

A Case Study of the Formation Mechanism of “High Deposit and High Loan” in Listed Companies

—Take Kangmei Pharmaceutical’s Financial Fraud as an Example

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Abstract

Enterprise accounting fraud has always been a “cancer” for the healthy development of domestic and foreign capital markets. Many enterprises use information asymmetry to deceive investors and use accounting fraud to seek illegitimate benefits, and it has never ceased. Therefore, there is an urgent need to study and solve the problem of corporate accounting fraud. This paper studies this problem in order to improve the management ability of enterprises and improve the quality of audit information, which has important practical significance.

This paper intends to take Kangmei Pharmaceutical as an example to analyze the behavior motivation of accounting fraud, the means of fraud and the development of the situation after being punished by the securities regulatory authorities, and thus to reflect more comprehensively on the current state of governance of accounting fraud in Chinese enterprises. Finally, from the four aspects of establishing and improving of enterprise internal control, improving auditor’s auditing quality, strengthening accounts receivable control and strengthening enterprise risk management, it puts forward suggestions and opinions on improving the governance of accounting fraud in China’s enterprises.

Keywords: high deposit and loan, financial fraud

1. Introduction

After decades of rapid economic development, China’s comprehensive strength has been significantly improved, and the development of enterprises also put forward higher requirements. If enterprises fail to follow the trend of economic development, they will face the risk of being eliminated. In the enterprise, the fund is the key to the survival and development factors, but the enterprise’s internal funds are limited, if you want to get more profit you need to raise more capital to invest, many enterprises choose debt financing to leverage financial rod, the pharmaceutical industry is a “twin” deposit capital intensive industry, in the process of investment and development needs a large amount of funding, Therefore, kangmei pharmaceutical is highly dependent on financial leverage, and the operation of “high deposit and high loan” not only improves the revenue of pharmaceutical enterprises but also brings huge financial risks. Kangmei Pharmaceutical’s operating conditions have been exposed to the public. Based on this, the focus of the topic is to study the phenomenon of financial fraud and the causes of risk in the pharmaceutical industry at this stage from the perspective of the financial vision of “high deposit and high loan”.

In this paper, based on the related theory of financial management, the integrated use of management, investment and economic science and other multi-disciplinary knowledge and methods, follow the principle of combining qualitative and quantitative, from the definition of the concept of financial fraud and its management, through the present situation of the company’s financial fraud control points out its problems of financial management,

the theory significance.

2. Literature Review

Liu Linquan (2022) explores the reasons for the phenomenon of “high deposits and high loans” from the perspective of financial convergence and corporate governance. Through the risk analysis and identification of listed companies with “high deposits and high loans”, it believes that this is closely related to information disclosure errors, low efficiency of capital use, financial fraud and other phenomena. Finally, it puts forward effective risk response strategies from the perspective of dynamic development. Li Wenbin (2019) discussed the causes and consequences of the company’s liability operation risks in combination with the current macro environment of the real estate industry, found out the early warning indicators of the real estate company in terms of financial risks, and put forward countermeasures for the company to prevent financial risks. Xiang Jie (2021) takes Hainan Haiyao as an example to analyze the causes and risks behind the “double high deposit and loan” in the pharmaceutical industry. Through the analysis at the macro level, it is concluded that considering the policy factors and economic factors, the abnormal phenomenon of “double high deposit and loan” is mainly caused by the two-invoice system and centralized procurement at the industry level, as well as the company’s strategy, investment and financing conditions. Then the possible financial risk and reputation risk are analyzed. From the attitude of “high deposit and high loan”, capital control ability, investment project benefit and strategic mode, suggestions are put forward for Hainan Haiyao to improve its financial vision. Mai Zhi’an (2021) takes Kangmei Pharmaceutical as an example to analyze the phenomenon of “high deposits and high loans” from five aspects: high deposits and high loans, inventory fraud, false reporting of operating income and operating cost, and high equity pledge, and puts forward corresponding strategies to avoid greater risks to the financial market and investors. Zhao Zongzi (2019) provides a way to find clues from the financial statements by analyzing the financial fraud methods of Kangmei Pharmaceutical co., LTD., and provides corresponding measures for enterprises to deal with the risk of financial fraud from three perspectives by focusing on the quality of financial statements, paying attention to the assets with articulating relationship and paying attention to related party transactions.

Based on the research of domestic and foreign scholars, the significance of this topic is of great significance, which can provide reasonable measures and suggestions for the prevention and control of financial risks of pharmaceutical enterprises under the operation of “high deposit and high loan”.

3. Fraud Triangle Theory

According to the fraud triangle theory, corporate fraud is composed of three elements: pressure, opportunity and self-rationalization. Without any one of them, corporate fraud cannot be formed. When the pressure accumulated to a certain degree, near the critical value, fraudsters will look for the right opportunity to implement financial fraud, when there is a gap in the internal control system, will provide fraud opportunities for fraudsters, and the low cost of illegal, so that fraudsters are not enough to be deterred. The root of corporate malpractice is the pressure factor. Stress comes from many sources, such as financial pressure, work-related pressure and other pressures.

4. Case Background

With the continuous development of the macro-economy and the growth of residents’ income in recent years, the development trend of China’s pharmaceutical industry shows a growing trend, which is reflected in the increasing sales revenue and total sales of the pharmaceutical industry. Since the outbreak of COVID-19 in early 2020, the demand for medicines and medical supplies has grown rapidly, and the government has introduced a series of policies and measures to promote the development of the pharmaceutical industry, resulting in a substantial increase in the production and sales of medicines and related medical supplies. However, in the context of a positive development trend in the pharmaceutical industry, the annual financial report released by Kangmei Pharmaceutical in April 2019 has attracted great attention from insiders. The financial statement presents a correction report for the errors in the 2017 annual report: 29.9 billion yuan of monetary capital and 8.9 billion yuan of operating income were added, 19.55 billion yuan of inventory and 7.6 billion yuan of operating costs were understated, so it can be known that the company’s monetary capital in 2017 was inflated by nearly 30 billion yuan. However, as early as 2016, Kangmei Pharmaceutical was suspected of financial fraud.

5. Cause Analysis

5.1 Financial Statement Analysis

5.1.1 Operational Capacity

Table 1. The operational capacity of Kangmei

year	2010	2011	2012	2013	2014	2015	2016	2017	2018
inventory turnover	1.93	2.78	3.06	2.69	2.11	1.51	1.35	1.30	0.54
accounts receivable turnover	8.92	10.68	11.13	8.8	8.11	7.56	7.67	7.11	3.63

Source: Wind

Two important indicators that can better reflect the company's operating capacity are inventory turnover and accounts receivable turnover. According to the annual report data from 2010 to 2018, the indicators of inventory turnover and accounts receivable turnover continue to weaken and show a downward trend, which also indicates that the actual operating capacity of Kangmei Pharmaceutical has declined. However, Kangmei pharmaceutical has been expanding its business. In 2018 alone, Kangmei Pharmaceutical invested 10 billion in the construction of industrial parks and mobile medical projects, and frequently acquired equity, and set up wholly-owned subsidiaries and joint ventures. It can be seen that the focus of Kangmei pharmaceutical is not on its main business.

5.1.2 Solvency Analysis

The key financial index of corporate financial management is the solvency index, which is the ability of a company to repay debts (divided into principal and interest). The solvency index is divided into the long-term solvency index and the short-term solvency index. This paper mainly selects kangmei Pharmaceutical from 2013 to the end of 2018 short-term debt solvency indicators liquidity ratio, quick ratio and cash ratio for analysis.



Figure 1. Indicators of debt repayment capacity

Source: Wind

As can be seen from FIG. 1, the current ratio was relatively high and stable from 2013 to 2019, both of which remained at about 2, indicating that the company had a large amount of capital in current assets, which could not be effectively utilized, possibly affecting the profitability of the company. From the perspective of quick ratio, the distribution of quick ratio from 2013 to 2017 was about 1.5, but it dropped to 0.7 rapidly in 2018. It can be seen that the quick ratio of the enterprise was not very stable, but its debt repayment ability remained relatively balanced from 2013 to 2017. Finally, the cash ratio of the company plunged in 2018, which shows that the company has poor short-term debt repayment ability and lacks short-term liquidity. Therefore, in the case of a lack of short-term liquidity, the company needs to borrow to meet its capital needs, so it is very likely to cover up its low liquidity by creating fictitious monetary capital.

5.2 Fraud Triangle Theory

5.2.1 Pressure

Kangmei pharmaceutical financial fraud pressure mainly comes from financial pressure. Kangmei pharmaceutical in the financial fraud scandal before the continuous years of net investment cash outflow. From 2014 to 2018, the net cash outflow caused by the company's investment activities was -769 million yuan, -1.444 billion yuan, -1.986 billion yuan, -1.53 billion yuan and -4.647 billion yuan, respectively. By the end of 2018, the

company's interest-bearing liabilities had reached 46.328 billion yuan. Therefore, in the days of debt and continuing to hold a large amount of investment expenditure, if not the use of financial fraud is difficult to cover up the company's huge investment capital pressure and debt servicing pressure, can not cover up its high asset-liability ratio, more unable to finance through the financial market to maintain the normal operation of the company.

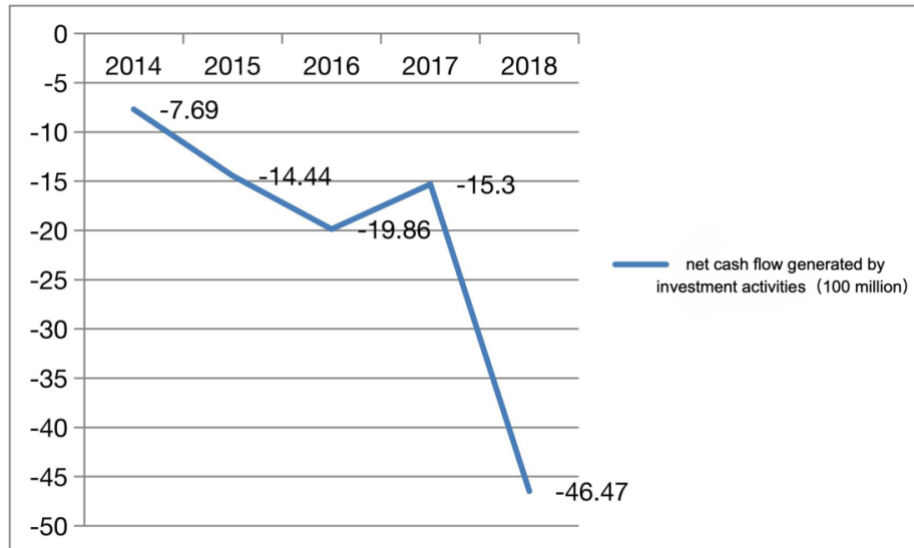


Figure 2. Net cash flow generated by investment activities

5.2.2 Opportunity

From the internal point of view, the actual controllers of Kangmei Pharmaceutical Ma Xingtian and his wife control Kangmei pharmaceutical in terms of shareholding and have formed actual control over the company's management. Before the scandal broke, the Ma Xingtian couple had direct and indirect ownership of 36.65 percent of Kangmei pharmaceutical, while the second to 10th shareholders had a combined stake of only about 22 percent, giving the couple effective control of the company. At the same time, Ma Xingtian and his wife's parents are natural shareholders of the company, and the company's management is typical of family management. The company's decision-making facilitates Ma Xingtian and his wife's actual control and manipulation of financial fraud.

In terms of external opportunities, the cooperation of accounting firms and the low cost of breaking laws and regulations have a certain role in promoting financial fraud. As the auditor Guangdong Zhongzhong Pearl River CPA Firm has provided audit services for the company for many years, it has formed a close cooperative relationship. Years of cooperation and lack of professional ethics in accounting firms contributed to the fraud and results on both sides. In addition, according to the CSRC's punishment notice, the Ma Xingtian couple's punishment measures are only to order Kangmei pharmaceutical to correct, fined the company 600,000 yuan, for the Ma Xingtian couple 900,000 yuan plus a lifelong ban from entering the securities market. The low cost of breaking laws and regulations is another important reason for counterfeiting.

5.2.3 Self-Rationalization

After kangmei Pharmaceutical's financial fraud was exposed, all parties concerned took external reasons as an excuse to provide a rationalization for their own behavior. Ma Xingtian and his wife believed that financial fraud occurred because of the company's rapid development, resulting in their own not having enough time to devote to the company's financial management and internal control, resulting in financial management not perfect, the company's internal control loopholes and financial fraud. And the supervisory department is to this matter also feels that there is no big fault in supervision. However, Kangmei Pharmaceutical has been continuously making financial fraud for many years, and the amount is huge. There are abnormal behaviors and phenomena such as management shareholding and information disclosure. For example, in 2018, the board of Supervisors of the company became zero shareholders of the company. We know nothing about Kangmei Pharmaceutical's fraud. No matter what excuse we put forward, the CSRC is responsible for the fraud.

6. Suggestions and Solutions

6.1 Optimize Internal Corporation

In the national regulatory system, Kangmei Pharmaceutical should consciously abide by the internal laws and regulations of the industry, clarify the positioning and direction of its own products, and should not illegally operate to obtain super-high returns, thus posing a threat to the capital security defined by investors. Invest in compliance to enhance customer confidence in the product and reduce uncertainty in customer definition minds. Not only that, the company ultimately chose to use the financial dance through fraud to overcome the crisis, maintaining the listing qualification is also necessarily related to the operation of the board of directors. Based on the growth of Kangmei Pharmaceutical, shareholders should materially consider replacing board members. And strengthen the legal consciousness of the board of directors, clear rules and regulations, reward and punishment system, regularly determine the board members of the training, so that even from the ideological level of violation of power and accounting fraud consequences of the seriousness of kangmei pharmaceutical and the impact on career.

6.2 Improve the Professional Ethics of Auditors

Generally speaking, auditors must be careful and meticulous in their work. When they are careless, mistakes are made and the pressure on auditors is unimaginable. Moreover, auditors in China are still very young and have very little experience in this field. Therefore, auditors of Kangmei Pharmaceutical must be familiar with and strictly abide by their professional ethics.

Kangmei Pharmaceutical auditors are the most important responsibility of the audit work, therefore, the quality of the audit staff will directly affect the work of the audit staff. After the founding of our country, the Central Committee of the Communist Party of China strengthened the training of auditors and constantly formed a relatively perfect evaluation, selection and training mechanism for auditors. And, in the continuous summary of relevant experience, and combined with the actual situation of Our country, constantly improve the “Audit Law”, so as to further clarify the management content of audit personnel. This provides a clear guarantee for the development of auditors.

6.3 Strengthen the Process Control of Accounts

Kangmei Pharmaceutical should establish a sound customer credit evaluation system from the perspective of dual-development cooperation and development, collect and carefully analyze the data related to receivables, collection schedule and unrecoverable losses of receivables in recent years. Understand customers’ business development, credit status and credit history in recent years, and divide all customers into different credit levels, record them and update them at any time. For those accounts, the receivable amount is not large. While reducing sales to a certain extent, large losses on doubtful receivables are avoided. Long credit terms absorb the opportunity cost of capital, making it difficult to attract short-term customers. The amount and duration of reductions must be determined based on a quantitative analysis of profit and cost of sale to ensure maximum profit increase and cost reduction.

7. Conclusion

Financial risk is not only an independent aspect of enterprise management but also a comprehensive management work. However, in the rapid economic development at the same time, kangmei pharmaceutical financial management problems also emerged, the financial control foundation is weak, the financial system is loose, the enterprise capital accumulation ability is weak, and the capital structure is unreasonable, cost management and control system is not sound and so on. Therefore, taking Kangmei Pharmaceutical as an example, it is of great significance to analyze the financial risks of the company, which will promote the reform and development of financial management of real estate enterprises.

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