

Changes of Civil Liability Risks of Audit Institutions under the Special Representative Litigation System——Take the Kangmei fraud case as an example

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Abstract. The new Securities Law proposes the concept of a special representative litigation system, increasing the efforts to protect the legitimate rights and interests of investors who are infringed upon, and the civil legal liability risks of audit institutions increase accordingly. To promote the healthy and orderly development of securities market and audit industry, this paper will take the Kangmei's fraud case, the first case in which the special representative litigation system is applied, as the starting point, and analyze the civil legal liability of the audit institution in the case, so as to explore the changes of the civil legal liability of the audit institution under the special representative litigation system, and then put forward enlightenment and suggestions for the audit institution to achieve risk reduction.

Keywords: Special Representative Litigation System; Kangmei's fraud case; civil legal obligation.

1. Background introduction

1.1. Overview of Kangmei Pharmaceutical Co., Ltd

Kangmei Pharmaceutical Co., Ltd., a private enterprise founded by Mr. Ma Xingtian in 1997, was listed on the Shanghai Stock Exchange in 2001. Kangmei's main business mainly focuses on traditional Chinese medicine decoction pieces, with the largest production scale and largest variety of traditional Chinese medicine decoction pieces in the industry. Kangmei continues to promote the construction of smart pharmacies and technological innovation, involving various key links of the entire traditional Chinese medicine industry chain, and was once a "white horse stock" in the pharmaceutical industry.

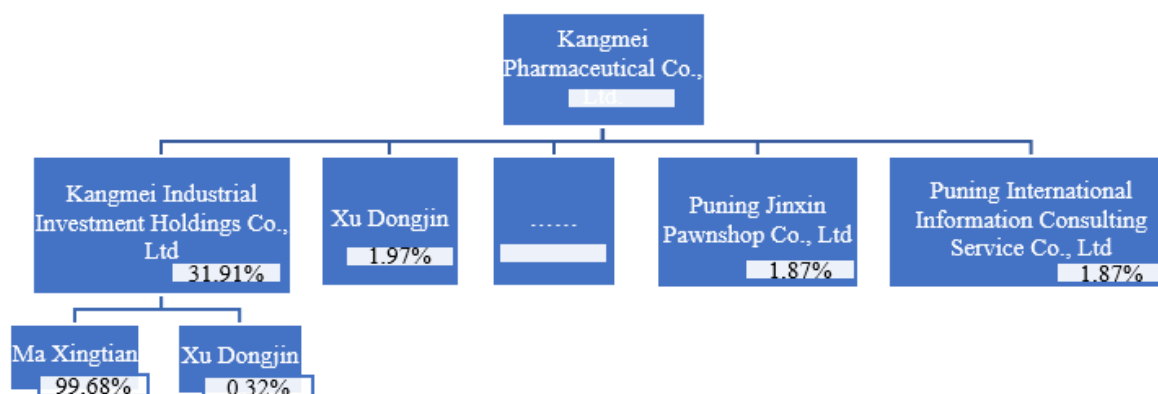


Fig 1. 2018 equity structure chart of Kangmei pharmaceutical.

1.2. Overview of Kangmei Pharmaceutical Co., Ltd

On October 16, 2018, Kangmei was exposed to have fabricated with its stock price plummeted. On December 28, 2018, Kangmei Pharmaceutical officially received the Notice of Investigation from the CSRC. On April 30, 2019, Kangmei Pharmaceutical announced that there was an accounting difference of 30 billion yuan in monetary capital and made retroactive adjustment, denying its financial fraud. Guangdong Zhengzhong Zhujiang Certified public Accountants Co.,Ltd. issued an audit report with qualified opinions on the financial report of Kangmei in 2017. On May 17, 2019,

the CSRC notified Kangmei Pharmaceutical of its illegal behaviors such as income fraud and false increase of bank deposits after filing and investigation. On August 16 of the same year, the CSRC considered that Kangmei Pharmaceutical had been subjectively and maliciously engaged in financial fraud since 2016. Given the serious circumstance, the CSRC took administrative punishment and banned Kangmei's entry into the market for life. In 2021, Guangzhou Intermediate People's Court made a first instance judgment on the lawsuit of Kangmei Pharmaceutical case, which is the first time that the special representative litigation system is applied in China.



Fig 2. Development sequence diagram of Kangmei pharmaceutical case.

2. Analysis of Legal Liability of Zhengzhong Zhujiang Accounting Firm's Audit Failure

2.1. Relevant Legal Basis

2.1.1. Joint and several liability and supplementary liability

Article 173 of the Securities Law of 2014 stipulates that if a securities service institution produces or issues documents that contain false records, misleading statements, or significant omissions, causing losses to others, it shall bear joint and several liability with the principal, except for those that can prove that it is not at fault. However, in practice, the role of this regulation is extremely limited [1]. In 2019, Article 163 of the new Securities Law continued to use this provision.

In 2007, the Supreme People's Court's "Several Provisions on the Trial of Civil Tort Compensation Cases Involving Accounting Firms in Audit Business Activities" distinguished the forms of liability under different faults and clarified that accounting firms should bear joint liability for compensation if they issue false reports "knowingly" and other subjective and intentional circumstances; its supplementary liability for compensation shall be determined according to the magnitude of its negligence, where an accounting firm negligently issues an untrue report [2]. This provision has established an important measurement standard for solving the civil liability of accounting firms in judicial practice [3]. Article 13 of the provisions of the Supreme People's Court on the trial of civil compensation cases for misrepresentation infringement in the securities market further defines that the fault in Article 163 of the securities law of 2019 is intentional and gross negligence.

2.1.2. Full and partial joint and several liability

The Securities Law does not clearly stipulate that the joint liability is "fully borne", which means that the possibility of "partially borne" still exists. In judicial practice, the second trial judgment of the ST Zhongan Technology case in 2021 decomposed the "joint liability" into two parts: "full joint liability" and "partial joint liability" for the first time. In the joint liability, the degree of fault of the intermediary agency was taken into account, which determined the proportion of joint liability.

2.2. Zhengzhong Zhujiang Accounting Firm's Audit Error Facts

2.2.1. Issuance of an unreserved opinion

There were false records in the annual audit reports of Kangmei Pharmaceutical from 2016 to 2018 issued by Zhengzhong Zhujiang, and at the same time, Zhengzhong Zhujiang issued standard unqualified audit opinions for the financial statements of Kangmei Pharmaceutical in 2016 and 2017 and a reserved opinion for the financial statements of 2018.

2.2.2. Incompleteness of managementsystem audit program

During the audit of the 2016 and 2017 annual reports, for the two sets of relatively separate and closely related JEke industry management system and Kingdee EAS accounting processing system, the relevant auditors of Zhujiang selectively ignored the existence of the JEke system of Kangmei Pharmaceutical, did not pay attention to the differences between the two sets of systems and analyze the causes and possible impacts. The necessary audit procedures were not implemented, resulting in a lack of adequacy and appropriateness of audit evidence.

2.2.3. Defects in the audit of financial statements

There were defects in the audit of the financial statements of Zhengzhong Zhujiang in 2016, 2017 and 2018, mainly including: in the stage of risk identification and assessment, there was no effective summary of major risks and audit procedure planning for situations such as large ending balance of monetary funds and "high deposits with high loans"; in the audit of the monetary capital account, Zhengzhong Zhujiang's correspondence procedure did not achieve effective control, and there were obvious exceptions or contradictions in the data obtained in the audit of monetary fund accounts. There were major defects in the countermeasures of operating income, such as lack of attention to system differences, failure to implement operating income verification procedures, "stuffing" of risk assessment verification transaction data, and contradictory or obviously abnormal audit evidence. In 2017, the project manager even cooperated with the financial staff of Kangmei to intercept the confirmation letters.

2.3. The Identification of Legal Liability of Zhengzhong Zhujiang Certified Public Accountants Corporation

Due to the fault of Zhengzhong Zhujiang Certified Public Accountants Co., Ltd. in the audit activities, it issued false reports and caused the relevant 55,326 investors who reasonably trusted and used the false reports issued by Zhengzhong Zhujiang to suffer huge losses. Therefore, Zhengzhong Zhujiang should bear the corresponding civil liabilities.

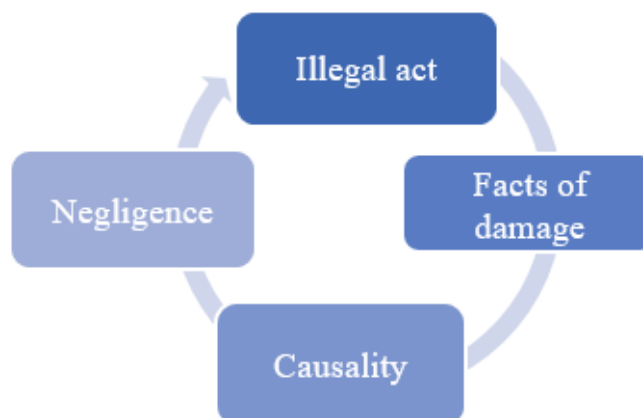


Fig 3. Four elements of tort liability.

In the Civil judgment issued by Guangzhou Intermediate People's Court, Zhengzhong Zhujiang CPA Firm should take on 100% civil liability, which can be explained from two aspects. On the one hand, it bears joint and several liability relative to supplementary liability; on the other hand, it assumes full joint liability as opposed to partial joint liability. At the first level, as mentioned above, the main basis and standard to distinguish the liability type of accounting firms is fault state: if there is gross negligence or fraud, they should bear joint and several liability; if there is a breach of contract or general negligence, it shall be liable for added fault liability.

According to the above analysis of the fault facts of Zhengzhong Zhujiang certified public accountants, its audit reports from 2016 to 2018 all contained false records, failed to implement the corresponding audit procedures for the business management system, had defects in the audit of financial statements, and did not indicate the untrue contents of important matters. For example, some

audit working papers were defective in the risk identification and assessment stage, auditors ignored the differences between the two systems, and the project manager forged the mailing path, "padded" confirmations of transaction data, and ignored obvious anomalies or conflicting information. Therefore, Zhengzhong Zhujiang Accounting Firm had false records and major omissions in its report, maliciously colluded with Kangmei Pharmaceutical to defraud users of relevant information, and there was both "subjective and intentional" fraud, and gross negligence of "being able to foresee but not foreseeable or having foreseen but believing that the accident would not happen and not taking measures". Its fault state determines that it should bear joint and several liability relative to supplementary liability.

As far as the division of joint and several liability is concerned, the decomposition of joint and several liability in judicial rulings is subjective to a certain extent. Most cases in which accounting firms bear joint and several liability still choose to adopt "full joint and several liability" in judicial practice. In this case, due to the disregard of laws and regulations, professional norms and other constraints, the consequences caused by the implementation of the audit had a wide range of influence, a deep degree of severity, and heavy losses, so Zhengzhong Zhujiang was judged to be 100% joint and several liability. Although it was inevitable that the judgment was affected by vague legal boundaries to a certain extent, it was still based on the actual situation of the case to make comprehensive considerations.

3. Risks of Civil Legal Liability of Audit Institutions under the Litigation System of Special Representatives

3.1. Summary of Special Representative Litigation System

According to Article 95 of the new Securities Law, China's special representative litigation system means that the investor protection agency, which is entrusted by more than 50 investors, can participate in litigation as a representative and register with the people's court for the rights holder confirmed by the securities registration and clearing institution in accordance with the provisions, except that the investors express their unwillingness to participate. The Kangmei Pharmaceutical case became the first special representative litigation case since the implementation of the new Securities Law.



Fig 4. Procedural points of the special representative litigation system.

3.2. Changes in Civil Liability Risks of Accounting Firms

3.2.1. Expansion of investors' litigation subject and increases of the amount of litigation subject

The enthusiasm of investors to participate in litigation will be affected by the litigation cost sharing mechanism. Investors will consider "cost-benefit" in the decision-making process of whether to participate in litigation. In the representative litigation of securities disputes, the litigation costs mainly include the court fees, case identification fees, notification fees, etc. Specifically, in the ordinary representative litigation, when the plaintiff accepts the way of "filing a case separately and handling it jointly" or "filing a case separately and handling it separately" adopted by the judicial organ [4], the plaintiff needs to pay the court the acceptance fee and notification fee of the case first. If he wins the lawsuit, he can request the court to compensate the defendant for the reasonable fees such as attorney fees. Therefore, in the ordinary representative litigation system, many investors may

give up taking litigation channels to safeguard their rights and interests under the consideration of the cost-benefit principle.

In the case of the special representative, the plaintiff does not need to pay the case acceptance fee in advance. Even if the case is lost, the plaintiff can still request the court to reduce the court costs, and the Investment Service Center will no longer charge investors any fees other than the necessary fees for the case. The “implicit participation + explicit withdrawal” method allows the rights holder directly become the plaintiff without explicitly refusing to participate in the lawsuit after the court issues the right registration announcement, so a large number of potential victimized investors can share the success of the lawsuit even if they do not take the initiative to take positive actions. No matter whether the accounting firm undertakes supplementary liability or joint and several liability, the amount of claims faced by the accounting firm will increase significantly, which further intensifies the civil liability risk. Under the special representative litigation system, the litigation cost sharing mechanism combined with “implicit participation + explicit withdrawal” greatly reduces the cost of rights protection for investors and lowers the threshold for investors to sue, thus increasing the violation cost and legal risk of accounting firms to bear civil liability.

3.2.2. Breaking through the restrictions on representative status and increasing risks through professional protection

Under the ordinary representative action system, the representative must be a party to the case. As users of audit reports, minority shareholders are at a disadvantage when they file lawsuits against accounting firms in terms of legal knowledge, evidence collection, information resources, time and energy, etc. There is a large gap between them and the defendant listed companies or accounting firms, and they are likely to realize individual rights protection at a higher cost and have a higher probability of losing the lawsuit [5].

Under the special representative litigation system, all investors will be included in the scope of litigation members by default. On the basis of sharing information resources, litigation costs and litigation results, Investor Protection Agencies break through the inherent cognition that representatives are limited to litigants, and turn to have dual identities of litigation representatives and plaintiffs, greatly narrowing the strength gap between minority shareholders, reducing the phenomenon that minority shareholders voluntarily giving up litigation due to the huge strength gap between themselves and the defendant, and also reducing the possibility of plaintiff losing the lawsuit due to lack of evidence, legal knowledge and other reasons [5]. Therefore, under the special representative action system, Investor Protection Agencies provide more professional and collective litigation protection for small and medium-sized investors, and impose strong sanctions on the illegal acts of accounting firms, which overcomes the collective action problem caused by the dispersion of investors, ensures the rights and interests of retail investors to a large extent, and further increases their legal risks of bearing civil liabilities [6].

3.3. Enlightenment on Preventing Civil Legal Liability Risks for Audit Institutions

3.3.1. Selecting Customers Carefully and Implementing the Pre-examination of Customer Qualifications

Before auditing, accounting firms should conduct sufficient customer analysis and carefully select their clients. Under the dual pressure of the new Securities Law and the special representative litigation system on accounting firms, the potential risks that accounting firms may bear for clients have increased unprecedentedly. If a high-risk enterprise is selected as the audit client, once the infringement compensation event of false statements in the securities market occurs, on the one hand, it is likely that the audited entity will not be able to repay, resulting in the final actual compensation by the accounting firm. On the other hand, there is the possibility that the audited entity will shirk its fault and expand the scope of responsibility of the accounting firm.

3.3.2. Improving Risk Awareness and Minimizing Audit Risks

Audit risks exist objectively, but certified public accountants and accounting firms can take active measures to minimize them. Accounting firms should establish the concept of risk. certified public accountants should abide by due prudence and reasonable suspicion, improve personal comprehensive quality, adopt effective audit methods, minimize the controllable auditing risks through effective audit procedures, strictly abide by audit standards and relevant regulations, and avoid the risk of civil liability for audit failure on the basis of implementing various obligations.

3.3.3. Implementing the Duty of Diligence and Standardizing the Practice Requirements of Certified Public Accountants

The main basis and standard for distinguishing the types of liability of accounting firms in the new securities law is fault state. Fraud corresponds to joint and several liability, and fault corresponds to supplementary liability. There are significant differences between supplementary liability and joint and several liability in the primary and secondary division of liability and the order of compensation. Therefore, the fundamental way for accounting firms to reduce the risk of civil liability is still to implement audit business in accordance with the relevant professional requirements. Auditors should maintain professional independence and basic audit suspicion on the basis of having the quality of audit professional ethics, be diligent and responsible, and implement audit business objectively and impartially.

3.3.4. Ensuring that the Audit Evidence Is Traceable and Properly Retained

Audit working papers are all audit work records and data collected by auditors when they perform audit services, and are also the main basis for clarifying audit responsibilities. A standardized and complete audit work draft can eliminate the possibility of subjective malice, thereby reducing the risk of civil legal liability. Therefore, attention should be paid to the recording and preservation of audit working papers in the audit work.

3.3.5. Setting up investor protection fund, establishing and improving the system of compensation in advance

The investor protection fund company accepts the entrustment of the investor of the special compensation fund to act as the fund manager and perform the corresponding duties of the manager, and its role as the public interest representative of the investor protection institution has been fully demonstrated [7]. However, the existing investor protection fund system in China is still lack of constraint and incentive mechanism, which largely depends on the individual, the main shareholders of the issuer or related securities companies, will and ability of investors. This also makes it a mere formality for the fund to play the role of compensation in advance, and the interests of investors cannot be effectively guaranteed. Therefore, it is necessary to establish and improve the norms for the establishment of insurance funds as soon as possible. When the accounting firms are faced with joint and several liability, this institutional arrangement will fully demonstrate its buffering effect and reduce the risk of civil liability exacerbated by the large capital gap that the auditee is unable to compensate.

4. Summary

The new Securities Law proposes the special representative litigation system. As the first case applying the special representative litigation system to judicial practice, Kangmei Pharmaceutical's fraud case sentenced the audit institution and the audited unit to joint and several liability for compensation. By analyzing the fault facts of Zhengzhong Zhujiang Certified Public Accountants, this paper identifies the joint and several liability relative to supplementary liability and the full joint and several liability relative to proportional joint and several liability respectively. Under the special representative litigation system, the punishment of false statements by audit institutions has increased, and the risk of civil legal liability has significantly increased. This paper believes that it is mainly

reflected in two aspects. First, the investor litigation subject has expanded, and the amount of litigation subject has increased. Second, the investor protection agency, as the plaintiff, provides professional protection for the injured investors. Based on the characteristics of the above changes in the risk of civil legal liability of audit institutions, this paper puts forward five suggestions on how to reduce the risk of civil legal liability of audit institutions from the perspective of before and after, such as properly recording and saving the audit work draft, establishing the system of investor protection fund, etc.

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