

Internal Audit Effectiveness on Corporate Governance and Financial Fraudulent Risk: Evidence from Kangmei Pharmaceutical

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Abstract: Over the last decade, financial fraud has occurred more frequently as it has become increasingly complicated, organized, and systematic, given the rapid growth of small and medium-sized enterprises. Due to the sudden economic downturn post-pandemic, firms facing extensive financial pressure tend to act more aggressively, eventually leading to the incentive to commit fraud. Thus, the research on financial fraud and its relationship with firms' corporate mechanisms is of great significance in helping the public better conduct control samples for future fraud prevention. Applying Kangmei Pharmaceutical's financial fraud case as a recent example, given the current accounting system and theoretical framework of fraud, by analyzing its internal audit quality and corporate governance, this article provides insight into how internal audit quality and corporate governance will ultimately contribute to the overall fraud risk.

1 INTRODUCTION

With the development of the global economy and the international market, growing attention from the public has been focused on financial fraud associated with financial statement misconduct and audit failure. The U.S. Committee of Sponsoring Organizations of the Treadway Commission's financial statement fraud study from 1897 to 1997 in U.S. public companies revealed that approximately 40% of financial fraud occurred in industries including technology, healthcare, and financial services (Beasley, Carcello, Hermanson, & Lapides, 2000). This astonishing finding indicates a growing risk of violations in selected industries. However, many previous studies conducted in the last century did not fairly present any fraud control samples, emphasizing the effectiveness of the firm's audit committee and functions of its corporate governance mechanisms (Beasley et al., 2000), which raised public concerns about the validity and universality of their results. Hence, further investigation should be conducted among the selected industries to determine the degree of the mentioned fraud control samples in mitigating financial fraud in public companies, using the recent fraud example of Kangmei Pharmaceutical as a case study illustration.

A focus on Kangmei Pharmaceutical is appropriate for many reasons. First, this incident occurred after a series of financial frauds in Chinese

listed companies such as Lantian Corporation, Wanfu Biotechnology, Green Earth, Zhangzi Island, Kangde Xin, etc., which means the fraudulent behaviour persists despite repeated bans as the Chinese capital market has grown rapidly in recent years (Zhang, 2023). The disturbing trends warn public stakeholders to pay more attention to the relevant industry. Meanwhile, the repetitive occurrence of such incidents also indicates a lack of enforcement of the regulations, which is also a crucial factor beyond low public awareness. Under such circumstances, the revelation and analysis of Kangmei Pharmaceutical fraud are critical to understanding the formulation of financial fraud in enterprises and how fraud control samples failed to prevent it.

Second, when examining Kangmei Pharmaceutical's detailed ownership structure, a disturbing discovery is made: the company is solely controlled by a single person, Ma Xingtian, with his wife as an affiliated person (Li, 2024). As a result, the imbalanced ownership structure contributed to Kangmei Pharmaceutical's vulnerable internal control and offered opportunities for the Ma couple, as the top management, to commit fraud.

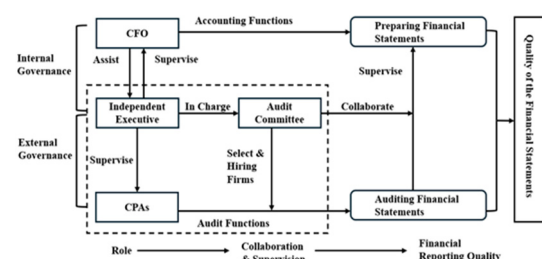
Finally, according to the China Securities Regulatory Commission (CSRC) release, the audit partner, Zhengzhong the Pearl River, failed to detect material misstatements presented in Kangmei Pharmaceutical's financial statements and issued standard unqualified opinions on the 2016 and 2017

annual reports, which led to the serious audit failure and subsequent financial fraud (Ye, Bai, & Xue, 2022). Therefore, Kangmei Pharmaceutical's financial fraud is a typical example of a firm's misconduct due to weak corporate governance and auditors' misconduct. This paper will examine the relationship between the internal audit quality and the control effectiveness of Kangmei Pharmaceutical's corporate governance and potential enterprises' fraudulent behaviours.

2 DEFINE INTERNAL AUDIT AND FINANCIAL FRAUD

2.1 Internal Audit Quality and Audit Committee Functions

With growing concern regarding a series of financial frauds in the Chinese enterprise market within the past decades, the role of internal audit (IA) has evolved and expanded into massive activities associated with corporate governance, as it provides effective internal control systems, which makes a strong corporate governance mechanism and enables greater trust from the external auditors in internal settings (Ferrari, Cunha, & Boff, 2023). Based on the International Financial Reporting Standards (IFRS) requirements, all listed companies should form an Audit Committee involving key components that at least three members presented in the committee, all members are independent executives, and at least one member obtains financial expertise (Krishnan, 2005). Per IFRS, public companies must appoint an audit committee to hire external auditors who obtain a Certified Public Accountant (CPA) license to become audit partners and conduct financial statement audits to convince investors and stakeholders to trust the firm's financial conditions.



Alt Text for Graphical Figure: A diagram showing the complete accounting system involving accounting and auditing functions from the internal and external governance angles.

Figure 1: Theoretical Framework of Firms' Effective Accounting System (Ye et al., 2022).

Figure 1 shows that firms can enhance financial statement quality only when internal and external governance cooperate well in the circled area. As a key functional department involving internal and external governance, the effectiveness of the audit committee is critical.

2.2 Financial Fraud Theories

The theoretical approach mainly includes the Fraud Triangle Theory and the GONE Theory. Of all three factors contributing to potential fraud, pressure is the majority cause due to firms' need to meet the financial forecasting, compensation and incentive structures, external financing, or poor performance (Hogan, Rezaee, Riley, & Velury, 2008), while weak internal control will offer opportunities for top management to manipulate revenues and earnings to attract more investors. Besides, justification factors allow some excuses to justify themselves as "reasonable" when committing fraud. In contrast, the GONE theory supposes individuals are profit-seeking, and their behavior is rational; if there is an opportunity and they believe it will be difficult to be exposed in the future, they will inevitably engage in fraudulent actions (Luo, 2020).

2.3 The Relationship Between IA Quality and Financial Fraud

Compared to companies without fraud, companies that commit fraud typically have either no audit committee present or the members of the audit committee are not entirely independent directors who receive financial benefits such as stock options from the company (Beasley et al., 2000). Furthermore, a larger audit committee involving more independent directors would have more expertise in terms of diversity to provide more objected decision-making and enhance accountability and oversight since more independent members in the audit committee also reflect more time, finances, and administrative support (Pasko, Zhang, Pyzhikova, & Mykhailova, 2024). The hypothesis test shows that the two distinct but important aspects of the internal audit function, competence and independence, jointly strongly improve financial reporting quality (Abbott, Daugherty, Parker, & Peters, 2016), supporting the above finding. Moreover, firms with a well-organized audit committee typically have strong internal control and IA quality, as mentioned above, which enhance corporate governance to reduce the incentive for fraud. For this reason, high IA quality greatly reduces the opportunity fraud factors and helps organizations construct a healthy corporate environment.

3 EVIDENCE FROM KANGMEI PHARMACEUTICAL

3.1 Company Background

Kangmei Pharmaceutical was founded in 1997 by Xu Yanjun and Xu Dongjin. However, Xu's spouse, Ma Xingtian, physically controlled the company as the sole director. In 2001, the company successfully went public and was listed on the Shanghai Stock Exchange. During the past two decades, Kangmei Pharmaceutical has mainly produced and sold traditional Chinese medicine, chemical drugs, health

food, purchased products, and Chinese medicinal materials. As of 2018, 154 companies were included in its consolidated financial statements, with 46 newly included, 33 newly formed and 13 newly merged (Luo, 2020), making the company one of the major operators in China's pharmaceutical industry. However, in October 2018, Kangmei was accused by several financial analysts and journalists of manipulating and falsifying its operating revenue, stock inventories, cash and other current assets.

As shown in Table 1, a series of investigations was launched, leading to a tremendous fraud sequence.

Table 1: Timeline of Kangmei Pharmaceutical's Fraud (Ye et al., 2022).

Stage	Timeline	Significant Event
Stage I	October 2018 – December 2018	The financial analysis article questioning Kangmei Pharmaceutical's fraud has been released, and the firm's stock price has declined significantly. On Dec 28 th , 2018, the CSRC investigated Kangmei Pharmaceutical's violation of information disclosure regulations.
Stage II	April 2019	Kangmei Pharmaceutical has released its 2018 annual report and announcement on correcting accounting errors in the previous period, with nearly 30 billion yuan of funds missing.
Stage III	May 2019 – November 2021	The Shanghai Stock Exchange issued a letter of inquiry in May 2019, and the CSRC issued a notice of investigation to Zhengzhong Pearl River. On May 14 th , 2020, the CSRC issued the "Administrative Penalty Decision" and "Market Ban Decision" to Kangmei Pharmaceutical. On Nov 12 th , 2021, the Guangzhou Intermediate People's Court made a first-trial judgment on the class action lawsuit.

The audit partner of Kangmei Pharmaceutical since 2001 is Zhengzhong Pearl River Accounting Firm. Zhengzhong Pearl River, founded in 2000 and registered in Guangzhou, is one of the earliest accounting firms in China. In 2013, the firm switched from a limited liability partnership (LLP) to a general partnership (GPP). Since then, Zhengzhong Pearl River has ranked 22nd in the "2018 Top 100 Accounting Firms by Business Revenue" released by the China Association of Certified Public Accountants (CACPA) and obtained 91 clients by the end of 2018 (Luo, 2020). However, such a famous CPA firm fails to detect the abnormal transactions in Kangmei Pharmaceutical's 2016-2018 annual report, thus consequently being blamed by CSRC for the other party responsible for Kangmei's financial fraud. Therefore, the following sections will analyze the details of Kangmei Pharmaceutical's fraud from both IA and governance perspectives and follow the fraud risk factors to determine the ultimate cause and the aftermath of this incident.

3.2 Assessment of the IA Quality

First, since Zhengzhong Pearl River failed to detect the falsified financial statement prepared by Kangmei Pharmaceutical, the primary focus is on Kangmei's internal audit department to determine whether they adequately oversee the board and monitor the external audit. When examining the company's board structure and the audit committee, the first concerning factor is the threat of independence. The three audit committee members, Luo Jiaqian, Ma Huanzhou, and Wen Shaoqian, all have management positions within the company, which means they are not independent executives, causing the audit committee to lose its independence completely (Zhang, 2023). Additionally, two of these executives are of senior age (Zhang, 2023), making people question their competence to adequately monitor the company's accounting department and provide sufficient supervision to the IA. On the other hand, Zhengzhong Pearl River has been Kangmei's audit partner for 17 years, making the external auditors also face the familiarity risk, in which auditors become too familiar with the client's transactions to detect any

material misstatements. The reason why Kangmei Pharmaceutical was reluctant to switch partners may be due to the consideration of lowering the audit fee because auditors are risk-oriented; when companies experience increasing risks, such as rapid growth, organizational instability, and financial complexity, the audit cost will increase due to the extra work performed by the auditors (Bentley, Omer, & Sharp, 2013). Based on the information above, Kangmei Pharmaceutical has the above characteristics since it grew rapidly as of 2018, and in that single year, it also had complex transactions such as consolidations. Hence, the management had incentives to reduce the audit cost for not switching audit partners for a long time, even though the accounting industry recommends that firms regularly switch audit partners every five to ten years to avoid familiarity risk. Since Zhengzhong Pearl River has been Kangmei's audit partners for almost twice the recommended time frame, their audit failure is foreseeable. Therefore, the external audit failure is another vital evidence that the IA quality of Kangmei Pharmaceutical is seriously inadequate, as the audit committee should have monitored and prevented such events by notifying the board beforehand.

3.3 Assessment of the Corporate Governance and Internal Control

Subsequently, susceptors also point out that the controller of Kangmei Pharmaceutical deliberately selected those who were too old to maintain sufficient supervision and empowerment to be the audit committee members to undercut its function when committing fraud, leading to questions about Kangmei's corporate governance and control. In 1999, The Blue Ribbon Commission (BRC) listed various factors from the board's characteristics that could affect the audit committee's effectiveness, such as composition, independence, knowledge and expertise, effectiveness, power, duties and responsibilities, and the association between board characteristics and earnings manipulation and fraud (Cohen, Krishnamoorthy, & Wright, 2004). By closely investigating Kangmei's board structures, there is a high functional overlap between the controllers and the top management. The board chairman, Ma Xingtian, also worked as the company's CEO, with his wife, Xu Dongjin, the top manager, meaning they monitored their own work. Compared to the Ma couple, none of the other shareholders own more than 5% of the company shares, which means Ma has dominant control over the decision-making and financial forecasting of the entire company, and other executives cannot counteract his irrational movements (Li, 2024).

Furthermore, the ownership structure has created conditions for the Ma couple, as major shareholders, to fully control the board decisions. Since they have authority over the appointment, removal, and compensation of members of the supervisory board and audit committee through the shareholders' meeting, the audit committee virtually have no supervisory to effectively constrain the Ma couple as they were not independent directors (Liang, 2021), which led to serious internal control deficiencies and a lack of corporate governance within the company. Another indication is that the three audit committee members held positions in Kangmei Pharmaceutical, which significantly deteriorated the independence, a crucial factor in the audit committee's ability to confront management and effectively collaborate with external auditors (Cohen et al., 2004), consequently minimizing control effectiveness.

3.4 Assessment of the Fraud Risk

Eventually, from the theoretical framework, these control weaknesses provide board incentives and opportunities for the Ma couple to manipulate the company's earnings and falsify the financial statements over many years.

Applying the fraud triangle theory, the external incentives mainly came from the financial pressure since the company was rapidly growing. By the end of the second quarter of 2018, Kangmei Pharmaceutical had tripled its total assets compared to five years ago through investment. As of December 31, 2018, the company had borrowed nearly 29.1 billion Chinese yuan (CNY), and the top ten shareholders of Kangmei almost pledged all their shares (Wang, 2021). As a result, pressures to obtain more funds for its operating activities and debt covenant is the Ma couple's primary incentive for financial fraud. On the other hand, the opportunity factors are also displayed internally. According to the previous analysis, a malfunctioned internal audit team lacking effective corporate governance and control opens the gate to misrepresentations in financial statements since neither the internal supervision nor the external audit detection was very effective in this case. Finally, the Ma couple also had a fluke mind in that they justified their misconduct to external factors like the company's rapid growth rather than their incentives, while the executives from the audit committee also had similar excuse as the extreme ownership and equity structures did not provide them enough motivation to perform their duties (Wang, 2021). Ultimately, all three factors contribute to a series of Kangmei's financial fraud.

Likewise, under the GONE theory, the Ma couple's excuses could be easily punctured since the company's rapid growth is not a natural movement.

Instead, as the controller, they made rapid expansion and aggressive financial movements to satisfy greed in their mind. Meanwhile, market opportunity factors also played a role since managers have incentives to misstate earnings to maintain a higher stock price (Dechow, Ge, Larson, & Sloan, 2011), exactly what the Ma couple did when engaging in fraud. In addition, the pressure factors also explain the need for them to conduct fraudulent activities because of their urgent request for funds to fulfill the company's cash flow gaps. Lastly, internal opportunities, such as insufficient supervision and regulatory enforcement, increase the overall exposure to fraud risk from an unsound system (Li, 2024).

4 REVELATIONS OF KANGMEI'S FRAUD SCANDAL

In Kangmei's financial fraud case, the Chief Financial Officer (CFO), independent executives, and the audit partners each committed dereliction of duty, together proving that the entire enterprise mechanism between all three was a total system failure. However, this case also provides valuable lessons to the Chinese and global enterprises market, especially high-risk industries, to avoid the same mistake. Hence, several recommendations and enforcement have been made by the CSRC.

4.1 Improving the Corporate Governance Structure

The primary reason for Kangmei's fraud was that the unbalanced ownership structure gave the Ma couple too much authority as the board chairman. The succession directors should allocate the equity structure more reasonably and distribute the shares evenly to all board members to avoid a single shareholder dominating the entire board's decisions. Moreover, the newly established board should ensure that an odd number of directors are present on the board, for instance, five executives before the fraud incident. In that case, a majority vote should be introduced to ensure the board decision is made in favour of the majority shareholder groups so that their decision.

4.2 Standardizing Financial Reporting Procedures

During the CSRC's investigation, there was a sequence of financial misconduct in the CFO's representation and Kangmei Pharmaceutical's financial statement presentation, meaning that the

staff in its accounting department did not perform their duties per IFRS requirements and under accounting conceptual frameworks. Thus, the company should also increase staff training to ensure they have adequate financial expertise to follow the required accounting procedures when preparing financial statements. Ethical training should also be introduced on a staff working basis to increase the moral status of financial employees and reduce the likelihood of fraud. At the same time, extra attention should be paid to external auditors' independence and competence to avoid the case of Zhengzhong Pearl River's corruption with Kangmei's top management and violating the professional code of conduct as a CPA.

4.3 Enhancing the Audit Committee's Functions to Improve IA Quality

While notable action was taken to improve the external auditor's expertise, the IA department should be emphasized more when reconstructing the corporate environment. Without internal audits' unique efforts and expertise in companies' organizational operations, the organization would experience significantly more disclosures of material weaknesses and revelations of financial noncompliance (Holt & DeZoort, 2009), which heavily reduces the effectiveness and efficiency of external auditors. The U.S. Security Exchange Commission (SEC) officials have repeatedly emphasized the importance of the internal audit function to the success of a company's fraud prevention and financial statement fair representation (Holt & DeZoort, 2009). Kangmei Pharmaceutical's newly elected board should take subsequent actions to reconstruct the audit committee by ensuring that at least three members of the board's independent directors regularly perform their duties with at least one obtained financial expertise.

4.4 Establishing a Comprehensive System for Corporate Mechanisms Cross-Monitoring One Another

Accordingly, the ultimate cause of Kangmei Pharmaceutical's fraud was a chain of reactions of complex system failure when all three components regarding the corporate governance, IA, and external auditors simultaneously failed in the corporate mechanism as a whole. The company should redesign its corporate mechanisms to let all three pieces function independently from each other but collaborate well through cross-checking. Besides, external effort should also help reduce the chances of fraud and prompt companies to establish a more

functional and transparent corporate mechanism. Law enforcement departments, such as the CSRC, should tighten relevant regulations to eliminate any loopholes for potential fraud and better direct enforcement.

5 CONCLUSION

This article uses Kangmei Pharmaceutical's financial fraud as an illustrative example to conduct a detailed analysis of its IA quality and corporate governance and apply the fraud theories to determine how these factors contribute to Kangmei's significant financial fraud. Based on extensive research and analysis, the IA quality will positively influence the company's internal control and corporate governance since an effective audit committee will monitor the company's financial activities, enabling the management to act in the shareholder's interests. The audit committee can also collaborate with the external auditors, as the internal control is strong, and the external auditors will perform less audit work. They can focus more on the risky account to improve both the effectiveness and efficiency of the overall audit work. At the same time, since the audit committee members are independent board executives, they also provide the board oversight and help prevent financial fraud internally by monitoring the external auditors' work and potential fraudulent behaviors conducted by top management. Regarding the case study, Kangmei Pharmaceutical demonstrated the exact opposite side by showing its chaotic corporate governance, making single shareholders dominate the entire board, significantly weakening the effectiveness of IA quality. Without the independent audit committee member providing sufficient supervision, the top management also corrupts its audit partner and leads to serious misrepresentation in financial reporting and subsequent audit failure, making all three parties liable for committing fraud.

The revelation from Kangmei Pharmaceutical also provides the industry with valuable insights to help reduce the likelihood of financial fraud from multiple perspectives. The internal approach should focus on enhancing the staff qualifications (the CPA competence and independence) and the function of the IA Committee to improve internal control, which helps eliminate the opportunity factors for committing fraud. The board should also reinforce the ethical code of conduct and corporate by-laws to its management and employees. By improving their moral status, the corporate environment is eventually healthier. External enforcement should tighten the regulations for industries obtaining a higher inherent risk of fraud, for instance, introducing harsh

punishments and joint liabilities for all parties engaging in fraud activities or negligent duties, as the CSRC did for consequences made by Kangmei Pharmaceutical's directors and the in-charge external auditors to reduce the top management's incentives for fraud.

Finally, this case study contains limitations in that it is a single example from the Chinese capital market. As the healthcare industry naturally involves a higher inherent risk for financial fraud, the results generated by Kangmei Pharmaceutical may not be fully representative and generalized to all companies and industries. In future research, more data should be obtained from multinational-based firms to help compare the fraud trend across countries. Equally important, more case analyses through different companies should be conducted cross-industries when comparing the IA quality and corporate governance to validate the study result.

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