

Analysis of Enterprise Audit Failure Issues: A Case Study of Guangdong Rongtai's Audit

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Abstract: In recent years, cases of audit failures have occurred frequently, causing significant losses to auditing firms, investors, and enterprises, and damaging the credibility of the auditing industry. This paper takes the audit failure event of Guangdong Rongtai Company as a case study. By analyzing this case, it points out that the audit failure was due to the insufficient professional competence of the certified public accountants (CPAs), their failure to maintain due professional skepticism, unreasonable audit procedures, and fraud by the management of the audited entity. Accordingly, suggestions for preventing audit failures are proposed, including that CPAs should strengthen their professional skills, adhere to professional skepticism, enhance the supervision of audit procedures, and enterprises should strengthen internal management to reduce the occurrence of audit failure cases.

Keywords: Audit Failure; Professional Competence; Audit Procedures; Professional Skepticism

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1.Introduction

Since the reform and opening up, China's social economy has developed rapidly, the number of enterprises has continuously increased like bamboo shoots after a spring rain, and the demand for auditing enterprise businesses has also risen^[1]. Auditing is an extremely important economic service, which involves auditors conducting detailed supervision and inspection of the financial status of the audited entity to ensure the authenticity and reliability of its financial information.

Certified Public Accountant (CPA) audits are independent third-party audits conducted by CPAs on the audited entity in accordance with relevant laws, regulations, and audit permissions. This requires CPAs to maintain due professional skepticism and possess corresponding professional competence during the audit. However, in recent years, audit failures have begun to occur frequently, causing huge losses to auditing firms, investors, and enterprises, which is shocking. Therefore, research on audit failure issues has profound significance, both theoretically and practically^[2].

2.Overview of Audit Failure

2.1 Meaning of Audit Failure

Audit failure specifically refers to the situation where auditors, during the audit process, do not truly evaluate the financial status of the audited entity accurately and meticulously in accordance with the institutional norms of the auditing industry. The occurrence of audit failure can cause huge losses to enterprises, investors, and society. For a company, audit failure indicates problems with its financial status and errors in its financial reports, which may seriously damage the company's

economic benefits and reputation. For auditors, audit failure indicates that they failed to strictly follow rules and regulations or performed incorrect actions in their work, which may lead to legal accountability and reputational damage. The consequences caused by audit failure are multifaceted^[3].

2.2 Causes of Audit Failure

The cause of audit failure is the situation where the audit results do not match the actual circumstances during the auditors' conduct of the audit on the audited entity. There can be many reasons for audit failure: insufficient professional competence of auditors, unreasonable application of audit methods, lack of cooperation within the audited entity, fraud, etc.

Generally speaking, the main reasons for audit failure are, on one hand, the improper application of audit methods by auditors. Audit methods refer to the series of norms and corresponding steps used by auditors to carry out audit work. On the other hand, it is the improper execution of audit procedures. Audit procedures mainly include investigating and understanding the basic situation of the audited entity, signing an engagement letter with the audited entity, preliminarily evaluating the internal control of the audited entity, determining materiality levels, analyzing audit risk, collecting audit evidence obtained during the execution of the audit, reviewing audit working papers, forming an audit opinion, and preparing the audit report. Any of these can lead to audit failure^[4]. In audit practice, if auditors themselves lack professional competence and are unfamiliar with audit procedures and methods, it is possible to arrive at audit results that are inconsistent with the actual situation. For example, during the audit process, auditors might misjudge the financial status and business operations of the audited entity, consequently failing to fully understand its business characteristics and not adopting sufficiently adaptive audit procedures, leading to problems in the audit.

The enterprise itself might also create barriers with auditors due to poor communication and mutual misunderstanding, which is also detrimental to the conduct of the audit business. An important factor affecting the accuracy of the audit conclusion is whether the audited entity provides complete and accurate financial information during the audit process and actively cooperates with the auditors in their work.

In today's continuously developing economy, to reduce the frequent occurrence of audit failure cases, CPA audits should strengthen their in-depth learning of audit procedures and methods, and continuously improve their operational skills. Additionally, enterprises should actively cooperate with the work of CPA audits, providing complete, detailed, and accurate financial information to auditors on a monthly or quarterly basis.

3. Case Analysis of Guangdong Rongtai Company

3.1 Introduction to Guangdong Rongtai Company

The Guangdong Rongtai Company case is an important case for studying audit failure issues. Analyzing the causes and reflecting on the audit failure of this company is conducive to an in-depth analysis of the causes and impacts of audit failure later, thereby summarizing the causes and impacts of audit failure from both the internal perspective of the audited entity and the perspective of the CPAs.

Guangdong Rongtai Company was established as a joint stock limited company with Guangdong Rongtai Advanced Ceramics Co., Ltd. and Jieyang Xingsheng Chemical Raw Materials Co., Ltd. as the main promoters, jointly with three other companies. In its early days, Guangdong Rongtai vigorously developed the scientific research industry, increased investment in emerging technology industries, and, to ensure the company had a continuous source of innovation capability, also took scientific research and innovation as its fundamental driving force. Internally, it emphasized the cultivation and importance of talent, establishing an effective performance management method. Thus, Guangdong Rongtai Company managed to stand out in the fierce market competition. As a well-known company, it once enjoyed a good reputation in the industry. However, during the audit process in 2018, auditors discovered a series of problems, which severely damaged the company's image and caused huge economic losses to the enterprise and investors. This also became the trigger for subsequent problems^[5].

3.2 Details of the Audit Failure Incident

Since Guangdong Rongtai Company announced its listing in 2001, Zhengzhong Zhujiang Accounting Firm had been providing audit services to the company. Over the years, Zhengzhong Zhujiang Accounting Firm issued unqualified audit opinions to the public. In 2019, Guangdong Rongtai Company suddenly changed its accounting firm during the audit, switching to

Dahua Certified Public Accountants for the audit. In that year's audit report, Dahua Certified Public Accountants issued a qualified opinion on the financial statements of Guangdong Rongtai Company, leading to a divergence of opinions between the audited entity and the audit firm. Under these circumstances, Guangdong Rongtai Company also failed to disclose its financial reports in a timely manner, which triggered an investigation by the China Securities Regulatory Commission (CSRC). After a detailed investigation, the CSRC found that Guangdong Rongtai Company had committed significant fraud in the financial audits for 2018 and 2019, which Zhengzhong Zhujiang Accounting Firm had failed to discover at the time. This fully indicates that the CPAs of Zhengzhong Zhujiang Accounting Firm did not strictly follow audit rules when auditing the company and issued an incorrect audit report, resulting in audit failure. In 2021, Guangdong Rongtai Company received a penalty notice from the CSRC.

4. Analysis of the Causes of Audit Failure in Guangdong Rongtai Company

4.1 Insufficient Professional Competence of Certified Public Accountants

The CPAs of Zhengzhong Zhujiang Accounting Firm lacked professional competence in handling the audit business of Guangdong Rongtai Company. Due to the lack of professional skills of the appointed CPAs, they were unable to conduct a comprehensive and detailed audit of the company's various businesses, thus issuing unreasonable audit opinions on Guangdong Rongtai Company's audit. In practical work, if auditors lack relevant business knowledge and audit experience, it may lead to difficulties in carrying out audit work, making it hard to identify potential problems and hidden risks^[6].

Zhengzhong Zhujiang Accounting Firm was established in 2000. At the beginning of its operation, it was diligent and meticulous in handling audit business, gaining a good reputation. However, as its business scale continuously expanded, Zhengzhong Zhujiang Accounting Firm absorbed many CPAs with varying abilities, and the firm lacked corresponding on-the-job training. This led to insufficient professional ability and lack of practical experience among its auditors. In the case of Guangdong Rongtai's audit failure, there was a phenomenon of the Guangdong Rongtai management itself deceiving superiors and subordinates and acting intentionally, which increased the difficulty of the audit work. To accurately identify and expose the company's fraud, CPAs with strong professional competence and extensive experience are needed. In the Guangdong Rongtai audit failure case, the CPAs failed to accurately identify the full picture of the internal fraud events at Guangdong Rongtai Company. They handled audit issues by taking things out of context and applying dogma, which is a manifestation of the insufficient professional competence of the CPAs.

4.2 CPAs' Failure to Maintain Due Professional Skepticism

The CPAs of Zhengzhong Zhujiang Accounting Firm failed to adhere to an attitude of professional skepticism in the audit of Guangdong Rongtai. The firm's accountants learned during their review of the company that three clients, including Jieyang Jin Hua Trading Co., Ltd., had transferred receivables from already deregistered customers to Jieyang Fenghua Chemical Additives Co., Ltd. and Jieyang Jiegao Footwear Co., Ltd., with the payment made by these two companies on behalf [of the deregistered clients]. During visits to the two proxy companies, the accountants failed to maintain due professional skepticism regarding the act of paying receivables on behalf under abnormal circumstances, suspecting that the audit evidence for this action was inconsistent with the situation where the proxy companies and the represented company were part of the same family, or the two were friend companies^[7]. The firm failed to obtain sufficient and appropriate audit evidence in a timely and accurate manner. The firm needed to increase necessary audit procedures in various aspects such as the real relationship between the agent and the payer, the reason for payment, and the time when the payment obligation was established.

Furthermore, the amount of cash flow between Guangdong Rongtai Company and its suppliers was much higher than expected, which was also an abnormal situation. In 2018, the funds paid by Guangdong Rongtai to three suppliers—Hetong Plastic, Zhongyue Agricultural Materials, and Yongjia Agricultural Materials—were more than five times the procurement amount recorded in their official documents. Moreover, in the absence of business operations, the amount received by Guangdong Rongtai Company from these three suppliers in 2018 was also several times that of normal activities. The CPAs noticed anomalies during the audit of this matter but still failed to maintain professional skepticism and did not further obtain sufficient appropriate audit evidence.

5. Unreasonable Audit Procedures by CPAs

In the Guangdong Rongtai Company case, the execution of audit procedures by the CPAs was unreasonable. Audit procedures are the core of audit work. If the audit program design is unreasonable, it is difficult to discover potential problems and risks within the company. In the audit work of Guangdong Rongtai Company, the execution of audit procedures had a certain degree of blindness and arbitrariness. Such defects affected the accuracy and effectiveness of the confirmation process work performed by the accountants. During the audit, the auditors requested confirmation letters for already deregistered customers Jieyang Haiwei Plastic Industry Co., Ltd. and Jieyang Wanliheng Plastic Products Co., Ltd. During the CPA's investigation period, this correspondence was handed over to its paying company, Taizhou Jiegao Footwear Co., Ltd., and then the reply letter was obtained directly from the financial director of Guangdong Rongtai.

The CPAs visited the three suppliers—Yongjia Agricultural Materials, Zhongyue Agricultural Materials, and Hetong Plastic—and received reply letters from each, but the CPAs did not obtain the reply letters directly from the confirming units. The sender of the reply letters was the Financial Director of Guangdong Rongtai, and the mailing address was the office address of Guangdong Rongtai. Zhengzhong Zhujiang Accounting Firm failed to follow up on this anomaly and also did not discover that the express tracking numbers for these three suppliers showed significant discrepancies.

In Guangdong Rongtai's procurement business, internal control activities such as "implementing an advance payment guarantee system and proportional payment management, establishing an advance payment ledger management system, regularly tracking and verifying large or long-term advance payments, and analyzing the reasonableness of fund occupation" were not actually performed. This is also an important manifestation of unreasonable audit procedures.

The CPAs' erroneous execution of the confirmation procedure was also one of the reasons leading to the audit failure. The purpose of the confirmation procedure is to obtain details about the audited entity and obtain corresponding evidence through third-party statements about relevant information and existing conditions. Confirmation is an important audit procedure for CPAs to obtain audit evidence when performing verification and capital verification services. Evidence obtained through confirmation is highly recognized by society, so confirmation is popular and frequently used. For letters related to the same audit object, if the auditor sends the summary table of confirmation results as comprehensive audit evidence and audit working papers to multiple respondents, their evaluation of the confirmation results should be recorded after receiving the replies. In the case of Guangdong Rongtai's audit failure, the CPAs failed to obtain replies directly from the confirming units as required by the standards during the confirmation process, indicating inadequate execution of their confirmation procedures.

After accepting the audit engagement from the audited entity, CPAs need to comprehensively and meticulously understand the situation of the audited entity. Auditors must not only understand the specific situation of Guangdong Rongtai Company in detail but also analyze practical problems realistically. They should also avoid audit engagements with high risks and where the auditors themselves are uncertain. The audit firm must ensure it has a clear understanding of its own audit engagements, which can also serve as the practical basis for subsequent audit work. In the initial stages of conducting the audit, due to the lack of in-depth understanding of the audited entity, the information collected about the audited entity can easily become somewhat one-sided due to time pressure. However, as the audit work on Guangdong Rongtai Company's business deepened, the auditors became more familiar with its internal situation. This could lead some CPAs, aiming to save audit costs, to directly apply past audit experience when collecting information about Guangdong Rongtai Company. In the case of Guangdong Rongtai's audit failure, this paper identified some unusual behaviors in Guangdong Rongtai Company, but the CPAs of the audit firm did not conduct investigations or research into these, nor did they strictly perform other duties expected of CPAs. Zhengzhong Zhujiang Accounting Firm was overly optimistic in its estimates of significant changes occurring during the audit process of Guangdong Rongtai Company and failed to strictly follow audit procedures in conducting the audit work.

Furthermore, during the 2018 and 2019 audit work, there was poor communication between the CPAs of Zhengzhong Zhujiang Accounting Firm and the audited entity, which also created obstacles to the smooth progress of the audit work. Poor communication between CPAs and the company's internal staff during the audit can lead to asymmetric and incomplete

information collected by the CPAs, which is also a manifestation of unreasonable audit procedures by the CPAs. The difficulty for CPAs in obtaining accurate and detailed internal financial information from Guangdong Rongtai Company limited the in-depth development of the audit work. Simultaneously, communication problems can also cause friction and conflict between the CPAs and the company's internal staff, further affecting the smooth progress of the audit work.

6. Fraud by the Management of the Audited Entity

Guangdong Rongtai Company failed to disclose related party relationships as required and deliberately concealed them. The Chairman of Guangdong Rongtai had his close associates actually control several companies from June 2008 to April 2019, including Guangdong Guohua Mechanical & Electrical Equipment Installation Co., Ltd., Jieyang Hetong Plastic Co., Ltd., Jieyang Zhongyue Agricultural Materials Co., Ltd., and Jieyang Yongjia Agricultural Materials Co., Ltd. It was also discovered that several employees of Guangdong Rongtai held nominal leadership positions in these companies, their main behavior being to control important functions and interfere with actual work in these companies^[9]. From this, it is not difficult to see that the boss of Guangdong Rongtai Company was also the actual boss of these four companies. Therefore, the aforementioned four companies all had related party relationships with Guangdong Rongtai. However, in its 2018 and 2019 annual reports, Guangdong Rongtai did not disclose this relationship as required by relevant regulations. Secondly, Guangdong Rongtai Company artificially increased profits through related parties to benefit from it. Guangdong Rongtai discovered that three customers with whom it had business dealings had been dissolved and were unreachable in March 2019, with total accounts receivable of 12.246 million yuan. To avoid making a full provision for bad debts on these receivables, Guangdong Rongtai Company used its own funds to make circular payments to related parties and third-party institutions such as Zhongyue Agricultural Materials and Hetong Plastic, and forged payment agreements. Guangdong Rongtai Company falsely claimed to have collected 12.246 million yuan from the three customers, thereby reducing the accounts receivable balance for these three customers to zero, thus avoiding recognizing a 12.246 million yuan bad debt for these three customers. This resulted in an overstatement of profits by 12.246 million yuan in the 2018 annual report, accounting for 6.87% of the total profit of 178.3345 million yuan disclosed in the 2018 annual report^[10].

Guangdong Rongtai Company employed methods of falsely reporting sales returns to artificially increase profits and benefit from it. In November 2019, the accounts receivable balance for 10 customers of Guangdong Rongtai Company was 31.2423 million yuan. However, when Guangdong Rongtai reviewed its accounts receivable at year-end, it found that, except for Jieyang Baishijia Footwear Co., Ltd., the other 9 customers had lost contact, and Baishijia Footwear was also unable to repay its outstanding debt. Guangdong Rongtai used its own funds and third-party institutions for circular payments to avoid making a provision for bad debts on accounts receivable in 2019, thereby avoiding a negative impact on the company's profits. Subsequently, the company created false third-party payment agreements, falsely claiming to have received 31.2423 million yuan, reducing the accounts receivable balance for these related customers to zero, thus avoiding a 31.2423 million yuan bad debt provision on these accounts. This resulted in an artificial increase in the company's 2019 profits by 31.2423 million yuan.

7. Suggestions for Preventing Audit Failure

7.1 CPAs Should Strengthen Their Professional Skills

Many CPAs, when they first obtain their CPA qualification and initially undertake audit work, can still firmly implement qualities such as independence, focus on professional foundations and learning ability, and handle practical problems cautiously, as if treading on thin ice. However, after dealing with daily work, especially large amounts of cyclical work, they begin to stop progressing, neglecting the continuous learning of professional knowledge and self-improvement. When encountering unexpected situations in practical work, they may panic and act rashly, causing economic losses to enterprises and investors, and damaging the reputation of the auditing industry. Therefore, as a CPA, one must pay attention to the continuous learning of professional knowledge, focus on the training of professional business levels, continuously accumulate experience, consolidate professional foundations, and enhance one's own professional quality.

In practical audit work, to obtain reasonable audit evidence, CPAs should always maintain a professional attitude during

the audit process, adhere to their stance, and be diligent and responsible. CPAs should promptly discover problems in the enterprise's financial data. Furthermore, CPAs need to continuously strengthen their professional skills, establish correct values, and adhere to principles. In their future work, they should be fully aware of the adjustments in accounting standards and keep pace with the development and changes in the industry. During the implementation of audit work, CPAs should continuously uphold their professional stance, distinguish right from wrong in their work, and fully exert the responsibilities of a CPA auditor.

7.2 Adhere to the CPA's Professional Skepticism

If CPAs cannot maintain an attitude of professional skepticism at all times in their work, they are likely to overlook various detailed issues in practical business operations, leading to the eventual occurrence of audit failure^[11]. The professional skepticism of CPAs requires that no CPA should consider identified frauds in an audit as isolated incidents. If audit evidence obtained from different sources is inconsistent, it may indicate that some or several pieces of audit evidence are unreliable. Similarly, if a management representation contradicts other audit evidence, the CPA should investigate this situation. If unusual circumstances are identified during the audit process, the CPA should conduct further investigation^[12]. In practical audit work, as a CPA, professional skepticism can allow auditors to "find doubts" in a traceable and targeted manner, rather than working mechanically and blindly, leading to audit failure. In the Guangdong Rongtai audit failure case, the CPAs failed to maintain the necessary professional skepticism, thus failing to promptly discover the close relationship between the audited entity and other related enterprises^[13].

7.3 Strengthen Supervision of CPA Audit Procedures

Currently, China's audit procedures are still not perfect compared to foreign countries, and there is a need to further strengthen the supervision of CPA audit procedures, strictly implement the responsibility system, and enforce the concept that whoever makes the error bears the responsibility. Strengthening the supervision of audit procedures can start from the following two aspects: First, increase the supervision of the audited entity and increase the penalties for financial fraud to raise the cost of deception for the audited entity. This will fundamentally curb the financial fraud behavior of audited companies. Second, strengthen the supervision of CPAs. The new "Securities Law" increases the responsibility of CPAs for false reporting by the audited entity, requiring accounting firms to bear joint liability for false reporting by the audited entity. This significantly increases the cost of violations for accounting firms, which has a certain deterrent effect on CPAs who make errors of varying degrees in their audit work. As a result, the phenomenon of CPAs colluding privately with audited entities will decrease. To avoid inefficient communication with the audited entity, repetitive supervision procedures, and clandestine cooperation between CPAs and the audited entity, various regulatory departments need to optimize communication channels, optimize the regulatory framework, clarify responsibilities, avoid misunderstandings and mutual buck-passing, and penalize enterprises and accounting firms that violate the law^[14]. Of course, punishment is not the ultimate goal. Regulatory agencies need to guide enterprises and CPAs to assume their respective responsibilities, strictly comply with relevant laws and regulations, and avoid illegal incidents.

8. Enterprises Should Strengthen Internal Management

If there are flaws within an enterprise, the probability of financial fraud increases significantly. Guangdong Rongtai used various methods for financial fraud, but the company's board of supervisors and other board members did not stop its behavior. Among them, the company's independent directors did not question its practices but adopted a permissive and indifferent attitude. Such behavior allowed major shareholders to manipulate the financial statements, which to some extent reflects the defects in Guangdong Rongtai's internal control system.

Although Guangdong Rongtai established an internal governance structure in accordance with the regulations for listed companies, its governance structure still had serious defects. The company's governance layer did not perform its duties diligently, and such chaos ultimately led to the serious consequences of financial fraud. To effectively prevent audit failure incidents, from the enterprise's internal perspective, perfecting the enterprise's internal control system, establishing a strict supervision system, improving the effectiveness of corporate governance, continuously leveraging the supervisory duties of independent directors, and strengthening internal enterprise management are urgent tasks for improving the enterprise's

internal control system^[15]. Whether it is the audited object or the auditing object, all aspects rely on improving the audit system, comprehensively applying various means and measures such as training and education, supervision and management, and professional ethics. Only in this way can the quality and efficiency of audit work be effectively improved, and the effectiveness of audit work in serving economic construction and social development be better guaranteed.

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