complete certain financial targets.

deliberate profit manipulation. By falsely increasing operating income, operating profit, monetary capital and other ways to whitewash performance to achieve the goal, thus embarking on the financial fraud this way of no return [2-5], at the same time, this move also attracted a large number of investors who do not know the truth to invest, for 2021 high compensation laid the foundation.

## 4. Countermeasures And Suggestions for the Governance of Fraud Motives of Kangmei Pharmaceutical

### 4.1 Formulate A Positive and Steady Enterprise Development Strategy

In this case, in order to seize the market, Kangmei Pharmaceutical carried out blind expansion, which caused a decline in the profitability of the enterprise and a serious financial crisis. Finally, it was forced to use accounting fraud to make up for the defect of poor capital turnover. Therefore, enterprises can make great efforts in financial fraud, focus on developing more legal and effective business strategies, effectively improve their core capabilities, protect the legitimate rights and interests of external investors, establish a good market image, and achieve long-term strategic goals. On the contrary, if the company is too eager for quick success and immediate benefits, only cares about the present, takes a series of extreme behaviors, or even illegally carries out financial fraud, which will not only increase the company's business risks, but also bring devastating consequences to the company and endanger the market development of the whole industry. In order to maintain the normal order of market economy, operators should guide enterprises to adopt diversified business

strategies to avoid risks and promote development. [6] The following are the specific measures and steps proposed in this paper. First, formulate the company's long-term goals and strategic plans and determine the direction of development. Secondly, according to the actual situation of the current industry environment, to fully understand the supply and demand of the market, and according to their own actual situation, formulate a diversified operation strategy, to avoid blindly rushing forward, the pursuit of rapid development; Finally, through the SWOT method, we can have a clear understanding of our own development ability and the real situation of our competitors, make full use of our own resource advantages, explore our own development potential, formulate a set of practical, effective and practical differentiated business strategies, and highlight our competitive advantages.

After the financial fraud incident, Guangzhou Pharmaceutical Group carried out a comprehensive reorganization of Kangmei Pharmaceutical's management, and the new leadership team quickly carried out a major turnover of Kangmei Pharmaceutical. Firstly, the enterprise structure is optimized and divided into three levels. Firstly, four supporting business units of strategic business segments are established; Second, the establishment of brand center, supply chain center, R & D center three; Third, the company has set up 13 background departments, including research institute, human resources Department, information and digital Department, which share and empower resources together to ensure close coordination with the company's strategic goals. Secondly, according to the overall planning of Guangzhou Pharmaceutical Group and Kangmei Pharmaceutical, Kangmei Pharmaceutical established the strategy of "12355", focused on the development of traditional Chinese medicine (TCM) Yinpian, and created a wise and healthy TCM brand, with two strategic main lines of "creating the whole chain characteristic industry of TCM Yinpian" and "providing services featuring medical care and health care". In addition, Kangmei pharmaceutical also strengthened the connection with Guangzhou Pharmaceutical Group. By taking advantage of the production

capacity cooperation between Kangmei Pharmaceutical and Baiyunshan Pharmaceutical and the support of the market in eastern Guangdong, Guangzhou Pharmaceutical Group has realized the synergy between Kangmei Pharmaceutical and Baiyunshan Pharmaceutical. Guangzhou Pharmaceutical Group has also led Kangmei Pharmaceutical to participate in public welfare activities such as fighting against the epidemic and disaster relief for many times, and has continuously improved its own brand image.

The effect of these measures is very obvious, within a year, Kangmei Pharmaceutical took off the star, from "\*ST Kangmei" to "ST Kangmei", and still continue to reduce the loss until 2023 to complete a major transformation, which also shows that this also shows how important an active, steady and appropriate development strategy is for the sustainable development of a company.

#### **4.2 Establishment of Diversified Assessment Criteria**

If the listed companies of our country want to keep a foothold in the tide of market economy, it is necessary to set up a diversified evaluation system. Due to the frequent financing in the early stage, Kangmei Pharmaceutical's operating income plummeted, so in the process of financial fraud, in order to whitewash the performance, it is necessary to evaluate the performance of the management, so as to promote the sustainable development of the company. In the current enterprise performance evaluation, the basis of performance evaluation is generally profit and stock price, which is not perfect, but has become an important indicator of enterprise business performance. Under this mechanism, financial fraud will inevitably occur when management faces a decline in performance, profitability, and profitability that is difficult to reverse. Therefore, to establish a diversified evaluation system, for reducing the motivation of accounting fraud in listed companies in our country, has very important significance [7-8] Listed companies should build a diversified evaluation system, its main contents are as follows: first, it is necessary to conduct multi-dimensional, multi-angle and multi-aspect evaluation of enterprise

performance, such as the use of balanced scorecard and other performance evaluation means; Secondly, it is necessary to change the evaluation method that only takes financial income as the evaluation index, and adopt a variety of indexes such as earnings income and economic value added to evaluate the enterprise performance. Third, we should pay more attention to the company's operating stability, asset quality, sustainable development ability and other aspects, rather than blindly pursue expansion. Fourthly, we should prevent excessive pursuit of immediate benefits and neglect of long-term benefits. We should not only pay attention to the evaluation of short-term performance, but also focus on the completion and long-term performance evaluation indicators. Fifth, when constructing a diversified evaluation index system, it is also necessary to pay attention to the authority of the evaluation subject to avoid cheating under the pressure of managers and other fraud actors, so as to effectively prevent and control financial fraud.

In view of this problem, Kangmei Pharmaceutical's solution is as follows: in the annual report from 2019 to 2022, the company has built a "three-in-one" performance evaluation system based on reality, that is, the performance evaluation system based on MBO [9], the ability evaluation system based on qualifications, and the performance evaluation system with rewards and punishments as the main content. In advance, the company agrees on rights and obligations with senior managers and signs a target responsibility statement; After the event, the performance monitoring of the whole assessment process should be carried out, and various information exchange channels and means should be established through contact management to collect all kinds of information of such employees. At the same time, according to the leader's ability model, the information is systematized, structured and visualized to ensure that the management behavior of managers is compatible with the operation needs of the enterprise. On this basis, the business performance of senior executives is linked to their compensation, rewards and punishments, and post changes, etc., and the connection with the department cost budget is used to motivate senior executives to strive to achieve the company's

business objectives. In addition, the introduction of "information disclosure", "accurate measurement", "performance improvement" and other means, the establishment of "goal decomposition, task tracking, whole-process assessment, feedback problems, incentive results, improve the gap" performance management closed loop, to assist enterprises to prevent operational risks, improve enterprise performance.

### 4.3 Expand Financing Channels for Listed Companies

Financing difficulty has become one of the main reasons for listed companies to cheat. [10] The government and society should provide diversified financing channels for listed companies, and appropriately reduce financing conditions and financing scale, which can reduce corporate fraud to some extent.

### 5. Conclusions

The financial fraud at Kangmei Pharmaceutical highlights the misbehavior that companies can take when faced with liquidity shortages, operational pressures and the pursuit of personal interests. Companies cover up their financial condition through frequent equity pledge and inflated performance, which not only damages the interests of investors, but also destroys the market order. To prevent such incidents, companies should develop sound development strategies, establish diversified evaluation systems, and broaden financing channels. After the incident, Kangmei Pharmaceutical took a series of rectification measures, including optimizing the corporate structure, repositioning the business model, establishing the performance evaluation system, and strengthening the cooperation with Guangzhou Pharmaceutical Group, which effectively helped the company gradually out of the dilemma and realized a major transformation. This shows that with proactive governance responses and appropriate strategic adjustments, companies can overcome challenges and achieve sustainable development.

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