

A Case Study on the Failure of Great Wisdom Audit

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Abstract: With the development of Internet technology, many new industries have sprung up, followed by the continuous innovation of business models and the increasing of settlement methods, but certified public accountants will face more and more audit risks. Certified public accountants are playing an increasingly important role in solving information asymmetry and maintaining the operation of the economic market. In this paper, it is believed that auditing can be prevented from the following aspects: Accounting firms should strengthen quality control and internal governance, and improve the independence of auditors; Certified public accountants themselves should keep their professional doubts, improve their professional competence, and carefully assess audit risks; At the same time, it is necessary to improve relevant laws and regulations, and increase the punishment and supervision of CSRC.

Keywords: Audit Failure; Financial Fraud; DZH

1. Case Introduction

1.1 Introduction of Da Wisdom and Lixin

1.1.1 Great Wisdom

Since its establishment, Da Wisdom is one of the leading Internet financial information service providers in China. Based on its long-term accumulation in the Internet field, the company has taken advantage of the Internet platform and big data to create a one-stop, intelligent Internet financial information service platform integrating consultation, service and transaction to provide professional and timely financial data and data analysis to investors and corresponding products and services to the majority of Internet customers.

1.1.2 Lixin

Lixin CPA was founded in 1927 by Pan Xulun, with a registered capital of 5 million RMB, and its headquarters is established in Shanghai, which can independently undertake CPA business according to the law. Lixin CPA has been developing for more than 90 years and is ahead of most of its peers in terms of business strength and business quality, and has been the independent third-party auditor of Great Wisdom since 2010.

1.2 Introduction to the audit process

1.2.1 Overstatement of income

1.2.1.1 Early recognition of revenue

In December 2013, in order to sell the company's software, Da Wisdom promised its customers on the official website that if the customers "failed to meet the expectations" of the product within three months (i.e., March 31 of the following year) after purchasing

financial software of more than 38,000 yuan, Da Wisdom would give them a full and unconditional refund, so they quickly achieved. The sales revenue increased significantly. In the process of selling the software, it was difficult to determine the condition of "not meeting the expectation" because Da Wisdom promised a full and unconditional refund within three months. The customer's needs varied, and whether the customer's expectations could be met was entirely up to the customer's subjective decision, so the refund rate could not be projected. It may seem to increase sales revenue in the short term, but then there may be a large number of refunds.

1.2.1.2 Inflated revenue

First of all, in December 2013, Great Wisdom made an invitation to customers, and its telemarketers collected 2.87 million yuan of funds from customers on the pretext of focusing on IPO and purchasing high-yield financial products, and concealed the real business situation of customers, and included the funds in the main business income, but there was no specific business record situation. Such operation made Great Wisdom's 2013 profit inflated by 2.87 million yuan. Then on December 24 of the same year, Great Wisdom signed a cooperation contract with Beijing Guanghengmei Advertising Co., Ltd, but it was only a framework agreement, and only when the customer really had the demand for advertising placement would the contract be re-entered and the relevant fees paid according to the specific needs of the customer. When there was no actual advertising placement, Great Wisdom recorded revenue of 940,000 yuan, which was an inflated revenue.

1.2.2 Under-costing

Great Wisdom included the year-end bonus for employees in the previous year in the current year's cost expense, included the cost expense in 2012 in 2013, and then deferred the cost expense in 2013 to 2014, resulting in an understatement of cost expense of \$24.95 million in 2013 and a year-end bonus of \$31.24 million in 2013, which had a significant impact on the amount of earnings for the year and did not truly reflect the operating condition of the enterprise.

1.2.3 Early recognition of subsidiary's purchase date and overstatement of profit

Shanghai Ji Dahui Information Technology, a wholly-owned subsidiary of Dahui, recognized the purchase date of its acquisition of Tianjin Mintai in advance, and such operation increased the profit of the consolidated financial statements in 2013 by RMB8.25 million and inflated goodwill by RMB4.33 million. According to the regulations, the purchase date cannot be counted when there is no actual control over Tianjin Mintai, so the operation here should be adjusted.

2. Reasons for audit failure

2.1 From the perspective of a CPA

2.1.1 Risk identification and assessment procedures are not done properly

In December 2013, Dazhong's revenue rose significantly when industry-wide revenue was gradually declining. Dazhong's revenue was unusual, and Lixin did not properly assess the risks involved and did not perform targeted audit procedures for possible audit risks. At the time of the significant increase in revenue and the large number of sales returns after the year, Lixin stated that they had pretended that customers had purchased products from Da Wisdom, saying that the sales staff had not made a "100% refund if not satisfied" promise. However, it is not possible to do the audit procedure of inquiry only, and the inquiry procedure cannot be used as an audit procedure alone, but should also include other audit procedures. Regarding the large number of refunds at the end of the period of Great Wisdom, the CPA once learned from the management of Great Wisdom that the reason for the large number of refunds was that the clients were dissatisfied with the investment advisory services, but the corresponding audit procedures were not recorded in the audit draft. The large number of clients of Great Wisdom and the dispersed personnel made it extremely difficult to do the correspondence procedure, so the direct and simple audit procedure of inquiry was adopted, but such audit evidence was not sufficient and effective.

2.1.2 Failure to maintain due professional suspicion

In that case, Great Wisdom had a substantial increase in revenue in one year, and more notably, the first three quarters of 2013 were loss-making, and only the fourth quarter had a substantial increase in revenue, turning the first three quarters into a loss. But the corresponding cost management expenses did not increase significantly, and the CPA should doubt here whether Great Wisdom has inflated its income. On the other hand, Da Wisdom has lost money for the second year in a row in 2012. According to China's regulations, if a listed company loses money for three consecutive years, it will face the risk of delisting, so we should consider whether Da Wisdom has the possibility of manipulating profits. The main business income of Da Wisdom does not change with the change of seasons, but through its main business income and net profit situation, Da Wisdom continuously lost money in the first three quarters, but turned around in the fourth quarter and achieved a significant increase in income. The auditors should have been reasonably suspicious of this unusual occurrence and focused on the unusual increase in revenue in the fourth quarter. However, LIC did not take a deeper look into such anomalies and only made adjustments to the subsequent refund amounts. It was the auditor's failure to maintain reasonable professional skepticism that led to the ongoing audit failure.

2.1.3 Professional competence is lacking

According to our CPA auditing standards, CPAs should investigate to identify the nature and causes of all deviations or misstatements and evaluate their possible impact on the purpose of audit procedures and other aspects of the audit. But Lixin's CPAs did not further expand the audit sample when they audited unusual electronic returns simply because the amount of misstatements found was well below the materiality level. But the materiality level is determined not only by whether its amount exceeds its value, but also by whether its amount ends up influencing the decisions of financial statement users. Therefore, the personnel concerned do not have a good understanding of the auditing standards, they are not competent enough for the work they undertake, they do not have a multifaceted understanding when conducting risk assessment, and they pay less attention to high-risk items, which is what leads to the issuance of wrong audit opinions.

2.2 From the firm's perspective

2.2.1 Inadequate internal governance

Before undertaking an audit engagement, in addition to ensuring the independence and professional competence of the CPA, it is important to ensure that there are no issues due to management integrity. A client relationship should be declined if the adverse impact of the client's problems cannot be reduced to an acceptable level. If a business is undertaken, risks should be controlled at all stages before, during and after the event. When LIC audited Dazhong, it did not have sufficient understanding of the economic environment and the state of the industry in which Dazhong was located to avoid project risks.

The CPA lacked standards for control testing in performing audit engagements. Therefore, there is a lack of prescribed policy basis in conducting the audit, especially in preparing the working papers, and Lixin's working papers have incomplete and non-standard format.

2.2.2 Fierce competition leads firms to pay no attention to audit quality

China's audit industry started relatively late, has not formed a completely healthy market competition. In order to survive, accounting firms have joined the ranks of low-cost competition, competition for business. With the opening of China's audit market to the outside world, local accounting firms not only have to compete with each other, but also face competitive pressure from international accounting firms, which has intensified the competition between small and medium-sized firms. In the face of this unfavorable situation, accounting firms in order to survive, they will blindly solicit business to increase their clientele, thus neglecting their own level of development. Secondly, since the professional level of most accounting firms does not differ much, they will also reduce the cost by actively reducing the audit quality in order to gain more profit in the low-price competition. If the basic costs

required for auditing are not met, then it is difficult to guarantee the audit quality.

2.2.3 Insufficient penalties for audit failure and low cost of non-compliance

In the case of Lixin audit of Great Wisdom, Lixin audit failure, although the fine of 2.1 million yuan, confiscation of business income of 700,000 yuan, the relevant signatory CPA also received a penalty of 100,000 yuan, but the strength of such penalties, whether to the accounting firm or the auditor did not cause serious damage to the individual, resulting in the low cost of the auditor's violation of the law, there is nothing binding on the individual, if the mistakes made. If the mistake is not found within the regulatory authorities, then the benefits will be far greater than the amount of punishment, even if the same mistake is found again, "the big deal is a fine," so accounting firms will take a chance, in order to reduce the cost of the audit will correspondingly reduce the quality of the audit, in order to obtain as much benefit as possible.

3. Related suggestions and insights

3.1 Recommendations for Lixin and other firms

3.1.1 For CPA

3.1.1.1 Maintain a high level of professional skepticism

During Lixin's audit of Great Wisdom, the CPA did not maintain professional skepticism, so it overlooked many areas that could give rise to audit risks. For example, in the fourth quarter of 2013, the sales revenue increased abnormally, the CPA ignored whether the revenue was legally compliant because it did not maintain professional skepticism, and did not discover the fact that Dazhi had recognized the inflated revenue in advance. Because Lixin was auditing Dazhong on an ongoing basis, it may have relied more on data from previous audits, which was one of the reasons for the audit failure.

3.1.1.2 Improving the professional competence of auditors

The professional competence of auditors is crucial in the work. First of all, the threshold should be raised in recruitment. In the past, personnel with CPA certificates would go directly to work in the firm, and the firm would also recruit college students for internship. In the process of performing audit work, the personnel with strong professional competence are in the minority, which will undoubtedly reduce the quality of audit. Do a good job of training when recruiting, and only recruit those who are qualified in training and supervise their studies as a way to cultivate talents.

Within the firm, a fair and effective reward and punishment mechanism should be established to help individuals find their own development goals and transform the improvement of professional competence into the internal motivation of employees, so as to drive employees to improve their self-motivation and work enthusiasm and fundamentally improve their professional competence.

3.1.1.3 Setting and implementing targeted audit procedures

When implementing a specific audit plan, the first step is to understand the audited entity and its environment, and to have a comprehensive understanding of the characteristics of the industry in which the audit subject is located, which is also a basic requirement. In the audit of Great Wisdom, the auditors failed to fully understand the Internet financial services industry in which Great Wisdom is located, revealing their lack of ability to audit this type of industry, and only by fully understanding the characteristics of the industry can they further make targeted audit procedures.

3.1.1.4 Prudent assessment of audit risks

As evidenced by this case of a failed audit of Great Wisdom, the auditors did not perform the risk assessment process well. One should fully understand the audited entity before accepting the engagement to see if it has a history of fraud or other matters that

indicate a high audit risk, and consider whether to undertake this audit engagement if there is a high probability of audit failure for the engagement. Audit risk depends on the risk of material misstatement and the risk of inspection, which should be carefully assessed because the risk of material misstatement is uncontrollable. In particular, the existence of weak controls and management override of internal controls should be a key concern for CPAs. Special consideration needs to be given to whether the identified risk is a risk from fraud and whether the risk is related to the economic environment.

3.1.2 Firm side

3.1.2.1 Strengthen the quality control and internal governance of the firm

In terms of performance appraisal, the firm should not only focus on the performance of the employees, but also trigger the consideration of their own professional ethics in terms of their overall quality. The extent of their contribution to the firm and their ability to work as a team should be included in the professional appraisal index. The appraisal process should be rewarded and punished by linking their results to their salaries. However, direct appraisal is not aimed at punishment, but to motivate employees to improve themselves and their moral quality, to create a good internal competitive environment and to improve the culture within the accounting firm.

3.1.2.2 Improving audit independence

From the perspective of auditing ethics, independence is the most basic requirement of auditing practice. It requires the CPA to maintain independence in substance and form when performing the audit, in order that the objectivity of the audit results cannot be affected by any interest. If independence is lacking, the audit results will not be true and the audit quality cannot be guaranteed. Each audit requires a risk assessment of matters that must be understood, such as the environment of the audited entity, so that material misstatements can be reduced to an acceptable level.

In order to promote the healthy development of the auditing profession and allow already excellent accounting firms to play a leading role in the industry, credibility rating standards should be established so that regulators do not just monitor the mistakes of the auditing profession, but allow them to work together to create a healthy auditing market.

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