

# Case study of Audit Failure of Small and Medium-sized Accounting Firms

-- Take \*ST Xinyi as an Example

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**Abstract:** Accounting firms are an indispensable party in the securities market and play a role that cannot be underestimated in supervising audited units and protecting investors. With the implementation of the dual filing system, small and medium-sized accounting firms have also begun to enter the securities market, which has further developed the securities market. However, in order to undertake business, small and medium-sized firms sell audit opinions to enterprises with caps with questionable financial quality, and audit failure is inevitable. This paper takes \*ST Xinyi as an example, analyzes the reasons for its fraud methods and audit failures, and puts forward some suggestions to reduce the occurrence of audit failures of listed companies by small and medium-sized firms.

**Keywords:** Audit failure, New securities law.

## 1. Introduction

In March 2020, the new securities law came into effect, and China's securities investment consulting services began to implement a dual filing system. Before the implementation of the dual filing system, accounting firms could only engage in the audit business of listed companies if they had "securities and futures business related qualifications", which undoubtedly created obstacles for small and medium-sized firms to undertake the audit business of listed companies, only 40 large accounting firms could engage in the audit business of listed companies, and thousands of small and medium-sized firms were blocked from the securities market. After the implementation of the dual filing system, according to the Institute of Certified Public Accountants, as of June 2022, 34 small and medium-sized accounting firms have filed with the CSRC and the State Council to begin undertaking securities service business. It can be seen that the dual filing system has brought opportunities for small and medium-sized firms to enter the securities market, and if the dual filing system can develop healthily, it will also promote the improvement and maturity of China's audit market to a certain extent.

### 1.1. Criteria for the classification of accounting firms

According to Jiang Minshen's large-scale division of large firms and small and medium-sized firms, this article will also adopt this division standard: large firms refer to accounting firms with operating income of more than 10 million yuan and more than 50 certified public accountants; Small and medium-sized firms refer to accounting firms with operating income of less than 10 million yuan and no more than 50 certified public accountants.

### 1.2. Characteristics of small and medium-sized accounting firms in China

1. Large quantity. As of the end of 2021, there were 8,911 accounting firms in China. There are only 40 large firms, most of which are small and medium-sized accounting firms.

2. Low business income. Small and medium-sized firms themselves do not have competitive advantages, the scale of clients that small and medium-sized firms can contact is not large, the audit report requirements they need are not high, and the price is relatively low. In addition, due to their own constraints, small and medium-sized firms cannot undertake more complex audit services, and the business they undertake is relatively simple, and their business income is naturally low.

3. There are fewer certified public accountants. Because small and medium-sized accounting firms do not have high business income, their investment costs in audit business will not be high, and they will not invest too much in talent reserves. In addition, audit professionals inevitably yearn for large firms, and it is difficult for small and medium-sized firms to retain professionals.

4. There are deficiencies in internal controls. Small and medium-sized firms have small organizations, and partners are prone to talk in the firm. However, if the partner's own professional quality is limited, it is inevitable that some unreasonable audit behaviors will occur, and if the partner is not proficient in the audit process, it is likely that the review will be a formality. In short, the deficiencies in the personal professionalism of the partners will have a great adverse impact on the internal control within the accounting firm.

## 2. Case Review

\*ST Xinyi is the first listed company customer of Tangtang Firm. Before Tangtang Firm undertook this audit business, \*ST Xinyi's annual audit accounting firm was Sichuan CEFC, and because \*ST Xinyi did not pay the annual audit fee as agreed, CEFC decided not to sign the 2019 annual report audit project. In March 2020, \*ST Xinyi announced that Tangtang Firm became its new annual audit accounting firm. Therefore, after the double filing, Tangtang Law Firm became the first small and medium-sized accounting firm in China to accept the audit business of annual reports of listed companies.

## 2.1. A brief description of the parties involved in the case

### 2.1.1. \*ST XinYi

\*ST Xinyi's original Chongqing Siwei Porcelain Industry Co., Ltd. was originally established in Chongqing in 1998 and listed the following year. After its listing, the company's operating conditions can be described as full of loopholes, and it has been "wearing stars and hats" for several years. In 2015, after bankruptcy reorganization, the company formally established "Xinjiang Yilu Wanyuan Business Holding Co., Ltd." in Xinjiang.

### 2.1.2. Shenzhen Tangtang Accounting Firm

Shenzhen Tangtang Accounting Firm (hereinafter referred to as "Tangtang Firm") is an accounting firm established by Wu Yutang in Shenzhen in December 2004. After the implementation of the new securities law, Tangtang Law became the first batch of accounting firms to enter the securities service industry through the dual filing system. From 2019 to 2021, the scale of audit business is shown in the following table:

**Table 1.** Scale of audited operations

Basic information	FY2019	FY2020	FY2021
Audit business income (million yuan)	35.77	497.61	609.69
Certified Public Accountant (Number)	9	11	9

Source: Tangtang Firm official website <http://www.ttcpa.cn/>

It can be seen from Table 1 that the audit business income of the hall firm in three years is far less than 10 million yuan, and the number of certified public accountants is obviously less than 50, so according to the division standard of the size of the firm, the hall firm belongs to small and medium-sized accounting firms.

## 2.2. Fraudulent means

According to the investigation of the China Securities Regulatory Commission, \*ST Xinyi's inflated operating income in 2018-2019 is shown in Table 2, and after adjustment and recovery, its operating income in 2018 and 2019 was less than 10 million yuan, and even the profit in 2019 was negative.

**Table 2.** \*ST XinYi inflated revenue and proportion in 2018-2019

	FY2018	FY2019
Inflated operating income (million yuan)	1,338.54	572.36
Inflated revenue accounts for operating income disclosed for the year	100%	55.13%

Source: Juchao Information Network <http://www.csrc.gov.cn/csrc/c101928/c2314047/content.shtml>

\*ST XinYi inflated revenue by:

1. Inflating the non-operating income of factoring business. In 2019, Yangyun Technology, a subsidiary of \*ST Xinyi, signed a factoring contract with a company in Shenzhen,

Telford Factoring, stipulating that a debt worth 238 million yuan of \*ST Xinyi would be transferred to Telf Factoring, and then Defu Factoring would pay 76 million yuan to Yangyun Technology within a one-month period, and the remaining amount would be paid within one year. However, in practice, Telf Factoring assumes the actual payment obligation in a few steps and is not responsible for debt collection. The first factoring fund was 4 million yuan from Heike Hanma, which was paid to Parkson Yiwei 75.903 million yuan in 27 transfers, and then the latter paid 75.901 million yuan to Ameer Dayi through 28 transaction processes, and then Ameer Dayi transferred 75.9 million yuan to Hengbo Jinsheng in 28 transfers, and Hengbo Jinsheng paid the funds to Heike Hanma. In this capital cycle, Ameer Dayi is a 90% subsidiary of \*ST Xinyi Holdings, and Amaid owns 10% of the equity of Hengbo Jinsheng, and the other 90% of the equity is owned by Hengbo Technology, and Heike Hanma is a wholly-owned subsidiary of Hengbo Technology. In fact, \*ST Xinyi did not receive any factoring funds, but it recognized the 75.9 million yuan received by Ameer as non-operating income of factoring business, thereby inflating the non-operating income and profit of 75.9 million yuan in 2019.

2. Inflated business income. In 2018, Yiyuan Huijin, a wholly-owned subsidiary of \*ST Xinyi, signed order contracts with Ashin Trading and Sibe Investment, respectively, and Yiyuan Huijin purchased iron ore concentrate from Northwest Investment and then sold it to Ashin Trading. He Mou, the actual controller of Ashin Commerce and Trade, who is also a shareholder of Sibe Investment, is actually friends with Huang Wei, the actual controller of \*ST Xinyi, and Yiyuan Huijin does not bear the relevant risks and benefits in this sales chain, nor does it obtain control of the goods, and the relevant economic benefits do not actually flow into Yiyuan Huijin, so this business does not meet the conditions for revenue recognition. However, \*ST Xinyi caused inflated operating income of 13.3854 million yuan and 2.1266 million yuan in 2018 and 2019 respectively through these two businesses.

3. Inflated property fee income. In November 2019, Han Zhenyuan, a subsidiary of \*ST Xinyi, entrusted the property management of its Kashgar open source market to \*ST Xinyi's grandson company Dingshengyuan, who was responsible for collecting property fees. The following month, Prosperity Yuan and Hongtengda agreed that Hongtengda would carry out the above-mentioned property services, and the fees would be collected by Hongtengda and owned by Hongtengda. The property management services of the open source market in 2019 are actually provided by Hongtengda, so the corresponding revenue and costs should also be recognized by it. As of the date of the 2019 report, Hongtengda has not transferred the property fee to Dingshengyuan, and Dingshengyuan itself has not provided property management services, has not recognized costs, and has not received relevant cash inflows. Therefore, it should not recognize the operating income of 2.297 million yuan in 2019, which caused its inflated operating income and profit of 2.297 million yuan in 2019.

4. Inflated rent offset income. \*ST Xinyi, Han Zhenyuan and their creditor Hongsheng Real Estate signed a "Rent Offset Agreement", agreeing to lease one of Han Zhenyuan's properties to Hongsheng Real Estate to settle the arrears of \*ST Xinyi. The lease term is one year in 2019, the annual rent is 1.365 million yuan, and Han Zhenyuan issued the opening lease invoice to Hongsheng Real Estate on December 31,

2019. However, after investigation, the CSRC found that the agreement did not exist in 2019, it was signed backwards during the 2020 audit period, and the content of the agreement was not actually performed. The rental right and use right of the relevant property are still in Han Zhenyuan's name, so the recognition of the above income is not eligible and led to an inflated operating income and profit of 1.3 million yuan in 2019.

### 2.3. Punishment results

For the above fraudulent acts and the failure of the audit, the administrative penalties given by the CSRC are as follows:

**Table 3.** Penalty results of the CSRC

Object	Punish
*ST XinYi	Warning, 8 million fine
Huang Wei	Warning, 12 million fine, lifetime market ban
Li Yong	Warning, 3 million fine, lifetime market ban
Tangtang Firm	Confiscated 1.97 million yuan of business income, imposed a fine of 11.82 million yuan, suspended and securities service business for one year
Wu Yutang	Warning, 1 million fine, 10-year market ban
Liu Runbin	Warning, 500,000 fine, 5-year market ban
Liu Yaohui	Warning, 300,000 fine, 3-year market ban

Source: China Securities Regulatory Commission <http://www.csrc.gov.cn/guestweb4/s>

## 3. The Performance and Reasons for The Audit Failure

### 3.1. Performance of audit failures

#### 3.1.1. Failure to conduct due diligence audits of revenue-related items

The above-mentioned fraudulent acts of inflated income were not dutifully audited by the law firm. First of all, with regard to the inflated factoring income, the court firm questioned the direct audit evidence obtained by the auditor, but the certified public accountant did not doubt the indirect evidence of correspondence obtained by the certified public accountant and did not further verify the authenticity of the factoring income. Secondly, for the inflated trade income, after the first audit, the firm believed that there was a material anomaly, but in the case of the risk of material misstatement, the firm did not obtain additional audit evidence for the implementation procedures. Finally, with regard to the inflated property fee income, the certified public accountant who had intended to sign the property fee contract believed that the property fee contract was a financial fraud and could not be recognized as income, and he also listed this matter as a reserved matter and made it known to Wu Yutang. However, the subsequent signing CPA did not pay attention to the details of the contract and the cost of the revenue, and he only recognized the income after requesting additional

clarification from the parties involved, and did not implement other audit procedures. In the case of a very high risk of fraud in the revenue items, the firm did not carry out extensive audit procedures to verify whether they were genuine, but instead hastily confirmed the reasonableness and authenticity of the revenue.

#### 3.1.2. Assist in amending the rent offset agreement

As for the so-called "Rent Offset Agreement" between \*ST Xinyi, Han Zhenyuan and Hongsheng Real Estate, after investigation, it was found that Wu Yutang assisted \*ST Xinyi in the 2020 fiscal period when the evidence was insufficient and the auditee refused to cooperate, indicating that its audit procedures had serious deficiencies.

#### 3.1.3. Modify and delete audit papers

During the first on-site audit, the project team members of Tangtang Law Firm found that there were some errors in Yiyuan Huijin's 2019 trade revenue, and believed that there was insufficient and appropriate audit evidence to prove its reasonableness, and recorded these in the audit papers. However, the certified public accountant who signed the audit report did not notice before issuing the report, and only after sorting out the draft did he find that instead of withdrawing the audit report, he modified the audit paper to support the audit report he issued.

#### 3.1.4. Failure to maintain control over the whole process of correspondence

When the hall was executing the letter, they did not maintain control over the whole process of the letter, and due to the restrictions of the epidemic, they directly gave Wu Yutang's mailbox to \*ST Xinyi, and after receiving the email reply, they did not verify the real owner of the mailbox. After the audit report date, they still sent inquiry letters to Sibe Investment and Ashin Trading through \*ST Xinyi, and did not supervise the letter process.

### 3.2. The reasons for the audit failure

#### 3.2.1. There are deficiencies in the quality control of the audit

The firm issued an audit report with a qualified opinion on \*ST Xinyi's 2019 financial report, and found that there was no misstatement in \*ST Xinyi's financial statements, except for the matters in the paragraph "forming the basis of the qualified opinion". Although \*ST Xinyi committed egregious fraud during this period, the court did not find these frauds. It can be seen that there are major audit quality control deficiencies in the audit of this project.

Before Tangtang accepted the audit commission of \*ST Xinyi, the audit opinion of ST's former auditor's financial statements on its prior period financial statements is shown in Table 4, and before the audit work, Tangtang still did not maintain vigilance and professional suspicion about \*ST Xinyi's financial position when it was aware of the financial quality of \*ST Xinyi for the previous year, and the accountant who was originally intended to sign refused to sign and replaced the accountant, nor did it require changes to the income identified as not meeting the requirements of accounting standards, therefore, The quality of the audit reports it issued was flawed.

**Table 4.** Audit opinion table of ST XinYi prior year financial report

Fiscal Year	Accounting firms	Audit fees (million yuan)	Type of audit opinion
2013	Baker Tilly International	50	disclaimer of opinion
2014	BDO	80	qualified opinion
2015	Moore Global	80	unqualified opinion with emphasis on matter paragraph
2016	Moore Global	53	qualified opinion
2017	Moore Global	80	qualified opinion
2018	HUA XIN	80	disclaimer of opinion

Source: CNINF <http://www.cninfo.com.cn/new/index>

Under the influence of the epidemic, the project has high requirements for the professional knowledge and competence of auditors, but the audit team members sent by Tangtang Firm do not take professional competence as the main indicator, but are basically relatives and friends of Wu Yutang, the partner of Tangtang Firm.

Finally, the audit review workflow of the hall is formal, and it is only a superficial act. Reviewers should participate in the whole process of audit review and properly implement it. But Wu Yutang signed the report without a full review of the manuscript; In addition, Liu Runbin's review work was limited to the electronic version of the audit report and some audit papers, and did not carefully review the audit evidence obtained.

### 3.2.2. CPAs lack independence

The independence of a certified public accountant requires that the certified public accountant maintain an objective and independent attitude when conducting audit work. Independence is the soul of audit work, and if he is unable to maintain independence, the objectivity and impartiality of his audit work will also be affected, and the professional judgment and audit procedures carried out by his independence will become rootless. In this case, the chairman of \*ST Xinyi first informed Wu Yutang of the types of audit opinions that could be issued in 2019, and Wu Yutang still undertook this audit business after learning about it, and the two reached a "cooperation": Tangtang promised not to issue a negative and could not express an opinion, \*ST Xinyi wanted to compensate Tangtang for the penalty losses that Tangtang may receive and promised to hand over the audit business in 2020 to Tangtang. This "drawer agreement" signed by both parties greatly undermines the detached independent status of CPAs. The performance pay of the audited project team is linked to the results of the audit report after inspection, and there is a contingent fee based on the type of report opinion issued; The replacement of the certified public accountant to be signed under pressure from outsiders also shows that the firm has seriously lost its independence.

### 3.2.3. Insufficient professional competence

Tangtang had not engaged in such securities service business before undertaking the audit business of \*ST Xinyi, and most of the audit business it had done before was the audit and agency bookkeeping business of some small enterprises. \*ST Xinyi is its first listed company customer, the scale, organizational structure, business type and other aspects of the listed company are quite different from the previous customers of ST Tang, and the audit procedures and risks faced by the two will inevitably be quite different, therefore, the audit experience accumulated before when auditing \*ST Xinyi may not help the certified public accountant make effective professional judgment and implement appropriate

and reasonable audit procedures.

## 4. Recommendations to Prevent Audit Failures of Small and Medium-sized Firms

### 4.1. Accounting firms

#### 4.1.1. Have a clear positioning for yourself and choose customers carefully

Since the promulgation and implementation of the New Securities Law, many small and medium-sized firms have been eager to undertake audit services in the securities market. Compared with large firms that undertake audit business of listed companies for many years, the scale of auditors and experience in the securities market of small and medium-sized firms are not as competitive as those of large firms. When selecting clients, small and medium-sized firms should comprehensively investigate the industry, legal and other relevant information of the client, compare the risks they will face after undertaking business with their own tolerance, and consider whether their professional competence can be competent. In this case, the audit opinions obtained by \*ST Xinyi, known as the "A-share suspension king", for three consecutive years showed that there were certain problems in its financial position, but it was still the next hot potato. The implementation time of the New Securities Law is not long, and it is difficult for small and medium-sized firms to form a mature and professional audit team for listed companies in a short period of time, so small and medium-sized firms should try to choose clients with good financial status and low risk.

#### 4.1.2. Keep a reasonable distance from the audited unit and maintain your independence

In this case, in order to undertake the business of \*ST Xinyi, Tangtang Law Firm sold its audit opinion and made a commitment with the audited unit when issuing the report, which seriously damaged its independence. In order to ensure the quality of audits, accountants and partners of small and medium-sized firms should reduce unnecessary contacts with audited entities, and should not link audit opinions with their own audit income. When undertaking business, the certified public accountant should adhere to the position of his independent third party, and cannot change or delete the necessary audit procedures according to the unreasonable needs of the audited entity, so as to help the audited entity rationalize the misleading statements. If the CPA loses its independence, statements with improper audit opinions are likely to mislead investors on the weaker side of obtaining information. The development of the service business in the securities market of small and medium-sized enterprises has only just begun, and if such a complicity between the two parties is revealed, it will have a negative impact on its

economy and reputation. Small and medium-sized firms do not have the same ability to withstand pressure as large firms, so it is very important to pay attention to maintaining their independence and strengthening professional ethics to prevent audit failure.

#### **4.1.3. Improve their professional competence**

The professional competence of a certified public accountant is to a large extent a key factor in the success or failure of an audit. In the securities market, CPAs in large firms usually have systematic and rich audit business experience and keen industry sense. Compared with large firms, accountants in small and medium-sized firms are slightly inadequate. In order to improve their professional competence, small and medium-sized firms should conduct regular training for their auditors, including but not limited to important repairs that emphasize professional ethics and handling typical cases. Secondly, special training should be provided to certified public accountants before the audit project is carried out, such as training on the characteristics of the industry in which the audited entity is located, the environment, and applicable laws and regulations. The most important point is that in the rapidly changing laws and regulations of the securities market, CPAs should establish a professional attitude of lifelong learning and constantly innovate their auditing skills.

## **4.2. Regulatory bodies**

### **4.2.1. Strengthen the intensity of inquiries to small and medium-sized audit services**

Frequent inquiries by regulators to small and medium-sized firms can increase the possibility of exposure of financial fraud in the audited business of small and medium-sized firms to a certain extent. With regard to the supervision of the capital market, it is necessary to stand in the perspective of the overall situation, carry out dynamic supervision of small and medium-sized firms from before and after the event, guide and standardize the auditing behavior of the securities market in the form of inquiries at any time, and avoid audit failures that may occur due to their own shortcomings.

### **4.2.2. Strengthen external penalties**

Improve relevant laws and regulations, and further increase the punishment for audit failures of small and medium-sized firms. As the first small and medium-sized firm to undertake the audit business of the securities market, the Tangtang Law Firm in this case was severely punished by the CSRC with the severe penalty of "six fines and one forfeiture", which to a certain extent sounded the alarm for the audit business of the subsequent small and medium-sized firms. The limitations of small and medium-sized firms' own defects, the imperfect development of the dual filing system, and the mixed nature

of listed companies have greatly increased the possibility of audit failure of small and medium-sized firms. The increase in the amount of penalties imposed on small and medium-sized firms for illegal audits makes the price to be paid after their audit failure much higher than the profits obtained by selling their audit opinions, which may protect the independence of small and medium-sized firms to a certain extent and improve their audit quality.

## **5. Conclusion**

This paper takes \*ST Xinyi as an example, analyzes the performance and causes of audit failures of the halls responsible for its audit business, and proposes corresponding measures to prevent audit failures. However, \*ST Xinyi is only a special case of audit failure cases of small and medium-sized enterprises, so the suggestions made are somewhat one-sided. At present, the development of the audit business of listed companies of small and medium-sized firms is not perfect, so audit failure will inevitably have a non-negligible negative impact on the development of such businesses by small and medium-sized firms. The dual filing system has been implemented in China for a relatively short time, and only when small and medium-sized firms improve their own business capabilities, accurately position their own situation, improve their professional competence, and then strengthen the regulators' concern and inquiry for small and medium-sized firms, can they promote the development of small and medium-sized firms under the dual filing system.

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