Research on the Motivation of Financial Fraud in Chinese Pharmaceutical Industry-Taking Kangmei Pharmaceutical as an Example

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Abstract: With the advancement of living standards and the continuous rise in demand for healthcare security, the pharmaceutical industry is poised for significant development. However, recent years have witnessed a concerning trend of financial misconduct among several publicly listed pharmaceutical companies in China. This unethical behavior has not only cast a shadow over the Chinese pharmaceutical market but also reverberated throughout the broader capital market. Consequently, an in-depth examination of the motivation of financial fraud within China's pharmaceutical sector holds profound importance.

Keywords: Pharmaceutical Industry; Financial Fraud; Fraud Motivation; Kangmei Pharmaceutical

1. Causes of Financial Fraud in the Pharmaceutical Industry

1.1 Low Industry Concentration and Weak Competitiveness

The pharmaceutical sector in China lags behind in development, characterized by a modest foundation and an extensive landscape of small-scale manufacturing entities. Consequently, the industry's concentration remains low. As illustrated in Table 2, the growth trajectory of major pharmaceutical manufacturing enterprises in China has been sluggish, while small and medium-sized players continue to penetrate the market, claiming a significant market share. Given the constrained market capacity at any given stage, only a handful of efficient companies can thrive once saturation is reached. In response, many pharmaceutical firms are compelled to minimize production costs and extraneous expenditures for survival. Unfortunately, this can lead to a detrimental cycle, hampering their capacity to secure market share, enhance production technology, and foster product innovation and research.

Table 2 Main economic data of industrial enterprises above designated size in China's pharmaceutical manufacturing industry from 2017 to 2021

Year	2017	2018	2019	2020	2021
Unit number	7532	7423	7392	8170	8629
Total assets (100 million Yuan)	30779.92	32856.55	33981.45	38010.09	44053.13
Main business income (100 million yuan)	27116.57	23986.3	26147.4	27960.3	29288.5
Sales expenses (100 million yuan)	3812.72	4767.34	4907.01	4654.63	4775.99
Operating profit (100 million yuan)	3251.8	3128.79	3117.56	3506.7	6271.4

Data source: National Bureau of Statistics website

In recent years, China's economic development has enticed numerous international pharmaceutical giants to enter the market, accentuating the disparity between Chinese and foreign pharmaceutical enterprises. While China has seen the emergence of quality enterprises like Hengrui Pharmaceutical Co. and Mindray Bio-Medical Electronics Co., the overall market competitiveness of Chinese pharmaceutical firms remains modest.

1.2 High Research and Development(R&D) risk

In the pharmaceutical manufacturing landscape, new drug R&D serves as the primary catalyst for further growth. As society and the economy advance, heightened health consciousness drives increased demand for drugs. This necessitates greater investments in drug R&D to meet consumer needs. However, such endeavors are resource-intensive and time-consuming, entailing numerous intricate steps and expenses ranging from ¥500 million to ¥2 billion. Consequently, this high-stakes, capital-intensive process poses significant financial risks. A single misstep can result in substantial losses, leading some companies to resort to financial fraud as a means of concealing setbacks.

Most Chinese pharmaceutical enterprises, particularly private ones, grapple with limited capital sources. Compounded with the capital-intensive nature of drug R&D, this often triggers a cash crunch. To address this, enterprises seek financing from financial institutions. Yet, these institutions are generally averse to the high risks inherent in pharmaceutical R&D, exacerbating financing challenges for pharmaceutical manufacturers.

1.3 Inadequate Internal Control System

In the Chinese economic market milieu, effective internal control stands as a linchpin for the long-term, healthy growth of enterprises, and serves as a vital deterrent against financial fraud. Regrettably, the current internal control systems of Chinese pharmaceutical companies are far from optimal, characterized by several key deficiencies. Firstly, pharmaceutical firms have yet to allocate sufficient resources for establishing robust internal control systems. Given the unique attributes of pharmaceutical products and the associated operational constraints, replicating internal control systems from other industries yields limited efficacy. Secondly, the sector's intricacies lead to complex internal control procedures necessitating specialized personnel. However, the dearth of internal control expertise and awareness undermines problem identification and implementation efficiency. Thirdly, many enterprises lack a comprehensive grasp of internal auditing, quality management, and internal audit control, manifesting as superficial understanding and ineffective internal audit practices. This leaves room for concealed vulnerabilities, ultimately resulting in irremediable financial loopholes.

2. Analysis of Financial Fraud Motivation in Kangmei Pharmaceutical Industry

2.1 Policy-induced Debt Servicing Pressure

China's adoption of the "two-invoice system" within the pharmaceutical industry has left a significant impact on pharmaceutical companies. While this system is expected to bring long-term benefits to the entire pharmaceutical sector, it has imposed substantial short-term financial pressure on pharmaceutical enterprises. Moreover, China's Securities Law explicitly outlines the consequences for listed companies experiencing consecutive financial losses. Such companies will have "ST" added to their name, and if losses persist for a third year, they face the risk of delisting. In response, Kangmei Pharmaceuticals embarked on a strategy of aggressive expansion and substantial investments in innovation and research and development to maintain its listed status and competitive position. However, the company's financial position couldn't sustain this rapid expansion, resulting in severe financial strain.

An analysis of Kangmei Pharmaceuticals' short-term solvency from 2015 to 2018, as presented in Table 2-1, reveals a troubling trend. Starting from the adjusted data in 2017, the quick ratio dropped by 0.93, and the cash ratio decreased by 1.17. This situation persisted into 2018, with both ratios falling well below the industry average for that year. These figures underscore the company's insufficient cash reserves to meet current liabilities, highlighting a substantial funding gap.

Table2-1 Short-term solvency analysis of Kangmei Pharmaceuticals 2015-2018

	2015	2016	2017(pre-correction)	2017(post-correction)	2018
Quick ratios	1.38	1.55	1.55	0.62	0.72
Industry averages	1.23	1.30	1.32	1.32	1.24
Cash ratios	1.14	1.36	1.33	0.16	0.07

Industry averages	0.88	0.94	0.95	0.95	0.88

Source: Kangmei Pharmaceuticals Annual Report 2015-2018 and National Bureau of Statistics website

Under ordinary circumstances, Kangmei Pharmaceuticals wouldn't need to resort to extensive financing if it had adequate liquid funds. However, the company pursued numerous financing options and accumulated high levels of debt, with almost all of its shares pledged by its top ten shareholders.

Furthermore, an examination of the data presented in Table 2-2 reveals that the enterprise's net present ratio over the past four years consistently remained below 1, indicating a low level of profitability. This discrepancy suggests that Kangmei Pharmaceuticals' actual operational performance may not align with the data disclosed in its financial reports. Taken together, these findings strongly suggest that Kangmei Pharmaceuticals faces a critical funding shortage, significant debt repayment pressure, and may even be motivated to engage in fraudulent activities.

Table2-2 Kangmei Pharmaceuticals Net Cash Flow from Operating Activities and Net Income,2015-2018 (RMB Billion)

Year	2015	2016	2017	2018
Net Profit	27.56	33.37	40.95	11.23
Net Profit Growth Rates(Using 2015 as a baseline)	—	22.38%	51.94%	-66.21%
Net Cash Flows from Operating Activities	5.09	16.03	18.43	-31.92
Net Present Value Ratio	0.18	0.48	0.45	-2.84

Source: Kangmei Pharmaceuticals Annual Reports 2015-2018

2.2 “Dominant Shareholding”

A primary contributing factor to financial fraud within Kangmei is the issue of "dominant shareholding." When a company experiences an over-concentration of share ownership, it often results in excessive influence by the controlling shareholder, eroding the independence of directors, including independent directors and supervisors. This lack of independence can facilitate the misappropriation of interests, potentially leading to severe financial misconduct.

Kangmei Industry holds a substantial 32.75% of Kangmei Pharmaceuticals' shares, making it the largest shareholder. Chairman Ma Xingtian, on the other hand, possesses a staggering 99.68% of the company's shares, while his wife, Xu Dongjin, who serves as a supervisor, holds an additional 0.32%. Additionally, Pu'ningJinxin Pawnshop Co., Ltd. and Pu'ning International Information Consulting Service Co., Ltd. each control 1.87% of Kangmei's shares, and Mr. and Mrs. Ma Xingtian are also the controlling shareholders of these two companies. In stark contrast to other shareholders, none of whom hold more than 5% of the company's shares, the Ma Xingtian couple wields absolute control and decision-making authority. This "one-share" internal control system undermines the company's development potential and fails to provide the necessary checks and balances, thereby increasing the likelihood of financial impropriety within the enterprise.

2.3 Lack of Independence in Accounting Firms

Guangdong ZhengzhongZhujiang Accounting Firm appears to have facilitated opportunities for financial fraud at Kangmei Pharmaceuticals. Having served as Kangmei Pharmaceuticals' auditor since its listing in 2001, the two entities have enjoyed a 20-year partnership, resulting in a high level of familiarity that compromised the accounting firm's independence. Furthermore, the auditing organization is subject to the listed company and shares its interests, potentially undermining its professional prudence and ethical standards. Despite Kangmei Pharmaceuticals' accounting errors involving a staggering 30 billion yuan in monetary funds from 2016 to 2018, Guangdong ZhengzhongZhujiang Accounting Firm issued a standard audit opinion. Consequently, it is difficult to dismiss suspicions regarding the firm's involvement in Kangmei Pharmaceuticals' financial fraud.

3. Conclusion

The pharmaceutical industry holds a pivotal role in safeguarding public health, and its potential for growth is promising. The emergence of the COVID-19 pandemic in late 2019 intensified the demand for medical products, catalyzing rapid industry development. Yet, due to the sector's inherent intricacies, coupled with stringent market supervision and policy constraints, the sector faces operational challenges. These may be the motivations that make it possible to commit financial malpractice.

This study delves deeper into the underlying drivers of financial fraud in the pharmaceutical industry, using the case of Kangmei Pharmaceuticals as an illustrative example. It offers valuable insights for addressing financial fraud governance in China, providing a foundation for future efforts to combat such issues within the industry.

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