

Research on Audit Risk Prevention and Control in Ruihua Accounting Firm

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Abstract: With the rapid development of the market economy, the market environment has become more complex and the forms of economic activities have become increasingly diverse, leading to an increasing audit risk. In recent years, there have been frequent incidents of audit failures in accounting firms, which have greatly impacted the market economy. As a result, people's trust in accounting firms has declined, and doubts have been raised about the professional competence of auditors. This paper takes the audit of Kangdexin by Ruihua Accounting Firm as a research object, aiming to identify specific instances of inadequate quality control in the audit process and propose strategies and recommendations to strengthen audit risk prevention and control.

Keywords: Audit Risk; Inspection Risk; Quality Control.

1. Introduction

In the midst of an unstable economic market, the business scope of listed companies has become increasingly diverse, posing challenges to the limitations of audit work. The risks and difficulties in the audit process have also been on the rise. The auditing industry is facing intensified competition, with rising labor costs and increased operational expenses for accounting firms. As audit work expands, the control of audit risks faces numerous threats. Therefore, it is crucial to enhance the construction of the audit risk control system in accounting firms in order to support healthy company operations, elevate business standards, maintain corporate image, improve management levels, and enhance audit risk control.

Porcuna Enguix Luis (2021) restructured the payment function of participants in the audit model research project and examined the relationship between the payment function and the audit risk, as well as the audit evidence of the participants [1]. Siew H (2021) proposed using Bayesian methods for quantitative risk analysis of audit business and put forward specific management models [2]. Rasheed Abdul P. C (2021) conducted research indicating that accounting firms can establish more rigorous and standardized audit risk control systems to ensure the ability and effectiveness of audit reports issued by relevant auditors in risk control [3].

2. Overview of Ruihua Accounting Firm

Ruihua Accounting Firm, formed through the merger of Guofu Haohua Accounting Firm and Zhongrui Yuehua Accounting Firm, is a large-scale, international, and professional accounting firm. Established in April 2013, Ruihua has 53 branch offices nationwide, with its headquarters located in Beijing. During its peak period, Ruihua employed 8,986 accounting professionals, including 2,266 certified accountants. According to the 2018 rankings released by the Chinese Institute of Certified Public Accountants, Ruihua ranked second in terms of revenue among domestic accounting firms and held the top positions

in the number of certified accountants, branch offices, and employees.

However, in recent years, Ruihua Accounting Firm has faced several instances of audit failures, resulting in multiple penalties from the China Securities Regulatory Commission (CSRC). These incidents have significantly impacted the firm's reputation and credibility. In December 2018, an administrative penalty notice revealed that Ruihua had issued false audit reports for the annual reports of Huaze Cobalt Nickel in 2013 and 2014, leading to fraudulent financial statements. In July 2019, the CSRC issued a preliminary notice of administrative penalties and market bans to Kangdexin, stating that Ruihua's audits of Kangdexin from 2015 to 2017 were deemed failures. Alongside the penalties imposed on Kangdexin, Ruihua Accounting Firm was also investigated. Several companies, including GoerTek and Tiantie, terminated their contracts with Ruihua. As a result, Ruihua experienced a significant decline in business and faced regulatory sanctions, causing severe damage to its operations.

While Ruihua Accounting Firm has a relatively complete organizational structure, there are some potential risks. Notably, the firm lacks a dedicated legal department, which may result in a weaker legal awareness within the organization, increasing the potential for economic losses and reputational damage in the face of legal disputes. Ruihua Accounting Firm has established internal regulations and systems for audit work and quality control, including the "Ruihua Accounting Firm (Special General Partnership) Quality Control System (Revised)" and its accompanying 15 management measures, as well as the "Ruihua Accounting Firm (Special General Partnership) Code of Professional Ethics (Revised)" and its accompanying three management measures. However, there is a lack of specific regulations addressing audit quality and compliance issues, which may affect the quality of audit work due to incomplete or inadequate regulations and the absence of necessary procedures or guidance.

3. Analysis of Major Misstatement Risks in Kangdexin's Annual Report Audit

Kangdexin Group is a new materials enterprise mainly focused on polymer composite membranes. Since its listing on the Shenzhen Stock Exchange in 2010, the company's market capitalization has soared from 3 billion RMB at its initial public offering in July 2010 to nearly 100 billion RMB, earning it the title of a "blue-chip stock" among many shareholders. However, in early 2019, Kangdexin announced its inability to repay short-term financing bonds worth 1 billion RMB. This led to suspicions among shareholders regarding the authenticity of Kangdexin's financial statement data. As a result, the company's stock price plummeted from 18.98 RMB on May 31, 2018, to 4.21 RMB on January 31, 2019, and the Shenzhen Stock Exchange issued a risk warning in January 2019.

From 2016 to 2018, Kangdexin incurred a total debt guarantee amount of 4.409 billion RMB, with the guarantee provided by the substantial funds of the optoelectronic material subsidiary. Kangdexin's subsidiary, Optoelectronic Materials Co., Ltd., signed four "Deposit Pledge Contracts" with Xiamen International Bank Beijing Branch and China Aviation Trust Co., Ltd. However, according to the agreement between Kangdexin and Beijing Bank Xidan Branch, there are clear indications of related-party transactions (as shown in Table 1). The disclosed bank deposit balances in the annual reports from 2015 to 2018 were falsely recorded and not disclosed within the specified timeframe. Additionally, the provision of related-party guarantees to the controlling shareholder was not disclosed in the annual reports.

Table 1. Amounts of Related-Party Transactions Occurred by Kangdexin Group from 2015 to 2018 (Unit: RMB 100 million)

Year	Amount of Related-Party Transactions	percentage of the latest audited net assets
2015	58.37	120.92%
2016	76.72	83.26%
2017	171.50	109.92%
2018	159.31	88.36%

Source: Sina Finance website.

4. Analysis of Deficiencies in Ruihua's Risk Assessment and Control of Kangdexin's Audit

4.1. Examination Risk Analysis

The examination risk arises from the improper on-site auditing methods employed by the auditors, which failed to achieve the expected results. During the audit of Kangdexin's annual report, Ruihua's auditors failed to detect issues with contract documents, pledge contracts, and other related documents. They did not implement alternative procedures for abnormal bank accounts, thereby failing to effectively control the examination risk. Ruihua did not examine the relevant records pertaining to Kangdexin's accounts receivable, such as sales contracts and bank documents. In certain balance sheets, the monetary funds increased from 10.1 billion at the end of 2015 to 18.5 billion at the end of 2017, and short-term borrowings increased from 3.4 billion at the end of 2015 to 6.6 billion at the end of 2017. However,

considering the fixed assets, construction in progress, and intangible assets, the combined total of these three categories has barely increased since 2015, indicating the presence of a "high deposits, high loans" phenomenon in Kangdexin. Ruihua's registered accountants did not pay sufficient attention to this abnormal occurrence of high deposits and high loans in Kangdexin. The company has artificially inflated its profits for four consecutive years, and even grassroots employees have noticed the abnormality in the company's operating conditions. Employees have clearly felt that customer payments are not as smooth as before, and there has been a significant change in cash flow. However, Ruihua failed to obtain information regarding Kangdexin's significant operational risks through preliminary inquiry procedures. The China Securities Regulatory Commission investigation revealed that Kangdexin had inflated its profits by 2.381 billion yuan, 3.089 billion yuan, and 3.974 billion yuan in 2015, 2016, and 2017, respectively, by fabricating sales transactions. However, Ruihua issued unqualified audit reports for all three years. After December 31, 2018, Kangdexin experienced significant sales returns, indicating a major problem with its operating revenue. Ruihua's auditors did not examine the amount of Kangdexin's operating revenue or verify the authenticity and accuracy of transactions and account balances related to sales. This includes not verifying the existence of invoices, checking the legality of invoices, or utilizing effective analytical procedures to compare and analyze the income from the previous period to the current period, as well as the income from previous months to the current months, to determine if there was any overstatement or understatement of revenue.

4.2. Analysis of the Formalism in Ruihua's Review System during the Audit Process of Kangdexin

Ruihua has maintained a long-standing cooperative relationship with Kangdexin, which raises concerns about the independence of the accounting firm. The alleged multi-billion data falsification by Kangdexin, coupled with the repeated issuance of inappropriate audit opinions by the accounting firm, highlights the potential lack of independence.

For instance, during the preparation of financial statements, it was found that the same individual could log into the accounts of project managers, department heads, or even partners. Such a review process lacks significance and is merely a formality, failing to ensure the quality of the audit.

Ruihua's accounting firm has implemented a four-level quality control system, with each level gradually increasing the level of personnel responsible for the review. However, in practice, the review at each level is often limited to a signature and completion of formal procedures without implementing effective personnel oversight and content verification.

This superficial review practice raises concerns about the effectiveness of Ruihua's quality control system in ensuring the integrity and reliability of the audit work. It undermines the credibility and quality of the audit reports issued by the accounting firm, as it fails to provide adequate assurance of the accuracy and compliance of the financial statements.

In summary, the continuous audit cooperation between Ruihua and Kangdexin has raised questions about the independence of the accounting firm. The superficial review practices and the lack of effective personnel oversight and content verification have compromised the quality and credibility of the audit work performed by Ruihua.

5. Recommendations for Audit Risk Prevention and Control by Accounting Firms

5.1. Gain a thorough Understanding of Clients to Enhance Risk Assessment Capabilities.

To achieve a successful audit, it is crucial for registered accountants to have a comprehensive understanding of the audited entity. This includes knowledge of the external environment and internal circumstances of the entity, such as industry trends, changes in laws and regulations, operational performance, and the suitability of the company's organizational structure. Registered accountants should pay attention to conducting on-site visits as it allows for a more direct and accurate acquisition of information about the company. By observing the company's production processes firsthand, they can gain a better understanding of its operational conditions.

During the audit process, registered accountants should combine financial statement data with on-site information to effectively evaluate the audited entity. They need to pay close attention to any unrealistic or contradictory indicators in the financial statements and assess whether significant risks exist. If significant risks are identified, appropriate measures should be taken to address them.

By incorporating these practices, registered accountants can enhance the quality and effectiveness of audits. The integration of on-site information and financial data enables a more comprehensive evaluation of the audited entity, leading to a more reliable and insightful audit opinion.

5.2. Effectively Utilize Analytical Procedures to Enhance Risk Assessment Effectiveness

In the audit of annual financial statements, registered accountants need to select key business areas for examination based on the known financial data and the results of the evaluation of internal control systems. The audit process requires the application of appropriate procedures to identify any inconsistencies in detail. It is important to assess the reasonableness of the audited entity's revenue and to evaluate the reasonableness of the data presented in the financial statements. Verification can be done through visible data, such as relevant bank deposits, to confirm the authenticity of the underlying data.

In certain circumstances, it may be necessary to conduct on-site investigations to reduce audit risks arising from abnormal situations within the audited entity. This allows for a more comprehensive understanding of the entity's operations and can provide valuable insights to support the

audit process.

By following these procedures and conducting thorough examinations, registered accountants can effectively assess the reliability and accuracy of the audited entity's financial statements, reduce audit risks, and provide stakeholders with a reliable and trustworthy audit opinion.

5.3. Maintain Professional Skepticism and Strengthen Examination of Audit Evidence Materials.

Maintaining professional skepticism and caution is essential for auditors to identify significant misstatements. During the audit process, auditors must uphold independence and avoid developing overly close relationships with clients to ensure that the audit remains unaffected by client influence. Cross-checking and verifying the collected evidence for consistency and reliability are methods that auditors can employ to maintain professional skepticism and ensure the reliability of audit evidence. These practices ultimately enhance the quality and credibility of the audit, providing stakeholders with assurance in the accuracy of the financial statements.

5.4. Establish a Quality Review System to Rigorously Control Audit Quality.

Accounting firms need to establish a comprehensive quality management system, including standardizing audit processes, defining audit procedures, and strengthening internal controls, to ensure that audit work is conducted in a standardized manner. They should strictly implement a three-tier review system by establishing a quality review institution and a team of professionals dedicated to conducting quality reviews of audit work. Additionally, establishing a sound quality feedback mechanism is essential to analyze and summarize review results, promptly identify issues, and drive improvements.

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