

Avoiding Audit Failures - A Case Study of Xintai Financial

Jiayuan Zhang^{1,a,*}

¹*School of Economics and Management, Beijing Institute of Graphic Communication, Beijing
102600, China*

a. ZhangJiaYuan666@outlook.com

**corresponding author*

Abstract: In recent years, financial fraud cases have been on the rise, with a combination of subjective reasons within companies and audit failures caused by negligence on the part of accounting firms. This paper examines the case of audit failure at Xintai Financial to understand how companies engage in financial fraud through illegal means, manipulate financial statements, and highlights the shortcomings of Beijing Xinghua Accounting Firm in their work, which contributed to the success of Xintai Financial's financial fraud. In conclusion, three insights are drawn to provide lessons for the future on how to prevent audit fraud effectively.

Keywords: Financial fraud, audit failure, effective oversight

1. Introduction

In many cases, financial fraud is a means adopted by companies to achieve certain objectives, which has attracted attention in academia. However, research on financial fraud issues in China is not yet rich, and companies use various methods during the fraud process. Therefore, a deeper understanding of financial fraud issues can help better identify and prevent corporate financial fraud. This paper provides a detailed account of the circumstances surrounding the financial fraud at Xintai Financial, explores their practices in financial fraud, and analyzes various aspects to propose measures for preventing financial fraud. The aim is to provide reference material for academic research on how to prevent financial fraud.

2. Theoretical Basis

Due to information asymmetry and conflicts of interest between company owners and operators, the registered accounting profession has emerged. To ensure the effective operation of a market economy, the rule of law and trustworthiness have emerged, and the degree of marketization is directly proportional to the development of the social legal system and the credibility of economic entities. To maximize their interests, company operators may manipulate financial information, and owners as well as other stakeholders in the public lack the professional skills to discern the authenticity of accounting information. This has led to the emergence of independent third-party registered accountants. However, in the actual auditing process, various factors can affect the prudence and independence of registered accountants, leading to audit failures. Nowadays, two popular definitions of audit failure are as follows:

Audit result view: From the perspective of social investors, this view reflects the self-interest of investors and expands the responsibilities of auditors. With the continuous improvement of laws and regulations, company owners and social investors increasingly use audited financial statements as a basis for economic decision-making. This increases the expectations of social investors regarding the results of auditor's reports and their desire for compensation from registered accountants if they suffer losses based on the audit report. Company owners and social investors believe that the audit report serves the public. If the audit report contains false statements or fails to meet the needs of report users, it is considered an audit failure.

Audit process view: From the perspective of the audit entity, registered accountants believe that audit personnel have failed to comply with audit standards and relevant laws and regulations, resulting in the issuance of false audit reports, ultimately leading to audit failure. This viewpoint is more in line with humanitarian spirit. As audit personnel prioritize enterprise risk-oriented considerations, they assess the order in which audit projects are scheduled and specific audit procedures based on a pre-determined likelihood of significant misstatements. They then conduct a systematic evaluation of the company's internal control system based on the assessed likelihood of significant misstatements. Based on this, key constructive opinions are presented.

3. Overview of Xintai Electric's Falsification

Since Xintai Electric was delisted in 2016, the spotlight has once again turned to the issue of audit failures. Financial fraud inflicts losses on industry progress and even the healthy development of society. This article analyzes the causes and consequences of Xintai Electric's financial falsification and audit failure, aiming to propose solutions and contribute to the further regulation and development of the auditing industry.

Xintai Electric's core business is the manufacturing and sale of energy-efficient power transmission equipment, with its headquarters located in Xintai, Liaoning. In the power industry supply sector, it is considered a leading enterprise.

Since 2011, Xintai Electric had been working on applying for an IPO listing with the China Securities Regulatory Commission. However, due to the losses incurred in its operating business, its profitability declined, leading to the failure of its initial IPO application. In 2012, Xintai made a second IPO application, which received approval from the regulatory commission, granting it the qualification for listing. In 2014, the company officially went public. In 2015, during a regulatory inspection, the regulatory authority uncovered potential fraudulent activities at Xintai Electric. As a result, they initiated an investigation into the matter. Ultimately, in May 2016, it was confirmed that Xintai Electric was engaged in financial fraud, leading to the initiation of mandatory delisting procedures. Xinghua Certified Public Accountants, the firm responsible for providing audit services throughout Xintai Electric's financial activities, also shares the inescapable responsibility. Their negligence in implementing audit procedures facilitated Xintai Electric's fraudulent behavior, and as a consequence, they faced penalties and mandatory corrective actions [1].

4. Detailed Analysis of Financial Fraud Methods

(1) Falsification of Accounts Receivable Receipts to Reduce Accounts Receivable

When a company accumulates excessive accounts receivable, the likelihood of bad debts increases significantly, affecting the quality of its assets and reducing its risk resilience.

Xintai Electric adopted a method in which they transferred funds from the company to customers and then had customers transfer the funds back to the company. Through this manipulation, the company's "accounts receivable" could be marked as collected, thereby reducing its bad debt reserves. Furthermore, Xintai Electric also engaged in financial maneuvers by utilizing borrowed funds from

external sources to artificially increase its accounts receivable ratio. Later on, Xintai Electric realized that this practice of borrowing money externally to repay its accounts receivable incurred high interest expenses. As a result, in their subsequent financial fraud, they began tampering with third-party documents such as bank records. They had employees falsify customer information and other data, mixing these counterfeit documents with genuine bank records, creating significant difficulty for auditors.

(2) Non-disclosure of Related Party Fund Usage as Required

Xintai Electric's management had borrowed over 60 million yuan in the name of employees from the company in 2015, primarily using employees to borrow company funds for non-operational purposes. Furthermore, the company failed to disclose the direction of these funds and had unclear records regarding the processing of these funds. Xintai Electric's illicit fund usage goes beyond this; its parent company, Liaoning Xintai, repeatedly used company funds but did not disclose it in their financial reports. Lastly, the actual controller of Xintai Electric also sold the company's real estate to closely related family members without the approval of the board of directors [2].

(3) Reducing Raw Material Costs to Inflate Profits

Xintai Electric's daily raw material purchases include steel, silicon steel, and copper, with raw materials accounting for over 90% of production costs. Reducing the cost of raw materials can substantially increase the company's profits. Based on an analysis of annual report data, it is evident that there were significant fluctuations in their operating income and operating cost change rates. Additionally, the company's prospectus from previous years revealed that its procurement costs were significantly lower than market prices, leading to an over 40% artificial profit inflation on the basis of actual profit figures.

5. Details of the Audit Failure by Beijing Xinghua Certified Public Accountants

(1) Failure to Notice Abnormal Transactions in Receivables and Payables

Accounts receivable and accounts payable are the company's assets and liabilities, and they represent the company's current assets and liabilities. Proper examination of accounts receivable is essential to verify the authenticity of financial data, ensure the timely collection of receivables, safeguard the legal rights and interests of both parties involved in economic transactions, and ensure the smooth operation of the company.

During their audit of Xintai Electric's financial statements for the IPO, Beijing Xinghua evaluated the "revenue" as an area of "significant risk of material misstatement" and categorized "risk of increasing revenue and profits" as a "specific risk" in their audit summary. While they correctly identified "accounts receivable" as a significant account and associated audit risk areas, they did not pay adequate attention during the audit procedures. Specifically, when faced with numerous and significant reversals in red, Beijing Xinghua did not maintain the necessary professional skepticism and caution. They failed to implement additional audit procedures or substantive tests. When confronted with substantial and unusual reversals, the certified public accountants only randomly selected a few vouchers for review, verifying the reasonableness of these redeterminations. Generally, redeterminations in transactions involving accounts receivable result from returns, and auditors should check for the presence of supporting documents like return requests and return receipts in the voucher attachments. If these documents are missing, they should question the financial personnel of the audited entity.

For a company like Xintai Electric with significant and substantial transactions involving accounts receivable, auditors should have assessed the possibility of financial fraud. This would have necessitated the implementation of further audit procedures such as the tracing method or the vouching method to verify the authenticity of the economic activities underlying these

redeterminations. The failure of the registered auditors to employ these effective techniques contributed to the audit failure of Xintai Electric [3].

(2) Failure to Conduct Alternative Tests on Banks' Customers with No Responses

Registered accountants typically use the letter confirmation procedure to ascertain the existence of customers, assets, and business transactions. Sending confirmation letters to banks is essential for verifying the authenticity of accounts receivable data. In China's independent auditing standards, registered accountants are required to perform confirmations for accounts receivable, and in cases where no responses are received, alternative audit procedures must be implemented to obtain results that are in accordance with the standards. This is done to ensure the truthfulness and reliability of accounts receivable.

In the penalty judgment document, it was mentioned that among customers who did not respond, two customers had falsified the reduction of accounts receivable. However, registered accountants did not conduct the appropriate alternative procedures regarding this matter. According to China's current auditing standards, registered accountants are required to perform alternative testing for relevant accounts with no response, such as examining original vouchers, bills, and other documents before and after transactions, to verify the authenticity of the transactions.

(3) Failure to Pay Adequate Attention to Unusual Situations in Bank Accounts

In the audit case, the registered accountants implemented inappropriate audit procedures, particularly in the areas of cash and bank transactions. They found it challenging to detect related fraudulent practices, which led to the audit failure. One crucial step in the process is the confirmation of the existence of cash balances. Xintai Electric's financial reports showed negative year-end balances in bank accounts, but the registered accountants did not pay attention to these discrepancies. They failed to conduct additional audit procedures or provide explanations in the work papers. It is not difficult to imagine their collusion with Xintai Electric's financial fraud.

Furthermore, in 2013, there was a significant difference between the cumulative amount of debits and the year-end debit balance in the Dandong City Commercial Bank account. Based on Xintai Electric's fraudulent methods, it can be inferred that the large debit amounts in early 2013 were due to the fictitious recovery of year-end accounts receivable, while the large number of fictitious recoveries at the end of 2013 led to a significant increase in the debit balance.

Finally, the accounting firm's conclusion in the audit report was an unqualified opinion. This misled the users of the financial statements, making them believe that Xintai Electric's financial health was relatively sound when, in reality, significant internal issues had already surfaced, subjecting investors to additional unknown risks.

(4) Failure to Accurately Assess the Effectiveness of Xintai Electric's Internal Controls

Xintai Electric's parent company, Deyi Wen, as the issuer, holds a 77.35% stake in the company, while family members hold 13.01% of Xintai Electric's shares. It is evident that the Deyi Wen family controls the decision-making power of Xintai Electric, leading to inevitable decision biases. The situation where shareholders mutually supervise each other is challenging to establish, and it fails to fulfill the supervisory function. For two consecutive years in 2013 and 2014, Beijing Xinghua issued an unqualified internal control audit report for Xintai Electric, acknowledging the reliability of the company's self-assessment reports on internal control effectiveness and believing that internal control design and execution were effective. Therefore, it is evident that Beijing Xinghua did not carry out the necessary control testing and incorrectly assessed the reasonableness of the company's internal control design and its effectiveness.

Due to the immense financial strain caused by Xintai Electric's recent successful initial public offering and the substantial expenditure on fabricating the recovery of accounts receivable, there was significant financial pressure. As a result, the budget for internal control audits was minimized. Beijing Xinghua, wanting to maintain its relationship with Xintai Electric while being unwilling to

allocate excessive manpower and resources that did not align with its business revenue, naturally reduced the effectiveness of internal control audits. This led to an inability to reasonably evaluate the effectiveness of Xintai Electric's internal controls.

6. How to Prevent Financial Fraud

From the practices of Xintai Electric and Beijing Xinghua Accounting Firm mentioned above, it is clear that strengthening the development of accounting firms and more effective regulation of enterprises require continuous exploration of new solutions by the academic community.

(1) Preventing Audit Failures at the Root

Establishing an effective internal audit within enterprises can rely on internal staff to objectively and independently assess the financial condition and operational status of the enterprise to ensure the legality and compliance of its operations. Ultimately, this leads to maximizing economic benefits, enhancing the enterprise's own capabilities, and improving the organization's operational conditions. The role of internal audits is also reflected in quantifying the overall situation of the enterprise into data, reducing operational risks, creating more value, and ensuring the safety of investment decisions for the enterprise. Additionally, by analyzing minor issues discovered through internal audits, targeted solutions can be implemented promptly, ensuring a smooth course for the enterprise's future.

However, in reality, many corporate management teams are corrupt, collude with each other, and have an irrational structure, making it difficult for the supervisory and evaluative role of internal audits to be effectively carried out. To utilize the supervisory role of internal audits, a scientific and reasonable internal audit mechanism can be established [4].

First, a third-party external professional auditing organization can be hired to take over the internal audit business of the enterprise. Through the involvement of external personnel, independence can be maintained, responsibilities can be clearly defined, and limited human and material resources can be efficiently utilized to carry out effective internal audits. This is beneficial for swiftly identifying departments and individuals with deviations. Second, a new, scientific audit model that integrates both prior and concurrent audits can be established, ultimately combined with post-audit analysis. Finally, standards for internal audit personnel admission can be established, creating a smooth performance evaluation mechanism. This helps motivate auditors to constantly keep up with the latest professional knowledge and improve their expertise, ensuring a high-quality internal audit team.

Apart from the assurance provided by internal audits, a scientifically perfected management structure can ensure orderly progress in the auditing process and remove obstacles hindering the implementation of audits. To prevent a single entity from dominating the enterprise, several improvements can be implemented:

Firstly, the voting mechanism at shareholder meetings should be improved to ensure that all shareholders have the right to decide on the company's business decisions. This restrains controlling shareholders and protects the interests of small and medium-sized investors. It is imperative to ensure that all shareholders can fully exercise their voting rights. Secondly, the structure of the enterprise management, especially the board of directors and shareholder meetings, needs to be perfected to ensure the relative independence of the management from the controlling shareholders. External directors can be appointed to manage the company's day-to-day operations. The establishment of an incompatible system for various departments and positions, especially regarding the incompatibility of power between the general manager and board members, is essential.

(2) Enhancing the Professionalism of Auditors as an Important Measure to Avoid Audit Failures

Registered accountants, as independent third parties, utilize their solid expertise in auditing and accounting to provide businesses with credible and reliable information about their financial condition. The competence of auditors is the core foundation for preventing audit failures. Before executing audit procedures and during the compilation of audit plans, auditors should analyze risk

assessment procedures meticulously. They should take into account the financial statement data, combined with the actual industry situation, to make reasonable and reliable judgments regarding the authenticity of the audited entity's financial data. Their role should extend beyond just verifying the correctness of the financial statement data. Based on the solid foundation of their professional knowledge and in consideration of the prevailing practice environment and pre-assessed areas of significant misstatement risks, auditors should flexibly implement audit procedures.

To ensure the professionalism of auditors, accounting firms should make efforts in the following areas. Firstly, they should ensure that all signing auditors obtain the required professional qualifications, allowing auditors to apply theoretical knowledge to practice effectively. Secondly, they should enhance the ongoing professional education of auditors, comprehensively adhere to the latest laws and regulations related to auditing and accounting, hold seminars on audit failure cases, analyze the fraudulent methods used by major companies and key points for avoiding audit failures. This ensures that registered accountants can identify and address the continuously evolving issues related to financial fraud, thus avoiding further audit failures and maintaining the healthy development of the auditing industry.

Registered accountants should fully embody the professional spirit of prudence and skepticism during the auditing process. When evaluating the financial data of public companies, they should be grounded in the nature of the audited entity and the overall industry context. Any abnormal data should be thoroughly investigated. Auditors should use their prudence and skepticism to verify the authenticity and reliability of the data. To prevent public companies from defrauding the public, registered accountants should delve deeply into the financial data of the audited entity and meticulously scrutinize every instance of abnormal business income. They should use audit procedures effectively to ensure the reliability of the audit evidence obtained, maintain the continuity between various data, and effectively mitigate audit risks [5].

(3) Government-Led Third-Party Oversight Reduces Fraud Risks

In the auditing industry, the lack of relevant laws and regulations, as well as the relatively lenient penalties imposed by the China Securities Regulatory Commission (CSRC) and government authorities for financial misconduct by listed companies and accounting firms, have resulted in wrongdoers not facing significant criminal or civil liabilities. This failure to compensate for the losses incurred by social investors is a prevalent issue in the capital markets. Only when the relevant regulatory bodies enhance penalties and measures [5] for wrongdoers can they attempt to compensate the losses of the general investing public. This is crucial for reducing the frequency of audit failures, maintaining the orderly operation of the capital markets, and safeguarding the legitimate rights and interests of all stakeholders. It is imperative that comprehensive accountability measures are applied to all those who engage in illegal or unethical behavior.

CSRC and government authorities should impose stringent administrative penalties that make the cost of misconduct far exceed the illegal gains. Furthermore, the permanent professional qualifications of individuals involved should be revoked. Only through these actions can a deterrent effect be achieved concerning accounting firms and their certified public accountants.

In addition to government oversight, the self-regulation role of the Certified Public Accountants (CPA) industry associations is particularly prominent. These self-regulation organizations, formed by participants within the auditing industry, are based on their voluntary commitment to oversee the compliance of accounting firms and their CPAs with professional standards. In comparison to government entities, these self-regulation organizations can provide a deeper, more specialized form of supervision over various accounting firms and their CPAs involved in audit cases. For publicly traded companies or accounting firms that violate ethical standards, they are subject to severe condemnation by both the CSRC and government authorities. Therefore, the self-regulation organizations within the CPA industry can further standardize the professional practices of

accounting firms and their auditors. Moreover, it is essential to raise the entry requirements for accounting firms, establish assessment mechanisms to encourage the improvement of audit quality among registered CPAs, and promote the formation of economies of scale among different accounting firms. By emphasizing complementary advantages, strategic mergers, and enhancing competitiveness, the CPA firms can eliminate the cutthroat competition in the audit market, foster cooperation, and collectively create a well-organized and healthy audit market. This collective effort aims to prevent audit failures ultimately.

7. Insights

In summary, to prevent financial fraud in businesses, a combined effort from both internal and external stakeholders is essential. It is primarily concluded that, within a company's internal governance, the establishment of relevant systems is necessary to prevent individuals from exploiting the company for their own interests. In the case of accounting firms, a reinforcement of their own development, adherence to professional ethics and standards is required. Additionally, government regulatory bodies and industry associations need to exercise strict supervision. Only through these concerted efforts can financial fraud be mitigated as much as possible. This article acknowledges its limitations, primarily due to practical constraints that make it challenging to conduct face-to-face interviews or obtain first-hand data. Furthermore, the author's expertise may have limitations, resulting in potential shortcomings in the analysis. With the rapid advancement of technologies like artificial intelligence in various fields, there is hope for leveraging high-tech solutions in the future to further standardize corporate financial practices.

References

- [1] Dong, Y., & Ma, X. (2021). *Analysis of the Causes of Financial Fraud in Xintai Electric and Countermeasures*. *Modern Business*, (25), 187-189. DOI: 10.14097/j.cnki.5392/2021.25.060.
- [2] Long, D. (2021). *Analysis of Xintai Electric's Financial Fraud Case from the Perspective of GONE Theory*. *International Business and Accounting*, (09), 47-51.
- [3] Leng, Y. (2020). *Implications of Xintai Electric's Financial Fraud Case for Domestic Regulation*. *Economic Research Reference*, (01), 198-199.
- [4] Zeng, Y. (2021). *Implications of Financial Fraud in Listed Companies: A Case Study of Xintai Electric*. *Modern Business*, (19), 126-128. DOI: 10.14097/j.cnki.5392/2021.19.039.
- [5] Long, D. (2022). *Analysis of Xintai Electric's Financial Fraud Case from the Perspective of Accounting Firms*. *Wealth Era*, (04), 119-121.