

# Misuse of Emphasis of Matter Paragraphs in Unqualified Audit Opinions

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**Abstract.** Audit opinion helps investors and creditors to understand the real financial situation of the enterprise, so that they can make smarter investment and credit decisions and protect their own interests. However, in auditing practice, the definition of an audit opinion is not very clear, and sometimes there is some ambiguity. Moreover, the auditing standards for the part of the emphasis of matter can be increased only provide some principal guidance, but not detailed list of specific application, which could lead to misunderstanding and misuse of the paragraph. In order to improve audit quality, the professional judgment and ethics of certified public accountants in issuing audit reports should be further emphasized.

**Keywords:** Audit Opinion; Emphasis of Matter; Misuse.

## 1. Introduction

A standard unqualified audit report implies that the accountant is satisfied that the financial statements of the enterprise are of satisfactory quality and that there are no matters that need to be emphasized. Earnings sustainability is an indicator of great concern to stakeholders such as investors and creditors. Enterprises that receive a standard unqualified opinion are generally more likely to gain the trust of investors and creditors and thus have better earnings sustainability [1]. Companies that receive an unqualified audit opinion with matter paragraphs are more likely to experience financial restatements in subsequent periods than companies that receive a standard opinion, and an unqualified audit opinion with matter paragraphs that do not contain going concern issues may also indicate a higher risk of misstatement [2]. However, an emphasis of matter paragraph merely increases the information content. This paragraph is included to help statement users understand the financial statements more thoroughly and to provide context for any issues or concerns that the auditor has identified during the audit process, but not all of this information is directly related to the audit opinion. If an emphasis of matter paragraph is mistakenly substituted for what should be disclosed as well as stated in the audit report, the type of audit opinion loses its intended meaning and is difficult to be relied upon by financial statement users.

## 2. The concept and development of Emphasis of Matter

An unqualified audit opinion with an emphasis of matter paragraph is a type of audit opinion where the auditor provides a clean bill of health for the financial statements but also highlights certain matters that they believe are important for the financial statement users to know. This additional information can help users to better understand the financial statements and make more informed decisions. However, it does not change the overall audit opinion, which remains unqualified. Therefore, like the standard unqualified audit opinion, an unqualified audit opinion with an emphasis of matter paragraph indicates that there are no unadjusted material misstatements in the financial statements of the audited entity. The difference is that the standard unqualified audit opinion indicates that there is no risk of material misstatement in the audited financial information of the audited entity, as well as no significant strategic operational risk; whereas the unqualified audit opinion with an emphasis of matter paragraph indicates that there is only a strategic operational risk affecting the information in the statements of the audited entity auditors present this information by means of an emphasis of matter paragraph in order to indicate the risks to the users of the information.

The standards on emphasis of matter paragraphs have also been continuously revised. In 2006, the national auditing standards emphasized material uncertainty with emphasis of matter paragraphs; the 2010 national auditing standards relied more on the professional judgment of the auditor. Among them, the 2010 edition of the standard does not specify the scope of application of emphasis of matter paragraphs, except for the clear definition of emphasis of matter paragraphs, and only provides examples in the guidance of the standard of practice to illustrate the situations in which the auditor may need to strengthen the emphasis of matter paragraphs. A comparison of the 2006 and 2010 editions of the auditing standards shows that the scope of application of the emphasis of matter paragraph has been expanded to include both uncertain and certain matters, as long as it is "critical".

The standard was revised in December 2016 and further standardizes the relationship between key audit matters and supplementary information. Based on the perspective of information users, the core content of the disclosure of unqualified audit opinion information with emphasis of matter paragraph includes significant adjustments in corporate strategy, significant deficiencies in corporate internal control, risks of corporate mergers and acquisitions [3], external guarantees, threats to the ability to continue as a going concern, pending lawsuits, significant adjustments to corporate accounting policies, significant revisions to corporate accounting estimates, a change in corporate performance, risks of environmental pollution, and a large number of layoffs of employees. and massive layoffs of employees by enterprises, etc. As for the different types of emphasis of matter segments, the market's ability to distinguish and identify them is very limited [4].

### **3. Risks associated with an unqualified audit opinion with Emphasis of Matters**

An unqualified audit opinion with emphasis of matter is the "least severe" of all non-standard audit opinions and indicates that the financial information of a listed company is not materially misstated. That means there is no audit risk. However, for information users, even if there is no audit risk, it does not mean that there is no business or other risk. They are not risks resulting from distorted information, but rather risks of failing to accurately understand the true information disclosed, and these risks may arise because of inadequate interpretation of the listed company's information by information users. Although listed companies have made disclosures about these risks, they are likely to be masked by other information disclosed at the same time. The need for them is equally urgent, and failure to know and interpret them accurately will also lead to losses.

A typical example of this is when an audit report that should have contained an adverse opinion, but was instead replaced by an unqualified opinion with an emphasis on matters section, which is particularly evident when the audited unit is involved in legal disputes. In order to cater to the needs of the audited entity, even if the auditor is aware of the litigation, the auditor may remove the relevant litigation materials from the audit file, and at the same time, in order to absolve himself of responsibility, make a cursory disclosure in the emphasis of matter paragraph and falsely claim that he has not received the relevant information on the outcome of the trial. This is a serious violation of the auditors' code of ethics and an extremely obvious abuse of the emphasis of matter paragraph, which deceives the information users and makes the audit report lose its proper function. This act seriously violates the professional ethics guidelines for registered accountants and is a blatant abuse of the emphasis matter paragraph, deceiving information users and rendering the audit report ineffective in its intended purpose.

In addition, in order to avoid the strict regulation of non-standard opinions, listed companies have a strong incentive to purchase audit opinions, and Lennox found that listed companies have successfully realized the purchase of audit opinions by improving the model. The transformation of an otherwise qualified opinion into an unqualified opinion with an emphasis of matter paragraph is an important means of corporate audit opinion buying [5].

## 4. Analysis of the audit opinion of Zhongchao Holdings

### 4.1. Company profile

Jiangsu Zhongchao Holding Co., Ltd (stock abbreviation: Zhongchao Holdings) is an A-share listed company on the main board of the Shenzhen Stock Exchange, whose predecessor was Zhongchao Cable, which was built and put into production in 2005. Since its listing in September 2010, Zhongchao Holdings has gradually developed into a group management enterprise involving wire and cable and upstream and downstream industries, nuclear power military equipment and other fields through mergers and acquisitions and restructuring, capital investment and establishment, etc. In 2020, Zhongchao Holdings' main business revenue in the cable industry was 5.12 billion, accounting for 94.23% of the company's revenue.

### 4.2. Cause of the incident

In October 2017, Zhongchao Group proposed to transfer 368 million shares of the listed company, representing 29% of the total share capital of the company, to Shenzhen Xintenghua, which is controlled by H. The transfer was carried out in two times, and after the first share transfer of 20%, H became the real controller of Zhongchao Holdings. When the transfer is about to reach one year, due to Shenzhen Xin Tenghua's failure to pay the share transfer price for the first tranche of shares on time, a material breach has occurred, the agreement is terminated, and the second 9% shares will no longer be delivered. But the company but "to be married to a bad husband", H get 20% of the equity in the super holdings, private carving 250 companies official seal and legal person official seal illegal financing loans, in office during the operation of a large number of violations of the guarantee, put the company in a critical situation. In November 2018, H went to the Jieyang City Public Security Bureau Economic Investigation Brigade to surrender.

### 4.3. Analysis of audit report opinions

In 2017, Baker Tilly International issued a standard unqualified opinion on the financial report audit and internal control audit of Zhongchao Holdings. However, due to the "turnip stamp incident", in 2018, Zhongchao Holdings was sued in 10 cases in Jieyang City People's Court of Guangdong Province; the total amount of external guarantees involved in the lawsuit was 339.12 million yuan. Meanwhile, the company was sued in 18 cases in Huangpi District People's Court of Wuhan; the total amount of external guarantees involved in the lawsuit was 274.94 million yuan, and the relevant cases have not yet been formally adjudicated. And the relevant cases have not yet been formally adjudicated. As a result, Baker Tilly issued an unqualified opinion with emphasis of matter on the financial report of Zhongchao Holdings.

In 2019, Baker Tilly International auditors issued an unqualified opinion with a paragraph on material uncertainty of going concern for the financial report of Zhongchao Holdings. However, Zhongchao Holdings incurred a net loss of RMB 458 million for the year, and received litigation documents such as court summonses and civil judgments one after another during the year. The reason for this is that H in the company's tenure without the company's shareholders meeting to consider the consent of the company in the name of the company to provide joint and several guarantees for the debts of his personal, associated units, associated natural persons pending litigation involved in 24 lawsuits, the amount involved in the lawsuits of 1.238 billion yuan, of which 15 pending lawsuits involved in the People's Court of Wuhan City, Huangpi District. Similarly, because of the uncertainty of the outstanding litigation, Baker Tilly International issued an unqualified opinion with emphasis of matter paragraph on the internal control report of Zhongchao Holdings.

In 2020, Baker Tilly International issued an unqualified opinion with an emphasis of matter paragraph for the financial report of Zhongchao Holdings and a standard unqualified opinion for the internal control report. The reason for the addition of the emphasis of matter paragraph is that it was involved in 15 pending lawsuits in the People's Court of Huangpi District, Wuhan City, amounting to RMB 273 million, for which a projected liability had been recognized in full in FY2019, and during

the current year. For the above cases, the civil judgment of the first instance was set aside by a civil ruling in the current year and remanded to the original court of first instance for retrial. If the final judgment is in favor of the Company, it may have a significant impact on the Company's financial statements.

## **5. Suggestionss**

### **5.1. Enhancement of market supervision by regulatory bodies**

In the process of market regulation, regulatory authorities should make the unqualified opinion with emphasis of matter paragraph as the focus of regulation to ensure that investors can obtain high-quality accounting information. Supervisory authorities should also strengthen financial supervision of enterprises to detect and correct non-compliance with accounting standards in a timely manner. When issuing audit reports, auditing organizations should strictly follow auditing standards and professional ethics requirements to conduct objective and fair audits of the financial statements of enterprises, so as to ensure that investors can obtain true and complete financial information.

### **5.2. Auditors should strengthen their professional judgment**

Firstly, auditors should focus on whether the listed company has any large debt defaults, violation of loan contracts and other commitment matters, loss of major customers, etc. Secondly, they should communicate adequately with the governance on the identified matters or situations, so as to timely understand the operation status and risk situation of the enterprise. When judging whether it is necessary to add emphasis of matter paragraphs, we also need to fully consider the needs and interests of financial statement users to ensure that the use of emphasis of matter paragraphs is in line with the purpose of the audit.

### **5.3. Investors should pay attention to increasing risk awareness**

Investors should pay close attention to the specific content of the audit report rather than limiting themselves to the type of audit opinion. When reading the audit report, focus on the emphasis of matter paragraph, combined with the specific circumstances of the enterprise, to determine the extent of the impact of the emphasis of matter paragraph on the enterprise's financial position and operating results. In addition to the audit report, investors can obtain information through various channels such as reviewing the financial statements, announcements, and industry information of the enterprise in order to fully understand the operating conditions and financial risks of the enterprise. When in doubt about the emphasis of matter paragraph in the audit report, they can seek advice from professional financial advisors or auditors to better understand and respond to possible risks.

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