

A Study on Audit Failures by Certified Public Accounting Firms

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Abstract: Audit failure occurs when certified public accountants (CPAs) fail to disclose significant misstatement risks in the audit report. Such failures frequently lead to various degrees of social harm. Therefore, it is crucial to investigate the causes of audit failures to address these issues fundamentally and prevent their occurrence from different angles. This paper examines audit failures from four perspectives: chaotic audit pricing, inadequate audit preparation, substandard CPA audit competence, and insufficient supervision of auditors. It proposes specific methods to reduce audit failures, including optimizing pricing, enhancing pre-audit preparations, refining audit procedures, and improving audit supervision.

Keywords: Certified Public Accounting Firms, Audit Failure, Audit Risk

1. Introduction

Certified public accounting firms are legally and compliantly providing independent audit services to audited entities, ensuring audit quality and avoiding audit failures. Audit supervision by CPA's is an essential external oversight mechanism that helps reveal misstatement risks in audited entities, thus preventing issues such as financial fraud. However, even reputable firms like Arthur Andersen, Lixin, Ruihua, and others have frequently experienced audit failures in recent years, failing to disclose significant misstatement risks in their audit work. These audit failures have caused substantial social harm and severely damaged the reputation of CPA firms and the image and credibility of the CPA profession. This paper focuses on audit failures by CPA firms, using typical cases to explore the root causes of audit failures from the perspective of audit subjects and their behaviors, and considers feasible audit failure prevention methods suitable for the national context.

2. Theoretical Overview of CPA Firm Audit Failures

Research on CPA audit failures is abundant, with scholars summarizing the harm of audit failures through case analysis. Zhuo Chen and Zi Yu believe that audit failures represent significant audit quality defects, leading to audit supervision failures and the inability to disclose misstatement risks, potentially causing social harm [1]. Yan Wang, from the perspective of the GONE theory, explored the motivations behind financial fraud in listed companies, suggesting that CPA audit failures provide significant external opportunities for such fraud, making it indispensable to standardize CPA audits and prevent audit failures to prevent financial fraud in listed companies [2]. Yuting Qiu pointed out two perspectives on the definition of audit failure: outcome theory, where any inaccurate audit report

issued by a CPA is an audit failure, and process theory, where the CPA fails to issue an accurate audit report due to various reasons during the audit process, making it a subjective fault during the audit process [3].

The causes of CPA firm audit failures are manifold, ultimately rooted in inadequate internal controls, insufficient professional competence of auditors, and lack of audit independence. Yucheng Wu analyzed the audit failure case of Zhengzhong Zhujiang CPA firm's audit of Kangmei Pharmaceutical, highlighting the impact of weak internal controls, insufficient professional competence of auditors, and improper audit procedures and methods on audit failures [4]. Xinyuan Kang emphasized that independent auditing is the fundamental principle and prerequisite for CPA firms conducting audit activities. Some CPA firms, however, have long-term service relationships with specific audited entities, leading to conflicts of interest that threaten audit independence and potentially trigger audit failures [5]. Jing Qiu found that negligence by CPAs could lead to audit failures. If CPAs fail to adequately perform risk assessment, control testing, and substantive procedures, audit failures are likely to occur [6]. Additionally, delays in regulatory penalties by the Securities and Exchange Commission (SEC) and insufficient administrative penalties result in low costs of audit failures for CPA firms, failing to effectively prevent audit failures through external supervision and penalties. For instance, Zhenfei Yao and Yan Wang found that the SEC's lengthy penalty processes and weak penalties, primarily fines and warnings, indirectly lead to audit failures [7].

To prevent audit failures by CPA firms, it is necessary to standardize audit operations and strengthen audit supervision. Qiyun Liu suggested improving CPA's professional ethics and capabilities, focusing on continuous learning and prudent judgment, and encouraging CPAs to use various effective audit methods [8]. Xinyuan Kang proposed organizational reforms in CPA firms to enhance their independence and reduce audit failures due to internal control deficiencies [5]. Zhenfei Yao and Yan Wang recommended establishing a separate institution led by the State Council to supervise and manage CPA firms, enhancing industry self-discipline and supervision to prevent audit failures [7].

3. Analysis of Causes of CPA Firm Audit Failures

3.1. Chaotic Audit Pricing Leading to Industry Irregularities

The current market lacks a comprehensive audit pricing and supervision mechanism, resulting in unhealthy competition among CPA firms. Firms often engage in price wars to win business, leading to reduced audit procedures and quality. Additionally, some firms charge excessively high fees, indicating possible conflicts of interest that threaten audit independence and increase the risk of audit failures. For example, Guangdong Zhengzhong Zhujiang CPA firm's audit fees for Kangmei Pharmaceutical grew significantly over the years, raising concerns about audit independence and increasing the risk of audit failures.

3.2. Inadequate Pre-Audit Preparations by CPA Firms

CPA firms must thoroughly investigate and evaluate audited entities before accepting engagements, comparing the complexity of the audit with the firm's capabilities. Failure to do so can lead to audit failures. In practice, some CPAs fail to adequately identify and prevent audit risks, leading to audit failures. For instance, according to accounting standards, enterprises must disclose related party transactions. However, substantial related party transactions were inadequately disclosed, and significant misstatements were not identified due to insufficient audit procedures and controls.

3.3. Need for Improved Professional Competence of CPAs

CPA's professional competence, including ethics, judgment, and other abilities, significantly impacts audit activities. In the case of Guangdong Rongtai Company, substantial transaction risks were not adequately identified due to a lack of professional skepticism and prudent judgment by the auditing CPA, leading to audit failure.

3.4. Inadequate Supervision of Auditors by CPA Firms

The internal control and supervision mechanisms within CPA firms significantly impact audit quality. Weak internal controls and formalized supervision processes can lead to audit failures, as seen in the case of auditors accepting bribes and losing audit independence.

4. Strategies to Prevent CPA Audit Failures

4.1. Standardizing Audit Pricing Mechanisms and Strengthening Industry Self-Discipline

Standardizing audit pricing mechanisms can promote healthy competition within the audit industry. The Chinese Institute of Certified Public Accountants (CICPA) should establish and enforce industry pricing standards and internal control norms, regulate audit fee practices, and introduce third-party supervision to reduce conflicts of interest.

4.2. Optimizing Pre-Audit Preparations and Enhancing Risk Warning Systems

CPA firms should enhance pre-audit preparations, focusing on identifying misstatement risks, setting audit objectives, and deploying appropriate audit procedures. This includes understanding the audited entity's operations, risks, and environment, and using expert opinions to improve risk identification and control.

4.3. Strengthening Audit Procedures to Identify Misstatement Risks

CPA firms should design targeted audit procedures based on identified significant misstatement risks, ensuring comprehensive and accurate audit evidence extraction. This involves considering industry-specific factors and using similar enterprise cases to refine audit procedures.

4.4. Enhancing Dynamic Audit Supervision to Improve Audit Quality

CPA firms should enhance supervision of auditors, ensuring independence and cutting off conflicts of interest. This includes keeping up with regulatory changes, improving internal controls, and dynamically monitoring auditors' work to maintain high audit standards.

5. Conclusion

CPA auditing is a critical external supervision mechanism that helps reveal misstatement risks and prevent financial fraud. However, audit failures have led to audit supervision failures and severe social harm. The root causes of audit failures are insufficient audit capabilities and inadequate risk identification, evaluation, and control by CPAs. This paper suggests that CPA firms should rationally undertake audit engagements, identify misstatement risks, set scientific audit procedures, and enhance internal controls and supervision to reduce audit failures.

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