

Analysis of Financial Fraud in Listed Companies Based on the CRIME Theory A Case Study of Kangmei Pharmaceutical

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Abstract

Financial fraud by listed companies disrupts capital market order and impedes high-quality development of the capital market. As a highly representative large-scale financial fraud case in the A-share market, Kangmei Pharmaceutical fully exposes internal governance deficiencies and external regulatory shortcomings in family-controlled listed companies. This paper adopts the CRIME theory as its analytical framework to examine the formation mechanism of Kangmei Pharmaceutical's financial fraud across five dimensions: fraud perpetrators, fraud methods, fraud motives, supervisory mechanisms, and fraud consequences. Research findings indicate that the actual controller orchestrated financial falsification through multiple covert means. Driven by both capital expansion and personal gain, internal and external supervisory mechanisms failed simultaneously. This fraud incident not only harmed investor interests but also inflicted profound damage on the overall credibility of the pharmaceutical capital market. Accordingly, countermeasures for financial fraud prevention and control are proposed from four aspects. By optimizing assessment and incentive mechanisms, improving corporate governance structures, cultivating corporate integrity culture, and strengthening diversified regulatory models, listed companies can be assisted in effectively preventing financial fraud. It is expected that this study will provide practical references for standardized governance of the capital market.

Keywords

Listed companies; financial fraud; CRIME theory; Kangmei Pharmaceutical.

1. Introduction

While China's domestic capital market has continued to develop and expand, financial fraud by listed companies has occurred from time to time. Some enterprises have embellished their financial statements by inflating assets, fabricating revenues, and concealing related-party transactions, which not only directly harms the interests of the broad masses of small and medium-sized investors but also undermines fair market trading and impedes the standardized development of the capital market [1]. The pharmaceutical industry is characterized by difficulties in inventory verification and complex project accounting, which provides operational space for financial fraud, and the issue of financial fraud among listed pharmaceutical companies merits attention [2].

Kangmei Pharmaceutical was once a blue-chip stock with a market value of one hundred billion in China's traditional Chinese medicine industry. Its systematic financial fraud case from 2016 to 2018 caused a sensation in the capital market, with a huge fraud amount and a long duration, centrally reflecting multiple problems such as the "one dominant shareholder" structure of family-controlled listed companies, ineffective internal controls, and inadequate performance of duties by intermediary institutions[3]. This paper selects Kangmei Pharmaceutical as the

research object, relies on the CRIME theory to analyze the causes of fraud, summarizes the multifaceted harms brought by the fraud, and proposes targeted prevention and control recommendations, thereby also providing reference for risk governance of similar listed companies.

2. Relevant Concepts and Theoretical Foundations

2.1. The Concept and Types of Financial Fraud.

Financial fraud refers to deliberate illegal acts committed by responsible entities such as a company's actual controller and management, who, with the subjective intent of securing improper benefits, prepare false financial reports through means including fictitious transactions, alteration of accounting data, and concealment of major related-party matters. It is characterized by subjectivity, concealment, and high harmfulness^[4].

Financial fraud is primarily classified into two categories: financial statement fraud and asset misappropriation fraud. Financial statement fraud mainly involves window-dressing practices such as inflating revenue and profits, overstating assets, and concealing liabilities; asset misappropriation fraud predominantly refers to the misappropriation or occupation of funds of a listed company by major shareholders or management, theft of corporate assets, and the direct tunneling-out of the listed company, thereby harming the interests of all shareholders^[5].

2.2. The Core Elements of the CRIME Theory

The CRIME theory, proposed by the American scholar Zabihollah Rezaee, comprises five key elements: C (Cooks) – the perpetrators of fraud, namely the actual controllers, management and key staff who carry out or orchestrate the fraud; R (Recipes) – the methods of fraud, i.e. the specific operational techniques used by enterprises to commit financial fraud; I (Incentives) – the motives for fraud, namely the pressures and financial incentives that drive fraudulent behaviour; M (Monitoring): the oversight mechanisms, encompassing internal corporate governance and controls, external audits, government regulation and public scrutiny; E (End Result): the consequences of fraud, namely the various negative impacts resulting from its exposure^[6]. These five elements interact with one another, providing a comprehensive explanation of the entire process of financial fraud, from its inception to its exposure.

3. Overview of the Financial Fraud Case of Kangmei Pharmaceutical

3.1. Company Profile

Kangmei Pharmaceutical was established in 1997 and listed on the Shanghai Stock Exchange in 2001. Its principal businesses encompass traditional Chinese medicine decoction pieces, trading of traditional Chinese medicinal materials, and pharmaceutical distribution. At its peak, the company maintained dozens of subsidiaries and controlled a substantial share of domestic traditional Chinese medicinal materials trading markets, positioning itself as a benchmark enterprise in the traditional Chinese medicine industry. The company was effectively controlled by the couple Ma Xingtian and Xu Dongjin, constituting a typical family-controlled listed company^[6]. Relying on continuous capital market expansion, its market capitalization once exceeded one hundred billion yuan. In later periods, in order to conceal operational pressures, the company engaged in large-scale financial fraud. In 2018, it was formally investigated by the China Securities Regulatory Commission and subsequently subjected to administrative, criminal, and civil liabilities. Only after completing reorganization did it gradually resume operations.

3.2. Disclosure Process of the Fraud Incident

As early as 2012, media outlets had raised questions regarding Kangmei Pharmaceutical's asset and profit data, but the enterprise suppressed public opinion through public relations measures. In 2018, the market persistently questioned the contradictory coexistence of the company's substantial monetary funds and high liabilities. In December of the same year, the China Securities Regulatory Commission formally opened an investigation. In April 2019, Kangmei Pharmaceutical issued a correction announcement regarding accounting errors, admitting that its 2017 annual report had overstated monetary funds by nearly 30 billion yuan, thereby fully exposing the major financial fraud. Subsequently, the Shanghai Stock Exchange imposed ST risk warning designation on the company, and the China Securities Regulatory Commission initiated comprehensive accountability proceedings against the enterprise, its actual controllers, and Zhengzhong Zhujiang Certified Public Accountants. This case also became the first special representative litigation case in the A-share market, with investors receiving substantial civil compensation [3].

3.3. Core Fraud Facts and Penalty

Outcomes According to the administrative penalty decision issued by the China Securities Regulatory Commission, Kangmei Pharmaceutical engaged in organized and systematic financial fraud from 2016 to 2018 [2].

Table 1 Major Fraud Data of Kangmei Pharmaceutical

Item	Fraud Content	Fraud Scale
Fictitious increase of monetary funds	Forging bank documents and official seals	A cumulative overstatement of 88.6 billion yuan in three years
Fictitious increase of operating revenue	Fabricating sales businesses and issuing false invoices	A cumulative overstatement of 29.128 billion yuan in three years
Fictitious increase of operating profit	Supporting false cost accounting	A cumulative overstatement of 4.101 billion yuan in three years
Fictitious increase of non-current assets	Overstating construction in progress, fixed assets and investment property	A total overstatement of 3.605 billion yuan
Concealment of related-party transactions	Non-operating fund occupation by related parties of the actual controller	Undisclosed fund occupation totaling 11.619 billion yuan

Source: Administrative Penalty Decision of China Securities Regulatory Commission

At the administrative level, the company was imposed a maximum fine of RMB 600,000, while Ma Xingtian and his spouse, along with more than twenty senior executives, were fined and subjected to market bans; Zhengzhong Zhujiang Certified Public Accountants was ordered to disgorge its business revenue and pay a fine. At the criminal level, the actual controller Ma Xingtian was sentenced to 12 years of fixed-term imprisonment under the combined punishment for multiple crimes. At the civil level, through special representative litigation, the company and relevant responsible persons were ordered to compensate investors RMB 2.459 billion, thereby establishing a trinity of administrative, criminal, and civil accountability.

4. Analysis of Fraud Causes Based on the CRIME Theory

4.1. Perpetrators (Cooks): Fraud Orchestrated by Family Controlling Shareholders Through Organized Collusion

The Kangmei Pharmaceutical fraud constitutes a typical case of family-dominated organized fraud. Ma Xingtian and his spouse collectively held 38.54% of the company's shares through multiple affiliated entities, thereby establishing absolute control over the company and placing themselves above the board of directors, the supervisory board, and independent directors. Personnel from the finance and treasury departments colluded with the controlling shareholders to forge bank documents and manipulate fund transfers, with multiple individuals jointly participating in the fraudulent activities—this was by no means attributable to isolated employee negligence. The core management exhibited a deficiency in integrity and legal awareness; the controlling shareholders had prior records of regulatory violations including bribery, reflecting an absence of ethical boundaries. The internal audit function was subordinated to management control, rendering it incapable of performing its oversight and checks-and-balances role. The highly dispersed shareholding structure among minority shareholders further impeded their ability to constrain the controlling shareholders.

Table 2 Equity Structure Related to the Actual Controllers of Kangmei Pharmaceutical

Shareholder Entity	Shareholding Ratio	Description of Control Relationship
Kangmei Industrial Investment Holding Co., Ltd.	32.83%	Controlled by Ma Xingtian and Xu Dongjin; the largest shareholder
Xu Dongjin	1.97%	Spouse of Ma Xingtian, Vice Chairperson
Two affiliated companies in Puning City	3.74% in total	Entities actually controlled by the couple of actual controllers
Total shareholding of actual controllers	38.54%	The family achieves absolute control over the listed company
Minority public shareholders	51.71%	Dispersed equity and insufficient restriction capacity

Source: 2018 Annual Report of Kangmei Pharmaceutical

4.2. Fraudulent Methods (Recipes): A Diversified Array of Tactics Forming a Closed Loop of Falsification.

Kangmei Pharmaceutical fully exploited the characteristics of the traditional Chinese medicinal materials industry, namely the considerable difficulty in inventory verification and engineering project accounting, and employed multiple fraudulent methods to form a complete closed loop. First, it forged bank documents and official seals to inflate monetary funds, thereby concealing the funding shortfall arising from the misappropriation of funds by controlling shareholders. Second, it fabricated sales contracts and issued false invoices to inflate operating revenue and profits, while simultaneously matching these with falsified cost data to align reported financial indicators with industry norms and reduce the probability of detection. Third, it recorded projects that were not yet completed and did not meet recognition criteria, thereby inflating various non-current assets to fill the book funding gap. Fourth, it concealed substantial related-party fund transactions and failed to disclose in its annual reports the fact that related parties had misappropriated funds of the listed company. The coordination among these multiple

methods enabled the fraudulent conduct to remain undetected by auditors for consecutive years.

4.3. Fraud Incentives: The Dual Drivers of Financing Pressure and Profit-Seeking Demands

First, financing needs serve as a primary driver. Amid fierce expansion and competition in the traditional Chinese medicine industry, enterprises require substantial capital for full-industry-chain deployment. Meanwhile, the controlling shareholder's equity pledge ratio is extremely high. To meet the performance thresholds for bank loans, bond issuance, and equity refinancing, and to avoid margin calls on pledged shares, enterprises need to window-dress their financial statements to secure external funding. Second, there exists the practical pressure to sustain stock prices and industry leadership. The market holds high performance growth expectations for blue-chip stocks; any decline in performance would trigger a sharp drop in stock prices, undermining corporate financing capacity and brand reputation. Finally, there is the controlling shareholder's personal profit-seeking motive: major shareholders misappropriate listed company funds through related parties for off-balance-sheet investments and debt repayment, and seek personal wealth appreciation by maintaining high stock prices, all at the expense of the listed company and minority investors.

4.4. Monitoring Mechanisms: Dual Failure of Internal and External Oversight.

With respect to internal oversight, the dominance of a single controlling shareholder resulted in a breakdown of corporate governance. The board of directors, the supervisory board, and independent directors were unable to discharge their duties independently, internal control systems became merely formalistic, and approval of large-sum fund transfers and control over related-party transactions were left unconstrained. The internal audit department lacked independent status and was incapable of conducting substantive verification. At the level of external oversight, Zhongzheng Zhujiang Certified Public Accountants (Special General Partnership) had long undertaken audit engagements while having lost independence, failed to perform effective confirmation procedures for substantial monetary funds, and issued unqualified audit opinions for multiple consecutive years, resulting in a failure of intermediary oversight. Under the former Securities Law, the maximum fine for corporate fraud was merely RMB 600,000. Against fraud amounts reaching tens of billions, the cost of illegality was excessively low and deterrence was insufficient. In addition, the high degree of difficulty in asset verification in the Chinese medicinal materials industry further increased the difficulty of regulatory identification. The superposition of multiple loopholes enabled the fraud to persist for many years.

4.5. Consequences of Fraud (End Result): Multiple stakeholders suffered severe damage.

At the corporate level, following the exposure of the fraud, the company's market capitalization, valued in the hundreds of billions, evaporated substantially, its brand reputation collapsed, its financing channels were severed, and its operations fell into distress, with multiple responsible individuals receiving legal punishment. At the investor level, numerous retail investors who had made investment decisions based on falsified financial statements incurred substantial losses; although they obtained compensation through class action litigation, market investment confidence was severely undermined. With respect to intermediary institutions, the reputation of Zhengzhong Zhujiang Accounting Firm collapsed, accompanied by a massive loss of clients. At the industry and societal levels, the incident eroded trust in the capital market while exerting adverse effects on the supply chain of traditional Chinese medicinal materials and the industry's credit environment, exposing deficiencies in the governance and regulation of family-controlled listed companies.

5. Financial Fraud Risk Prevention and Control Countermeasures

5.1. Optimizing the Performance Evaluation and Incentive Mechanism

Listed companies should abandon the profit-only and revenue-only evaluation orientation, establish a diversified evaluation system, and incorporate such non-short-term financial indicators as cash flow quality, internal control compliance, and information disclosure quality, so as to reduce management's excessive pursuit of short-term performance. A deferred payment system for management performance bonuses should be implemented, under which bonuses may only be paid after independent auditing confirms the authenticity of financial data, thereby curbing management's short-term fraudulent impulses. The pace of corporate expansion should be reasonably controlled, and the proportion of equity pledges held by major shareholders should be reduced, so as to alleviate from the source the fraud incentives arising from financing pressure.

5.2. Improving Corporate Internal Governance Family-controlled

enterprises should optimize their equity structure, introduce institutional investors, and appropriately dilute the excessively high shareholding of actual controllers, thereby mitigating the problem of a single dominant shareholder. The independence of independent directors and internal audit departments should be safeguarded, and internal audit departments should be granted the authority to report major leads directly to regulatory authorities. Approval procedures for large-amount capital expenditures and related-party transactions should be improved, cross-review across multiple positions should be implemented, and the risk of related-party fund misappropriation should be strictly controlled. Regular internal control self-inspections should be carried out to promptly identify governance loopholes, ensuring that internal control systems are effectively implemented rather than merely remaining on paper.

5.3. Cultivating a Corporate Culture of Integrity and Compliance

Enterprises should establish a top-down business culture of integrity and compliance, with management setting an exemplary tone for compliance. Regular warning education based on financial fraud cases and legal training should be conducted for key positions such as senior executives, finance, and treasury personnel, clarifying the legal consequences of financial falsification. Integrity and compliance should be incorporated into employee performance evaluation and promotion assessment, a mechanism for accountability in cases of dishonesty should be established, and ethical constraints should be integrated into daily management, thereby reducing the likelihood of fraud at the ideological level.

5.4. Strengthening Multi-Dimensional External Supervision Regulatory

authorities should leverage big data technology to build a dynamic risk monitoring system for listed companies, enabling early warning of abnormalities in monetary funds, related-party transactions, and financial indicators. The responsibilities of intermediary institutions should be firmly enforced, the audit rotation system should be strictly implemented, and heavier penalties should be imposed on audit institutions that fail to exercise due diligence, with such failures recorded in industry blacklists. The new Securities Law should be fully implemented, administrative penalties, civil recovery, and criminal accountability for financial falsification should be intensified, and the cost of violations should be raised. Public reporting channels should be kept open, and a multi-stakeholder supervision system involving government regulation, intermediary institutions, and public participation should be constructed.

6. Conclusion

Drawing on CRIME theory, this paper analyses the financial fraud case involving Kangmei Pharmaceutical from five dimensions: the perpetrators, methods, motives, supervision and consequences. The research indicates that the actual controller spearheaded the financial fraud through multiple covert means. Driven by both capital expansion and personal gain, both internal and external oversight mechanisms failed. This fraud incident not only harmed investors' interests but also dealt a profound blow to the overall credibility of the pharmaceutical capital market.

Preventing financial fraud in listed companies is a systemic endeavour. Internally, enterprises need to optimise equity and performance appraisal mechanisms, strengthen internal control governance, and foster a culture of integrity. At the external regulatory level, digital tools must be utilised to enhance detection capabilities, the responsibilities of intermediaries must be reinforced, and the costs of non-compliance must be increased; only through multi-stakeholder collaboration can financial fraud be curbed. As this paper analyses a single case within the pharmaceutical sector, it has certain limitations; future research could expand the sample size to conduct comparative studies on corporate fraud across different industries.

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