

# Zhengzhong Zhujiang to Kangmei Pharmaceutical Audit Failed

Yang Li, Ping Qin

College of Management, Sichuan University of Science and Engineering, Yibin, China

---

## ABSTRACT

In recent years, the problem of corporate financial fraud is frequent, and accounting firms as an independent third party, should be to improve the quality of accounting information disclosure of listed companies, state-owned enterprises and financial enterprises, but more and more accounting firms are involved. Therefore, this paper through Zhengzhong Zhujiang certified public accountants in the analysis of kangmei pharmaceutical audit failure cases, aims to help auditors more comprehensive consider the main influencing factors of audit failure, insight into the main problems existing in the audit, for the similar problems related subject to improve Suggestions, help effectively reduce the possibility of audit failure.

## KEYWORDS

Zhengzhong Zhujiang; Kangmei pharmaceutical; Audit failure

---

## 1. INTRODUCTION

In May 2018, the market value of Kangmei Pharmaceutical Co., Ltd. was as high as 139 billion yuan, and in January 2019, the total market value was only 35.613 billion yuan. As a leading enterprise of Chinese medicine decoction pieces in China, why did the market value lose 103.387 billion yuan in just 8 months? Why did Guangdong Zhongzhong Zhujiang Accounting Firm, which provides annual audit service for Kangmei Pharmaceutical for 18 consecutive years, be cancelled from its practicing certificate? What is the connection between the two?

## 2. THEORETICAL RESEARCH RELATED TO AUDIT FAILURE

### 2.1. Definition of Audit Failure

At present, the academic definition of audit failure is divided into result failure theory and process failure theory. According to the result failure theory, the audit failure should be judged according to whether the audit opinion is the same as the auditee, only based on the result, regardless of whether the certified public accountants carry out their work in accordance with the requirements of the audit standards. Process failure argument, should be according to the certified public accountants in the audit whether comply with the audit standards to determine whether the audit failure, as long as the certified public accountants perform the reasonable audit procedures for the appropriate audit evidence, and based on the audit opinion, even if certified public accountants failed to find major misstatement in financial statements, finally issued with the facts of the audit opinion, also does not belong to the audit failure.

Despite the differences between the two views, whether the audit opinions are consistent with the financial situation of the audited units is taken as an important reference. In addition, the publication of audit opinions is based on the premise of the audit procedures implemented in the audit process,

and the two are closely related, and the process and results should be studied together. To sum up, this paper will mainly discuss the "process failure theory" to analyze the related factors of Kangmei pharmaceutical audit failure.

## 2.2. Main Reasons for Audit Failure

Considering that accounting firms to certified public accountants audit work review, undertake the different responsibilities in the audit work, should be analyzed to them, therefore, can be the cause of the audit failure case is divided into four aspects, respectively is the auditees, certified public accountants, firm and external regulation. This paper will take the practical case as an example to analyze the audit failure factors of Kangmei Pharmaceutical industry, in order to find out the relevant problems existing in the audit work.

## 3. ANALYSIS OF AUDIT FAILURE OF KANGMEI PHARMACEUTICAL

### 3.1. Financial Fraud Analysis of Kangmei Pharmaceutical Company

#### 3.1.1. Inflated monetary funds

From January 2016 to June 2018, In Kangmei Pharmaceutical's 2016 Annual Report, 2017 Annual Report and 2018 semi-annual Report, the monetary funds were 22.549 billion yuan, 29.944 billion yuan and 36.188 billion yuan, Accounting for 41.13%, 43.57% and 45.96% of the total assets disclosed in the corresponding reporting period, 76.74%, 93.18% and 108.24% of the disclosed net assets, Its means of inflated monetary funds is simple and crude, Documents directly by forging or altering relevant bank documents, Such as large certificates of deposit or bank statements, Or by means of false financial accounting, In order to achieve the purpose of forging sales collection with the inflated income.

**Table 1.** Comparison of monetary fund correction data of Kangmei Pharmaceutical from 2016 to 2018

report item	Semi-annual report in 2018	In 2017	In 2016
Before correction monetary funds (yuan)	39,885,402,608.21	34,151,434,208.68	27,325,140,365.21
corrected monetary funds (yuan)	3,697,363,248.71	4,207,124,387.23	4,776,626,879.79
disclosed total assets (yuan)	78,738,051,902.70	68,722,020,630.61	54,823,896,576.81
disclosed net assets (yuan)	33,433,784,699.90	32,134,974,060.05	29,383,127,034.14
falsely increased amount (yuan)	36,188,039,359.50	29,944,309,821.45	22,548,513,485.42
ratio of disclosed total assets%	45.96	43.57	41.13
ratio of disclosed net assets%	108.24	93.18	76.74

Data source: Kangmei Pharmaceutical Regular Report and Administrative Punishment Decision of CSRC (2020) No.24

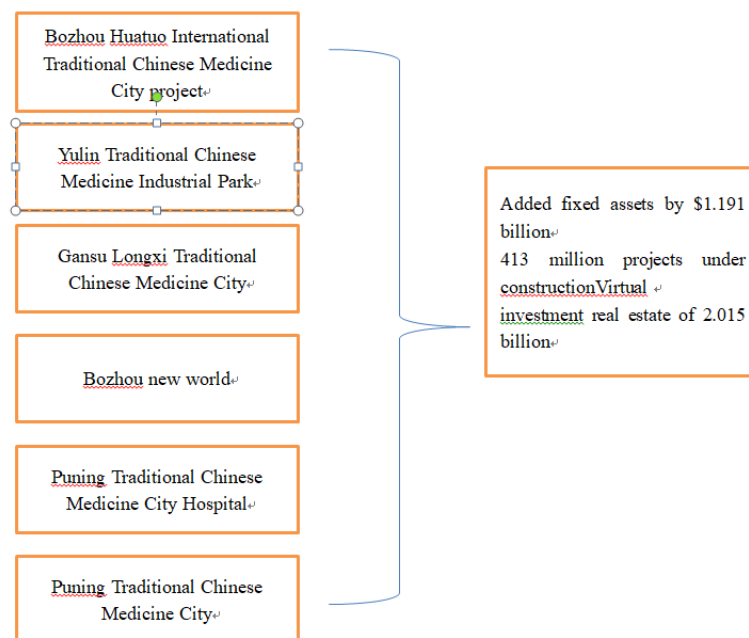
In 2017 annual report as an example, kang mei pharmaceutical can be used to pay bank deposits more than 34 billion yuan, but this part of the funds generated interest income is only 270 million yuan, the annualized yield is only 0.8%, slightly higher than current deposit interest, under normal circumstances to buy current finance about 2% -3% yield, indicating the possibility of inflated bank deposits. As can be seen from the trend of the proportion of inflated assets to disclosed assets, the

ratio of inflated monetary funds to disclosed assets of Kangmei Pharmaceutical increased year by year, accounting for 76.74% of disclosed net assets in 2016 to 108.24% in 2018.

### 3.1.2. Deflate fixed assets

According to the investigation results of the CSRC, there are significant false records in the financial statements of Kangmei Pharmaceutical in 2018. well-being

Of the 2.831 billion yuan under construction recorded in the annual report of American Pharmaceutical, 413 million yuan is used for the construction of the smart medical service center, which has been highly advocated by Ma Xingtian, the actual control of the company. However, compared with the audit report issued by Zhengzhong Zhujiang Accounting Firm, no audit vouchers related to the construction project are found, which means that the amount of the project under construction is inflated. In addition, Kangmei Pharmaceutical confirmed the projects that were not qualified as fixed assets and investment real estate, making the amount of fixed assets more than 1.191 billion and the amount of investment real estate 2.015 billion. The projects involved are six projects such as Bozhou Huatuo International Traditional Chinese Medicine City project. The specific situation is shown in Figure 3.



**Figure 1.** Schematic diagram of the long-term asset accumulation of Kangmei Pharmaceutical Company

### 3.1.3. The inflated inventory

In recent years, with the rapid development of the pharmaceutical industry, the proportion of inventory in the total assets of most pharmaceutical enterprises has been declining year after year, while the proportion of inventory in the total assets of Kangmei Pharmaceutical has been increasing year by year. Due to the natural nature of Chinese herbal medicine, it is difficult to check the value of its inventory, and accurate pricing is difficult, so biological assets are commonly used by TCM enterprises to fake. Since 2010, kang mei pharmaceutical biological assets rising trend, by the end of 2018 has been as high as 3.6 billion yuan, after kang mei pharmaceutical through borrowing to continue hoarding of Chinese medicine, the inventory even reached 23.292 billion yuan, in the same period the pharmaceutical industry average inventory accounted for only 12% of the total assets, kang pharmaceutical inventory in 2018 the proportion of total assets has reached more than 50%. In terms of the previous sales level and operating performance, such a large amount of inventory has not been sold out for more than 30 years, which is obviously not reasonable. In addition, the company did not set aside corresponding impairment provisions for its biological assets, nor did it give a detailed

explanation on the growth cycle of ginseng. All indications indicate that Kangmei Pharmaceutical carried out financial fraud by inflated inventory.

### **3.2. Audit Failure of the Zhengzhong Zhujiang**

#### **3.2.1. The audit opinion issued by Zhengzhong Zhujiang is inappropriate**

In the 2016,2017,2018 annual report of Kangmei Pharmaceutical, there were false records of inflated operating income and monetary funds. The audit opinions issued by the financial reports of Kangmei Pharmaceutical in 2016,2017 and 2018 in 2017,2018 and 2019 are inconsistent with the reality.

#### **3.2.2. In the audit process of the 2016 and 2017 annual statements, Zhongzhong Zhujiang has not obtained sufficient audit evidence**

As the pharmaceutical supply chain system of Kangmei Pharmaceutical, Jieke is connected with the industry regulatory authorities. However, Zhongzhong Zhujiang Company did not audit it in accordance with the established audit plan according to the requirements of the audit standards, and did not confirm the difference between the system and Kingdee EAS system, nor did it confirm the correlation between the two systems. In the internal control test and the substantive procedures, it only obtained the audit evidence of Kingdee EAS system, did not consider the data of Jeco system, and did not explain it. Therefore, the audit evidence obtained is not sufficient.

#### **3.2.3. There are defects in the audit of the 2016 —— 2018 financial statements of Kangmei Pharmaceutical**

##### **(1) Wrong risk identification and assessment results, and some audit papers are defective**

In the audit process of Kangmei Pharmaceutical from 2016 to 2018, there were risk identification and assessment defects of different degrees. In 2016,2017 annual report in the process of audit, Zhengzhong Zhujiang to kang mei pharmaceutical overall risk rating is moderate, monetary funds due to the existence of obvious "loan twin" and the final balance, operating income, the characteristics of complex transaction, there are fraud risk, but Zhengzhong Zhujiang turned a blind eye, did not identify the existence of fraud risk. In the audit of the 2018 annual report, although The overall risk rating of Kangmei Pharmaceutical was "significant risk", it did not rate the revenue of the pharmaceutical trade, while Kangmei Pharmaceutical's Chinese herbal medicine trade business was not recorded in its business management information system —— Jike System.

##### **(2) Defects in monetary capital risk response measures**

###### **1) There are significant risks in the internal control test procedures**

First, one of the control points is "the control of current reconciliation", which is mainly based on the data of Jike system for customers, suppliers, sales department, procurement department and financial department. The audit paper of the internal control test recorded that the auditor consulted the Statistical Table of Sales Collection and the Statistical Table of Procurement Payment on the spot, and there was no corresponding audit evidence on the single audit paper, proving that it was not implemented.

The second is one of the control points, "fund reconciliation". Zhengzhong Zhujiang only performs internal control test procedures for bank deposit reconciliation, excluding cash reconciliation, which cannot achieve the audit goal of the whole control point. However, when evaluating the internal control of the monetary capital activities of Kangmei Pharmaceutical, the evaluation was concluded that the control activities were effective and implemented. The evaluation was not supported by sufficient and appropriate audit evidence, and the evaluation conclusion was inappropriate.

## **4. ANALYSIS OF THE REASONS FOR THE AUDIT FAILURE**

### **4.1. Lack of Independence of Certified Public Accountants**

Independence is the soul of the CPA audit. If the independence cannot be maintained, the accountants cannot carry out the audit work objectively and impartially, and the subsequent professional judgment and the implementation of the audit procedures will lose the foundation.

To some extent, the subject of the auditor damages the independence of the auditor. Since the listing of Kangmei Pharmaceutical, Zhengzhong Zhujiang has audited its financial statements for a long time, and the cooperation time is nearly 20 years. In the 20 years of audit process, Zhengzhong Zhujiang should have a full understanding of the financial situation of Kangmei Pharmaceutical. However, on the premise that the third party constantly raised questions from Kangmei Pharmaceutical, Zhongzhong Zhujiang issued a standard unqualified audit report to Kangmei Pharmaceutical before the publication of the 2017 annual report of Kangmei Pharmaceutical. Years of audit service have made Zhongzhong Zhujiang a close partner of Kangmei Pharmaceutical. The close relationship and interests lead Zhongzhong Zhujiang to relax its vigilance and despise the independent compliance, which finally leads to the failure of audit.

### **4.2. No Professional Doubt Was Maintained**

First of all, the final balance of monetary funds of Kangmei Pharmaceutical is large, and the signs of "double high deposit and loan" are very obvious, indicating that there are a large number of deposits and funds on the account, but at the same time, there are a large number of liabilities. Such abnormal signs of fraud should attract the attention of certified public accountants. Secondly, Kangmei Pharmaceutical has complex revenue sources, including a large number of related party transactions, which should be included in the key areas of risk assessment. Finally, there are problems in bank correspondence certificate and accounts receivable, such as abnormal bank reserved seal, and different recipients of replies involving the same person. Zhongzhong Zhujiang did not give due attention to all these factors, nor did it maintain due professional suspicion.

### **4.3. Audit Procedures are A Mere Formality**

#### **4.3.1. Bank confirmation procedures are not implemented in place**

In the kang pharmaceutical in 2017 and 2018 annual review, Zhengzhong Zhujiang are the corresponding correspondence program, namely the kang pharmaceutical bank deposit correspondence to the bank, and received the reply, but the audit program only stay in form, Zhengzhong Zhujiang is not fully comparative analysis of correspondence content. For example, the monetary capital of Kangmei Pharmaceutical is 34.151 billion yuan, accounting for 49.7% of its total assets, which is very abundant capital compared with other enterprises in the industry, however, there are 11.37 billion yuan in the account of Kangmei Pharmaceutical, "high deposit and loan" is questionable.

#### **4.3.2. Insufficient implementation of revenue recognition audit procedures**

The investigation found that Kangmei Pharmaceutical designed a complete set of process to increase revenue. In the audit itself, revenue is the area that needs the focus of auditors. In the face of the obvious income fraud means of Kangmei Pharmaceutical, CPA only said that they cannot make a clear judgment due to the inconsistent internal and external audit evidence, and did not implement further audit procedures to dig into the problems.

#### 4.3.3. Unreasonable programming of inventory supervision plate

In the audit process, special attention should be paid to inventory, especially the high proportion of Kangmei Pharmaceutical. However, in the audit process, Zhujiang only designed the general monitoring plan, and did not pay attention to the possible specific risks. In addition, in the process of inventory monitoring, Zhengzhong Zhujiang only selected certain quantity or large volume of inventory items, and did not announce the selection proportion. In addition, Zhongzhong did not question the authenticity and reliability of the inventory list provided by Kangmei Pharmaceutical.

## 5. INSPIRATION

### 5.1. Strengthen the Modern Risk-Oriented Audit Mode, and Improve and Strictly Implement the Audit Procedures

Modern risk-oriented audit theory can better reveal the real operation situation of enterprises. Modern risk-oriented audit closely links the strategic management, operation management and strategic decision-making of enterprises, and also closely links the whole process of operation of an enterprise from top to bottom. From the perspective of comprehensive supervision of the audit work of the company from the perspective of actual operation and management is also an important theory of perfectly combining operational risk and audit risk according to the development of modern enterprises, so that more audited personnel can apply it to reality to carry out audit work. Through the comprehensive statistics of the historical evolution, development prospect, professional ability and professional ethics of the management level, layer by layer accumulation, comprehensive analysis of the risks of the audited units, so as to achieve the purpose of reducing the audit failure.

### 5.2. Innovate Audit Methods and Improve the Application of Big Data Audit

With the development of social economy, accounting is becoming more and more complex, and the audit work is becoming more and more difficult to carry out, and the requirements of audit methods are getting higher and higher. Traditional audit methods and audit technology are more and more difficult to keep up with the rapid development of enterprises, and the cases of audit failure are common. In this case, it is very important to innovate the audit methods and improve the application of big data audit.

Therefore, auditors can use targeted and innovative audit procedures when auditing pharmaceutical manufacturing enterprises. For example, for the inventory of large inventory of Kangmei Pharmaceutical, the auditor can prevent the time difference from fictitious inventory. For consumable biological assets, we should be more cautious, innovate audit methods and techniques, such as drone photography, improve the application of big data audit scope and scenarios, using big data computer technology to identify the types and quantity of Chinese medicinal materials, so as to make better inventory of inventory-consumable biological assets.

### 5.3. Enhance the Professional Competence of Auditors and Maintain Professional Doubts

Among the factors leading to audit failure, auditors' inability to maintain professional suspicion and lack of professional competence are the direct causes of audit failure. Many accountants ignore knowledge updating in their career, often rely on "old" to complete various audit projects, do not learn new audit standards, may neglect to identify common fraud means, neglect to deal with high-risk audit problems, and may paralyze the control of audit quality. All of these are potential factors contributing to audit failure. Therefore, it is necessary to strengthen the professional competence of CPA, maintain professional suspicion, and improve the prudence of audit projects.

## 5.4. Break the Disadvantages of Continuous Audit and Improve Audit Independence

In order to avoid the disadvantages of continuous audit, compulsory measures and measures for rotating audit institutions can be introduced to avoid long-term cooperation between listed companies and an audit institution, so as to prevent the practice of "transitional auditors" of the same listed company. Because the new auditors and new auditors to the new audited company also exist certain strangeness, so in the audit work will take a more objective perspective, this can reduce the auditor and the audited interests collusion, avoid "audit both sides", reduce the possibility of financial fraud, so as to avoid audit failure.

No matter when, the audit of certified public accountants is an important means of social supervision, and shoulder the responsibility of maintaining the efficient and healthy development of the market economy. The frequent occurrence of major audit mistakes is worth pondering. Behind each case is the reality of the current audit work. On this basis, the future development of the audit work should sum up experience, draw lessons, pay attention to the independence of CPA professional process, and professional doubt, at the same time on this basis of increasing technology, to create a fair and transparent audit environment, finally create a good audit environment, from small to large, in-depth management, effectively avoid audit failure cases, further optimize the audit work, realize the high efficiency of the audit work, achieve high quality audit.

## ACKNOWLEDGMENTS

This work is supported by Sichuan University of Science and Engineering Graduate Student Quality Course Construction Project, Project name: Audit Theory and Practice, Project Number: D10106023.

## REFERENCES

- [1] Zhou Ping, Xiang Jun. The status quo, causes and avoidance measures of audit failure of listed companies —— Based on the statistical analysis of the punishment decision of CSRC from 2008 to 2018 [J]. Friends of the Accounting, 2020 (2): 141-145.
- [2] Yu Ying, Zhang Yu. Research on audit reputation value and audit quality problems —— Take Kangmei Pharmaceutical as an example [J]. Accounting communication, 2021 (11): 121-125 + 139.
- [3] Jin Lijun, Zhang Yimeng, Tang Xiaoli. Characteristics and risk prevention of financial fraud in Kangdexin and Kangmei Pharmaceutical [J]. Business Accounting, 2020 (24): 51-53.
- [4] Zheng Xuan. Analysis of the reasons and countermeasures for the failure of the related party audit —— Based on the 2006-2020 CSRC punishment decision [J]. Chinese Certified Public Accountants, 2022 (01): 85-88.
- [5] Ye Qinhu, Ye Fan, Huang Shizhong. Construction of financial fraud identification framework —— Based on the accounting information system and the perspective of big data [J]. Accounting Research, 2022 (03): 3-16.
- [6] Ma Jun, He Yiyao. Analysis of the impact of big data audit on accounting firms [J]. Audit and Financial Management, 2024 (04): 3739.
- [7] Zhao Lifang, Guo Kai, Wang Lei. Study on the association between diligent and responsible identification of certified public accountants and audit failure [J]. Friends of the Accounting, 2022 (24): 70-76.