

# Analysis of Audit Failure Cases of Accounting Firms—Take Xinyongzhong and Audit LetV for Example

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**Abstract:** This article takes Shine Wing Certified Public Accountants as the research object, and uses the method of case study to analyze the causes and preventive measures of audit failures of accounting firms. Through the analysis, it is found that Shine Wing has defects in some audit procedures, and its audit failure is mainly caused by the accounting firm and the audited unit. Based on the flaws in Shine Wing's audit procedures and the reasons for audit failure, this paper summarizes the experience and lessons, and puts forward countermeasures against audit failure in a targeted manner.

**Keywords:** Audit Failure, Audit Quality, Accounting Firm, Certified Public Accountant

## 1. Introduction

Leshi Internet Information Technology (Beijing) Co., LTD. (Leshi Internet), a well-known video Internet company in China, has been found guilty of financial fraud. The company's auditing firm, Xinyonghe Zhonghe, was also investigated by the China Securities Regulatory Commission (CSRC) for not being diligent and was later fined a hefty sum.

## 2. Related Work

### 2.1. Introduction to LetV

Letv Information Technology (Beijing) Co., LTD. (hereinafter referred to as letV), as a video Internet company in China, has a unique sales and profit model: it makes profits through video copyright payment. By this method, it breaks the situation that video websites are difficult to make profits, and becomes the first profitable video website [1].

However, the good times did not last long. From 2007 to 2016, letV inflated its performance and faked its financial results for ten consecutive years [2]. The following is its inflated income and profit for ten years, which shows that it inflated a large amount of income, resulting in its inflated profit several times more than the actual profit. In 2015 and 2016, the total amount of falsely increased profits was 382,951,800 yuan and 432,763,300 yuan respectively, which was a huge amount and serious financial fraud [3-5], as shown in Table 1.

Table 1: Profit situation of letV

year	2012	2013	2014	2015	2016
Inflated income (10,000)	8965.33	19998.17	35194.19	39922.39	51247.00
Inflated profit (10,000 yuan)	8445.10	19339.69	34270.38	38295.18	43276.33
Inflated profit %	37.04%	78.49%	470.11%	516.32%	-131.66%

In fact, letV net fictitious profit, financial fraud has been years. Since its listing in 2010, it has not only used its own funds to cycle and collude with the fictitious business income [6], but also continued to inflate its performance by forging contracts, not actually executing framework contracts or unilaterally confirming swap contracts. Its financial fraud cases include:

1) Fictitious advertising business to recognize revenue, in the absence of fund collection, accounts receivable for a long time, falsely increase business revenue and profit.

2) In the case of fictitious advertising business confirmation of income, in the absence of funds to pay back, all or part of the accounts receivable will be offset through intangible assets, and the costs and profits will be falsely calculated accordingly [7].

3) Continued to falsely increase performance by fabricating business with third-party companies and constructing false capital circulation through Jia Yuting's control of bank accounts.

4) Confirmed income through the fictitious business of the third-party company, and constructed part of the false capital cycle through the bank account controlled by Jia Yuting and inflated the performance by recording receivables for a long time [8].

5) Recognized business income and inflated performance by signing advertising exchange framework contracts or fictitious advertising exchange contracts that were not actually executed with customers [9].

**2.2. Introduction of Xinyong Zhonghe**

Shine Wing Certified Public Accountants (special general partnership) was established in the early 1980s. It is the first professional service organization established under the influence of the reform and opening up policy in China, and it is also the accounting firm with the longest surviving time in my country. It has great market influence in itself.

Credit neutralization has provided services for letV for several years, and I have a relatively good understanding of its business scope and various matters. Among them, Xinyonghe provided audit services for letV's annual financial statements in 2015 and 2016, and issued audit reports with unreserved opinions and unreserved opinions with highlighted items respectively. The audit service fee in each year was 754,717 yuan, and the total fee was 1,509,434 yuan. Therefore, letV has been getting away with fraud for many years and Shinaga Zhonghe's audit failure has an important relationship [10].

Xinyongzhonghe, as an accounting firm providing audit authentication services for the annual report of letV from 2015 to 2016, did not find any clues of LetV in the audit, and did not adopt adequate and appropriate audit procedures to reduce audit risks. As a result, Xinyongzhonghe issued inappropriate audit opinions on the annual report of the two years. The fraud of Leshi Internet related transactions was not concealed until the CSRC and the media made extensive reports. With the deepening of the public's research on Leshi Internet, the derelict behavior of Xinyonghe, as the firm providing audit authentication business for Leshi Internet, was exposed [11].

**3. Deficiencies in Shinewing's Audit Procedures**

**3.1. Flaws in the Internal Control of the Advertising Business**

As shown in Figure 1, the knowledge acquisition process of corporate sustainable development is positively correlated with the company's future prospects. In 2015, the internal control process of letV's advertising business includes the link of "account reconciliation and adjustment": the accounts receivable supervisor reviews the account reconciliation report with customers every month, that is, whether the statements sent to customers have been recovered, whether the amount replied by customers is consistent with the amount recorded in the detailed accounts, if there is any difference, whether the reasons for the difference have been investigated and whether the accounting records need to be adjusted. However, due to the audit problem, the CPA did not carry out the walk-through test on this important link. Moreover, no samples were selected to test the effectiveness of internal control of advertising business "sales and collection cycle", but the audit conclusion of "effective internal control" was reached [12].

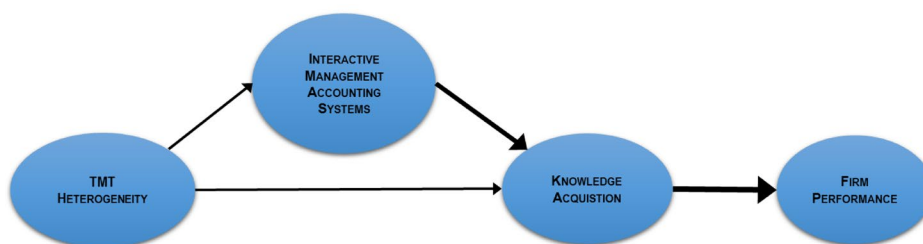


Figure 1: A company development flow chart

In 2016, the situation changed. CPA conducted an internal control test on the "sales and collection cycle" of letV's advertising business. Control objective "To confirm the sales revenue after the transfer of main risks and rewards" corresponding control measures are described as follows: after the actual advertising, the accounts receivable supervisor reviews the account reconciliation report with the customer, that is, whether the statement sent to the customer has been recovered, whether the customer reply amount is consistent with the detailed account record amount, if there is a difference, whether the reason for the difference has been investigated, whether the accounting needs to be adjusted Record.[13] However, the CPA found that this control measure had not been implemented when walking through the test, that is, it did not receive the customer's account reconciliation return, but still came to the audit conclusion that "no missing link was found in the sales collection cycle", and did not select samples for control test [14].

The CPA described the two internal control defects found in the "Business-Level Defect Assessment Form" as follows:

1) Letv checks accounts with customers every month according to the actual progress of advertising, but does not leave paper statements;

2) The advertising contract signed by letV stipulates that there should be a third-party testing report; however, most of the actual business execution is internal data information, which is not retained financially. If the other party does not give feedback after receiving the account verification email, it shall be regarded as approval. It is suggested that the company retain the confirmation information of the other party or both parties sign for confirmation. Certified public accountants will identify the above two defects as general defects.

According to the characteristics of letV's advertising business, the general practices of the advertising industry and the identification of the control measures by certified public accountants, the above defects should belong to the material defects of internal control. At the same time, the CPA did not realize that the above major defects increased the risk of fraud in the advertising business.

**3.2. IT Audit Testing Deficiencies**

The typical audit process is shown in Figure 2. There was a lack of evidence to support the conclusion in the audit of Ark System. After learning about the basic situation of letV's advertising business system -- Ark System through interviews, certified public accountants believed that the advertising business was more manually controlled and required to extract system data such as the amount and schedule of advertising of five companies such as Aokai Aviation Co., LTD. Tianjin Branch and Beijing Yimei Advertising Co., LTD. The certified public accountant recorded in the audit working paper that "no samples have been provided for the system data extraction of the investment volume and schedule of the five companies", and the certified public accountant did not carry out the walk through test and control test. The audit concluded that no anomaly was found [15].

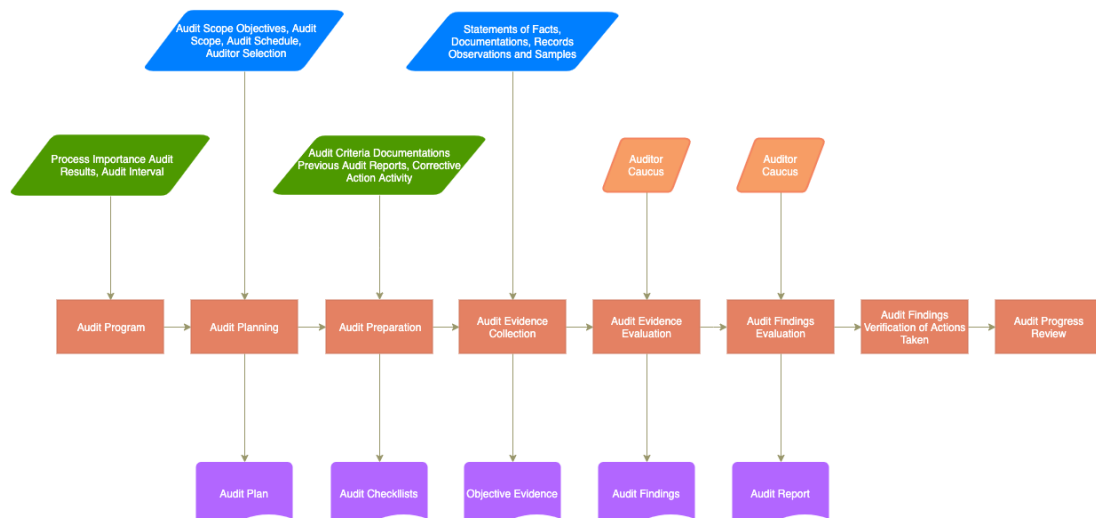


Figure 2: Audit process progress flowchart

In the substantive test procedure of operating income, the certified public accountant did not take

further audit procedures to obtain sufficient and appropriate audit evidence for the abnormal situation found. The certified public accountant extracted the exposure times of 40 advertisers based on orders in 2016 from the advertising business system—the Ark system, and the following 2 customers were not retrieved in the Ark system: Beijing Yili Culture Media Co., Ltd., China-Netherlands Dechangsheng Network Technology Co., Ltd. When the certified public accountant reviewed the above-mentioned extracted data, the reason why the above-mentioned two companies had advertising revenue in 2016 but could not retrieve the company names in the Ark system was explained as: the above-mentioned two companies replaced Hainan Ayang Technology Co., Ltd. and Beijing Xunsha Technology Co., Ltd. placed advertisements, but the Ark system did not update the information. However, the certified public accountant did not obtain evidence such as the advertising business contract or the advertising order of the substitute company to prove the rationality of the above explanation.

**3.3. Defects in operating income audit**

In 2015, the advertising revenue of letV was RMB 2,633,677,800, accounting for 20.3% of the current operating revenue, and an increase of 67.53% compared with that of 2014. In the risk assessment, certified public accountants identified the risk of fraud in Leshi's client management, shareholders and key managers, and the risk of fraud in sales revenue. There may also be irrational situations in the company's industrial clusters, as shown in Figure 3.

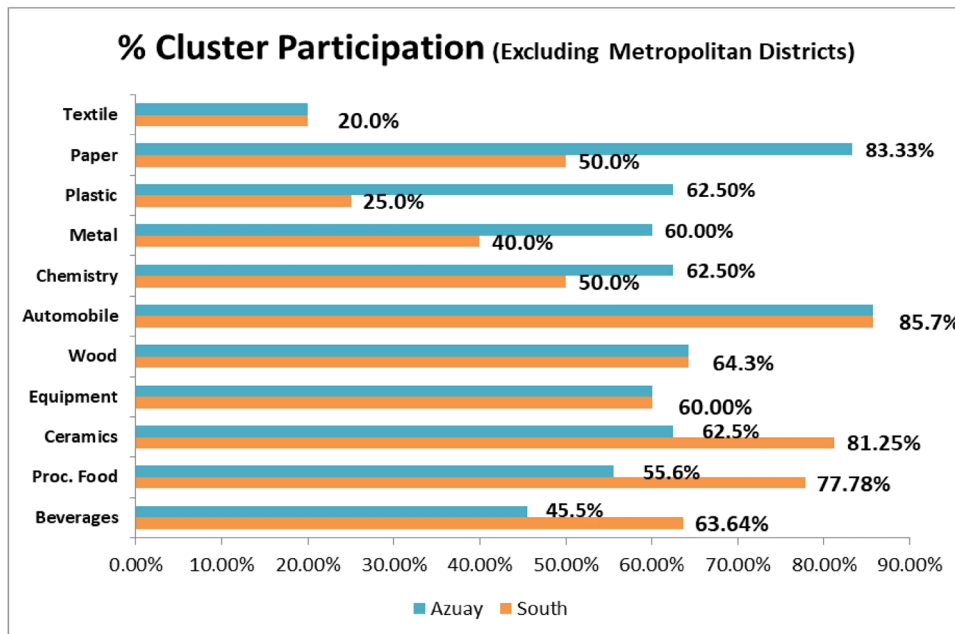


Figure 3: Unreasonable industrial cluster composition in a certain place

In this case, for the risk of material misstatement of advertising business income, CPA only designed two audit procedures in "Measures for Risk of Material Misstatement and Special Risks": 1. Compare current period revenue with previous period. Focus on volatile products; 2. Whether the schedule of the contract is consistent with the schedule of the advertising business system. Whether the income amount is consistent with the contract amount. Targeted audit procedures were not designed according to the characteristics of letV's advertising business and the above risk assessment. And these two programs do not completely remove the risk.

**4. Deficiencies in Shinewing's audit procedures**

By analyzing the audit failure case of Arthur Andersen Accounting Firm on WorldCom, Huang Shizhong concluded that the root cause of Arthur Andersen's audit failure on WorldCom was the lack of independence of Arthur Andersen in the audit process. Failing to maintain due professional suspicion, failing to fully understand all WorldCom's accounting policies and procedures before making audit plans, and failing to obtain direct audit evidence sufficient to support its audit opinion. Wang Jianxin used the fraud triangle theory to analyze the motivation, opportunity and self-

rationalization of the financial report fraud of listed companies and the firm's violations, and found that the audit failure is the result of the firm's violations and the financial report fraud of listed companies. In this paper, by referring to the analysis literature on the reasons for audit failure of well-known experts and scholars, and based on the case of audit failure of letV, this paper summarizes the reasons for the failure of audit of LetV by Xinyongzhonghe from the level of accounting firms and audites.

#### **4.1. Accounting Firm**

##### **4.1.1. The Personnel Rotation Mechanism of Continuous Audit Project Is Defective**

Auditing an enterprise with the same accounting firm for many years is prone to fraud. Xinyong Zhonghe has provided continuous audit services for letV for many years. Continuous audit has major disadvantages. For example, accounting firms are more familiar with the auditees, and the risk of excessive trust is easy to occur. In addition, accounting firms are insufficient to evaluate the professional competence and independence of the members of continuous audit projects due to cost considerations. In this case, some certified public accountants of Xinyong Zhonghe have participated in the audit business of letV for many times. The failure of accountants in the audit is closely related to the audit failure. It can be seen that Xinyong Zhonghe has defects in the rotation mechanism of the members of continuous audit projects.

##### **4.1.2. There is a Lack of Professional Skepticism Among Auditors in the Firm**

In this case, when auditing Leshi Internet, the auditors failed to maintain proper professional suspicion and did not regard such situation as abnormal and carry out further auditing procedures for the increase of advertising business income related to Leshi Internet, the addition of sales links in the sales process, the change of sales mode and the change of financial statements. Thus, it can be seen that maintaining professional skepticism plays a crucial role for auditors to successfully implement relevant auditing procedures and obtain appropriate audit opinions. When auditing the audited entity, auditors should always maintain professional suspicion, analyze whether the abnormal situation found in the auditing process is reasonable, if not, they should timely communicate with the management to obtain the management's explanation, and take further procedures to check the authenticity of the management's explanation.

#### **4.2. Audited Unit**

To a large extent, audit failure is due to the conflict between the audit objectives of CPA and the management objectives of the audited unit. When there is fraud in the financial statements during the audit period, the management of the audited unit will usually provide false information to the CPA in order to ensure its business performance, so as to achieve the purpose of confusing the public and getting through. Letv fabricated its advertising business and cooperated with third-party companies to fabricate its business. Then, it fabricated its financial statements by falsifying bills and other means. Therefore, when Xinyong Zhonghe conducted the audit, letV provided false materials to the audit team, which led to the audit failure to some extent.

### **5. Countermeasures to Prevent Audit Failure**

#### **5.1. Accounting Firm Level**

##### **5.1.1. System Mode: Strengthen Personnel Assignment and Rotate Key Auditors Regularly**

When auditing the auditee, the accounting firm should comprehensively consider the industry the auditee is in, the current development scale and business situation of the enterprise, and select certified public accountants who have relevant audit experience and are familiar with the audit risks of the industry. Different certified public accountants have professional experience in auditing enterprises in different industries. Therefore, in the stage of undertaking business, accounting firms should select certified public accountants with relevant work experience in the industry of the audited entity when assigning personnel.

For a long time engaged in the audit of the same company personnel for regular rotation, reduce the auditors and the company's interest exchanges, prevent the occurrence of financial fraud and audit failure, constantly ensure the audit quality to achieve the desired effect, play a good audit efficiency. In the actual implementation of audit authentication business, constantly update the audit team members

to accumulate the relevant knowledge of the industry, and constantly improve their own audit practice experience.

Auditors should also fully learn the professional knowledge of the industry in which the auditees are located, understand the applicable accounting standards and laws and regulations of the industry, identify the unique risk points on the premise of fully grasping the actual situation of the auditees, and carry out the corresponding audit procedures according to these situations. For the abnormal situations found, further audit procedures should be carried out. Reduce risk for accounting firms.

### **5.1.2. Personnel Training: Strengthen the Training of Auditors and Maintain a High Level of Professionalism**

Auditors should pay enough attention to abnormal transactions and situations. By checking contracts, bank transfer statements and warehouse entry and exit records, sampling the original vouchers of related party transactions, inquiring relevant financial personnel of the auditee and other methods, they should recalculate accordingly and compare and analyze the calculated data with those provided by the auditee. Determine if there is a significant difference.

Accounting firms should continuously strengthen personnel training, maintain the acuity and sensitivity of auditors, follow professional ethics and professional ethics, maintain a high level of professionalism, and timely analyze and deal with abnormal situations.

### **5.2. Audited Unit**

In the case of audit failure of Leshi Internet, the audited entity Leshi Internet attempted to cover up its financial problems by illegal means such as financial fraud due to its irregular operation, and was finally fined heavily. In addition, the accounting firm was also fined a huge amount of money due to its failure of audit due to its lack of diligence. Therefore, the audited company should operate legally in accordance with the rules and regulations in the daily business activities, shall not falsify business income and bank deposits, adhere to reasonable legal integrity management, in the company encountered bottlenecks in time to deal with the problem, reverse the loss, absolutely cannot through financial fraud and other ways to beautify the financial statements. If the enterprise and the occurrence of financial fraud, should be timely stop losses, should not let the auditors cover up for it, should be used to audit violations of the timely disclosure, so as to correct timely, the negative impact of the company will be minimized.

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