

# Factors Affecting Audit Independence: A Case Study Based on the Failure of Typical Financial Fraud Audits

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**Abstract.** Audit independence constrains the work of auditors and provides certain guarantees for the quality of audit execution. Audit independence is affected by various factors, such as the development of non-audit services, the completeness of audit procedures, and the auditors' competence. This paper takes the typical audit failure cases such as the Enron incident, the Zhenlong audit failure, and the financial fraud audit of Kangmei Pharmaceutical as examples, and conducts a case analysis on the influence of different factors on audit independence in these audit failure cases. The conclusion shows that strengthening audit independence should be done by improving the service quality of firms, the professional competence of certified public accountants, the engagement mechanism and external supervision.

**Keywords:** Audit independence; Non-audit services; Audit procedures; Auditor quality.

## 1. Introduction

On June 2<sup>nd</sup>, CITIC Guoan was executed the "Administrative Penalty Decision" by the SFC. It was exposed for allegedly having false records in its annual reports for seven consecutive years from 2009 to 2015, with a total cumulative inflated profit of 1.012 billion yuan. Since CITIC Guoan owns the mining right of West Tajiner Salt Lake in Qinghai and is the main developer of Qinghai Salt Lake, the audit involved is very important. How did such financial fraud escape the scrutiny of the audit firm and society? What was the loophole in the audit process of the firm? What went wrong with audit independence as a key guarantee of audit accuracy? Further, in the context of the current audit in China, what are the factors that may weaken audit independence in the context of the complex and changing audit? And what can we do to facilitate the enhancement of audit independence? There have been many studies on the factors influencing audit independence from the macro perspectives by empirical analysis, but few have summarized and analyzed the factors from the micro perspective by using specific cases as examples. Therefore, this paper analyzes and summarizes the typical audit failure cases and the influencing factors of audit independence through three cases: Enron incident, Zhenlong audit failure, and Kangmei Pharmaceutical audit failure, in order to provide corresponding reference for audit institutions, governments, and personnel engaged in audit-related work.

## 2. Literature Review and Theoretical Analysis

### 2.1 Audit Independence and Non-Audit Services

With its assurance and evaluation functions, audit has now gradually penetrated into all our economy and plays an important supervisory role. The old traditional audit services no longer meet the needs of various types of enterprises, and the demand of enterprises related to audit organizations has gradually turned to non-audit services of certified public accountants (CPAs). By comparing the positive and negative impacts of non-audit services on audited entities and social and economic development, Wu Yinjuan and Fu Mengyang (2021)[1] concluded that CPAs should gradually develop non-audit services to meet diversified market needs while ensuring the healthy development of audit business, and at the same time the government is supposed to strengthen the legal regulation of audit independence, improve the professionalism of CPAs, and enhance audit independence. Zhuang Feipeng (2019)[2] drew the same conclusion as the former by empirical analysis, arguing that in the case of the imperfect overall relevant regulations, the external complex economic factors easily affect the audit independence, and the existence of non-audit services provides the possibility

for audited entities to collude with CPAs. Therefore, in encouraging audit firms to focus on and strive to develop their non-audit services, the government should maintain sufficient attention and caution, improve the relevant legal policies, and provide a more stable social legal and economic environment, so as to effectively safeguard audit independence. The scope of non-audit services is wide and varied, and domestic non-audit services have only recently started with little roots and limited influence, so there is much room for development. On the basis of a comprehensive review of current non-audit business practices in China and a comprehensive review of western literature, Qing Xiaoquan, Wang Huacheng and Zhang Xin (2018)[3] conducted an analysis against the background of the current system in China to conclude that how to regulate auditors' provision of non-audit services to clients is a strong move to follow the general trend of gradual development of non-audit services in the future.

## 2.2 Audit Independence and Audit Procedures

Li Shiyong and Wang Yongxiu (2022)[4] believed that the current relevant system in China has clear requirements for CPAs to implement risk assessment procedures in the audit process. CPAs perform risk assessment usually helps to understand the audited entity and its environment and obtain relevant and effective information, and then identifies and assesses the risk of material misstatement. While the long-time cooperation and the close communication between GPCPA and the management of Kangmei Pharmaceutical have weakened the CPA's professional judgment and affected their independence, there is a great risk that the risk assessment procedures implemented by GPCPA are not rigorous. If the CPA has effectively used analytical procedures in the process of understanding the audited entity and its environment in accordance with the prescribed audit procedures, it would not have been difficult to find that the control risk of Kangmei Pharmaceutical is extremely high, and it should be given high attention as a special risk. Through the analysis of the loopholes that emerged in the audit procedures in Kangmei Pharmaceutical, Zeng Xiaoqi (2022)[5] argued that by maintaining a questioning mindset, specific and appropriate professional skepticism and keeping sensitive to risk factors, the professional judgments made by CPAs in the process of audit procedures are not influenced by the enterprise's management and other external factors. In this way, they are expected to maintain audit independence, make audit judgments from an objective perspective, perform audit procedures appropriately, reduce the risk of material misstatement, and improve audit quality. Chen Yanfen, Peng Junying, and Yao Li (2021)[6] reviewed and analyzed the nineteen administrative penalty decisions made by the CSRC and its dispatching agencies on the audit of listed companies' annual reports, and finally found that there are loopholes in most listed companies. For example, audit risks assessment procedures are not implemented as required and effectively adopted by workable measures. Therefore, in order to reduce the risks that may exist or appear when performing audit on audited entities, it is necessary to start from improving the professional judgment of CPAs. CPAs should put their clients first and focus on their own professional ethics and the audit competency they ultimately demonstrate. Throughout the audit process, attention should always be paid to the risk-oriented audit itself, and the guidance of risk assessment work is expected to be effectively exercised by reasonably executing effective audit procedures while incorporating actual information about the relevant audited entities.

## 2.3 Audit Independence and Auditor Quality

In recent years, the social and economic situation has become more complex, and the requirements for the breadth, depth and precision of the CPA's audit have been increased. The corresponding audit supervision and regulation is also being strengthened. Therefore, the quality of the relevant auditors of accounting firms should also be gradually improved to match. The development trend of audit has changed rapidly with the development of technology, and audit itself is characterized by strong professionalism, rapid updating of knowledge and strong practicality. Based on such characteristics, specific work practices often require auditors to travel all year round, and update their professional knowledge in a timely manner according to changes, who cannot stop learning to keep pace with the times. Auditors are considered as a professional part of audit, whose comprehensive quality not only

directly affects the quality of audit and its function, but also the market order in the macro view. By combining the perspective of "full audit coverage", Chen Qi (2022)[7] suggested that strengthening the quality of auditors can better guarantee the audit quality and maintain its independence, thus safeguarding the security of the national economy. Wu Juanjuan (2017)[8] analyzed the deficiencies of the internal auditors' quality of the People's Bank of China. It is proposed that auditors shall have correct audit attitudes, be aware of their own positions, earnestly abide by audit laws and regulations and adhere to the attitudes of "every omission must be brought to justice, every error must be investigated, and every irregularity must be corrected". They shall always be mindful of impartiality and shall not be afraid of offending people in interpersonal relationships with audit edge. Sun Hui (2016)[9] combined with the higher requirements for auditors constantly update under the situation of social and economic transformation, and proposed that the requirements for the quality of auditors will become more and more strict with the development of society. It is supposed to strengthen the management of audit teams, adopt advanced audit tools, and improve the risk perception ability of auditors in order to keep pace with the times.

### **3. Research Methodology and Case Presentation**

#### **3.1 Research Methodology**

This paper uses the case study method to analyze three typical audit cases with distinctive features, based on different causes of audit failure as the underlying factors, and gives suggestions on how to avoid similar results according to the different causes. Three typical cases of audit failure due to financial fraud including Enron, Zhenlong and Kangmei Pharmaceutical are selected for analysis in this paper. It is of great significance to analyze them based on the fact that the reasons for audit failure in these three cases are different but common. This paper analyzes the impact of non-audit services in the Enron incident, the execution of audit procedures in the Zhenlong audit failure, and the role of insufficient ethic quality of auditors in the audit results of Kangmei Pharmaceutical respectively.

#### **3.2 Case Presentation**

##### **3.2.1 Enron Incident**

Enron, a Houston-based energy trading company with many subsidiaries, operates in energy sales, other commodity distribution and risk management services. Its natural gas and electric energy purchase, sale and distribution business play an important role throughout the U.S. energy market. Enron was ranked at the top of the list of the top 500 companies in the U.S. for many years, surpassing international companies such as Microsoft, and was the object of admiration and envy of many business operators and attracted many investors. Enron's total revenues reached \$101 billion in 2000, and its fame gradually attracted more social attention. In early 2001, Enron's profitability model was publicly questioned for the first time, and it was found that Enron's profitability rate and return on investment were very low by analysis, and the actual money earned was actually very little. Enron's second quarter financial report was released in mid-October, showing a total loss of \$618 million and a loss of \$1.11 per share. As the investigation of Enron gradually deepened and more details of the affiliated companies were disclosed, Enron finally claimed that it misrepresented its earnings totaling \$600 million and declared bankruptcy soon after. Andersen, which had been providing audit services for Enron, was also found to have been falsifying its accounts for Enron. In addition, it was sued for not mentioning Enron's misreported profits and other related surplus quality management practices, as well as for destroying its own records, and eventually it declared bankruptcy.

Since then, the U.S. Congress passed the Sarbanes-Oxley Act in 2002, which introduced a series of new and strict regulations on how accounting firms provide non-audit services.

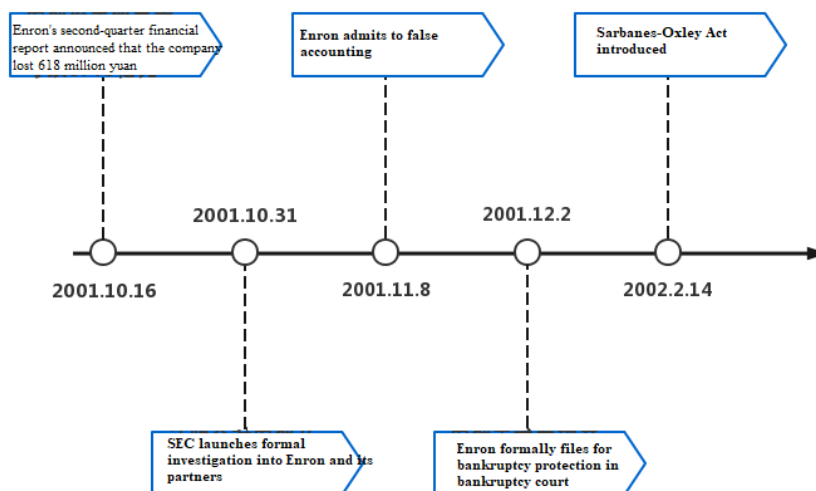


Figure 1. Schedule

- Enron issued its second quarter financial statements, declaring a loss of \$618 million
- CSRC investigated Enron and its partnerships
- Enron acknowledged fraudulent accounts
- Enron officially files for bankruptcy protection
- Publishment of Sarbanes-Oxley Act

### 3.2.2 Zhenlong Audit Failure

Ruihua Accounting Services is a large accounting firm in China with more than 9,000 employees and nearly 20,000 CPAs, and is highly regarded in the industry for its high quality of business and popularity. Liaoning Zhenlong Specialties is mainly engaged in the processing of seeds and kernels, and exports a large amount of pumpkin seed kernels and pine seed kernels to overseas every year. Most of the products of Zhenlong Specialties are exported, and the suppliers and customers are relatively scattered, so the investigation cost of procurement contract and sales contract is high. Zhenlong Specialties exploited the loopholes of this business characteristic and increased the number of overseas customers, the unit price of sales contract and fictitious contract content, and the cumulative fictitious revenue reached 82,685,200 yuan in just two years. Zhenlong Specialties falsified the production process of products and artificially reduced unit price for purchase of raw materials so that the recorded data lost its authenticity. In addition, it reduced the cost of raw materials artificially and the costs that should have been carried over by means of artificial cash transaction. Since most of the company's inventories were seasonal agricultural and sideline products, the possibility of deterioration and damage was high. However, Zhenlong Specialties failed to recognize the value of the deteriorating inventory in the books truthfully and chose to intentionally underestimate or ignore the quantity of the deteriorating inventory so as to inflate profits by inflating the quantity of the inventory.

### 3.2.3 Kangmei Pharmaceutical Audit Failure

Kangmei Pharmaceutical, known as Kangmei Pharmaceutical Co., LTD. was founded in 1997 by Ma Xingtian, a Chaoshan businessman, in Guangdong Province. As a large-scale modern pharmaceutical private enterprise integrating the supply and sales of pharmaceutical products, Chinese herbal pieces, TCM medicinal materials and medical equipment, etc., Kangmei Pharmaceutical's market value at its peak reached nearly RMB 140 billion. A research report in mid-October, 2018 raised questions about the financial problems of Kangmei Pharmaceutical and suggested the possibility of its falsification aroused suspicion in the community. The SFC then launched a related investigation into the financial situation of Kangmei. More than two months later,

Kangmei received a Notice of Investigation from the SFC, which suggested that the SFC would open a case against the company because it was involved in information disclosure violations. On May 17th, 2019, the SFC notified Kangmei of the financial fraud and pointed out that Kangmei had inflated its revenue by forging bank return vouchers, term deposit slips, and VAT invoices totaling 29.129 billion yuan. On the evening of August 16, the SFC officially issued a prior notice to Kangmei and confirmed its financial fraud. It can be concluded that the financial fraud of Kangmei Pharmaceutical is systematically implemented for a long time. However, in the face of the flawed Kangmei Pharmaceutical, the accounting firm of GPCPA, which was responsible for auditing Kangmei Pharmaceutical, had signed and issued an unqualified opinion on the audit of Kangmei Pharmaceutical every year. It indicates that its overall audit capability and the design of the relevant audit procedures are more problematic in existence and deserve further investigation.

### 3.3 Case Study

#### 3.3.1 On the Impact of Non-Audit Services on Audit Independence-an Analysis of Enron Incident as an Example

##### (1) Non-Audit Services: Enron

In the Enron incident, Andersen charged Enron high non-audit service fees in 2000, which were \$2 million higher than the audit service fees charged, and the amount of non-audit service fees was very noteworthy. Andersen provided Enron with a large number of non-audit services such as internal audit and consulting. Taking the provision of management consulting services, which are non-audit services too closely linked to the audited entities, as an example, the CPA, as the consultant being consulted, would take a more active attitude in making relevant decisions when actually performing the audit. Although the management of the audited entities can choose whether or not to accept the recommendations made by the CPA, most of the audited entities consult the CPA in order to obtain their opinions as a certain reference. In this role context, CPAs may be involved with the management of the audited entities to a certain extent, and thus may audit the auditee by themselves, which may damage the objective independence perspective of a third party and the audit independence as well.

##### (2) How to Properly Utilize Non-Audit Services

In the case of Enron, improper decisions in performing non-audit services could have a significant impact on audit independence and even the overall quality of audit. Moreover, if we only pay attention to the non-audit service, we can make full use of the special relationship between the CPA and the client, which improves the audit quality and reduces its cost. Combined with the analysis of Enron incident, there are two specific points as follows:

1. The provision of non-audit services facilitates the CPA's better understanding of the business activities and transactions of the audited entities, while providing more detailed information so that risks can be effectively identified and more effective audit procedures can be designed. But how to properly perform non-audit services and take full advantage of the benefits they offer is an issue that CPAs should be aware of. For example, it suggested to avoid excessive linkages in authority between those responsible and those involved in the upper and lower segments. In the Enron incident, more than 100 employees working at Enron were from Andersen, including its third-party audit, governance and management, which facilitates the subsequent collusion between the two sides. Therefore, accounting firms should reduce excessive association with audited entities in the provision of non-audit services. To avoid errors and other problems, the relevant authorities may consider requiring accounting firms not to provide non-audit services to companies during the provision of audit services and for one or two years before and after the audit, so as to ensure the audit independence while making full use of the convenience offered by non-audit services.

2. The provision of non-audit services requires objectivity and impartiality. The CPA's ability, knowledge, experience and ethical quality are what the firm values most and are the guarantee of audit quality. Having ethical quality and excellent professional technical ability which can be trusted help to keep the clients and enjoy a good reputation. Keeping an objective and independent work

attitude is a basic requirement for CPAs. Moreover, by providing non-audit services, the company has broadened its capital sources and improved its operating ability.

### **3.3.2 On the impact of Audit Procedures on Audit Independence-an Analysis of Kangmei Pharmaceutical as an Example**

#### **(1) Impact of Improper Audit Procedures on Audit Independence**

CPAs should fully implement risk assessment procedures in their practice and develop appropriate countermeasures for issues that arise, be accountable to the auditees, actively identify problems, and provide valuable audit information. While CPAs should identify and communicate with governance about the risks evident in the audited entities, they failed to communicate with governance about the significant risks to the monetary resources of Kangmei Pharmaceutical in a timely manner, and failed to provide appropriate solutions to the issues that arose at Kangmei Pharmaceutical as well. As an integral and critical part of audit, substantive procedures are important during the audit implementation[10]. For CPAs, they should perform correspondence procedures on the accounts involved in the necessary operational matters of the audited entities, and perform strict monitoring procedures on its inventories. However, there was a loophole in the CPA's audit of Kangmei Pharmaceutical's monetary funds, and its bank deposit correspondence procedures were not implemented as required. From the analysis of the results, the CPAs of GPCPA completely lacked proper ethical quality as well as practicing skills throughout the audit process. With over \$34 billion in monetary capital and nearly \$11.4 billion in short-term borrowings, such high asset and liability profile of Kangmei Pharmaceutical made the company fall into financial risk to a certain extent that auditors should be highly aware of. If the auditor did not implement other procedures to corroborate with the correspondence procedures, but only a single correspondence procedure as usual, it would largely weaken the effectiveness of the correspondence procedure, resulting in the inability to provide appropriate audit evidence for the true existence of bank deposits and greatly reduce the credibility of the audit results. In addition, the audit procedures for revenue recognition were not strictly controlled, which might affect the performance of audit independence. Due to the unreasonable execution of bank deposit procedures and the irregular supervision and management procedures of tangible assets, GPCPA maintained a positive attitude towards the authenticity and existence of monetary funds. As a result, Kangmei Pharmaceutical provided false "good" information to stakeholders by inflating its operating income and whitewashing its financial statements to the detriment of related investors. The CPA's lack of independence in this case leads to the audit failure and sets the stage for future financial fraud cases.

#### **(2) Auditors' Professionalism and Audit Independence- an Analysis of Zhenlong Specialties as an Example**

Domestic relevant audit standards require CPAs to combine the use of professional skills and specific realities when performing audits, and to analyze and view problems that arise with the audited entities in a prudent professional manner. If CPAs fail to maintain professional skepticism, it will have a significant adverse impact on audit independence. For example, when Ruihua audited the operating income of Zhenlong from 2012 to 2014, the audited entities did not adjust the contract format based on specific information such as the location of its overseas sales customers and the average market price, and the contract lacked basic elements of overseas goods sales contracts such as the quality agreement of goods, packaging requirements, payment terms (such as pay-as-you-go), invoices and documents. In addition, the export contract format adopted by Zhenlong Specialties before and after 2012 was also different, but the CPAs did not keep a proper professional attitude. There was a risk of material misstatement of operating income from 2013 to 2014, to which CPAs did not pay sufficient attention to and chose to ignore after consultation, resulting in the form and spirit of audit independence being undermined, who should be responsible for the result of the final audit failure. In this incident, the CPA's lack of skepticism towards the audited entities adversely affected the validity and reasonableness of the audit. The lack of professional skepticism of auditors and inadequate business training are important problems faced by Ruihua, and also a common phenomenon in the audit industry, which directly leads to audit failure. CPAs should pay special

attention to the presence of significant abnormalities in the audited entities when providing audit services, so that factors leading to audit risks can be removed to some extent. As a result, CPAs should attach great importance to abnormal situations on a continuous basis and perform appropriate audit procedures to maintain audit independence, anticipate audit risks and take relevant measures in advance.

## **4. Conclusion and Implications - Reflections on Improving Audit Independence Based on the above Analysis**

### **4.1 Improve Service Quality and Competitiveness**

Efforts to expand the scale and strength of local accounting firms and improve the quality of business services are conducive to maintaining the impartiality of the firms. The Top Four accounting firms are well known in China's audit industry by virtue of their strengths, rich international resources and experience. The larger, more well-funded accounting firms value their reputation accumulated over the years in the industry, because the cost of damage to reputation and loss of independence caused by deception and fraud is much higher than the loss of a client. For this reason, local small and medium-sized accounting firms in China should take appropriate reference from the "Top Four" model and gradually enhance their strength, some of which are suggested to increase their influence by expanding their non-audit services as well as their fields. The multi-dimensional and multi-touch development of accounting firms help bring more capital income and provide more solid financial backing, which also improves the firm's comprehensive business capabilities. Moreover, by reducing the fragmentation of local accounting firms through mergers and other means, it effectively reduces the dependence of audit firms on their clients to a certain extent. In addition, reducing the number of smaller audit firms or strongly supporting larger firms with greater independence either by mergers or expansion of operations will strengthen audit independence.

#### **4.1.1 Improve CPA's Professional Competence and Audit Independence**

Although there are prescribed standard audit procedures, different audit scenarios pose different problems in the course of the actual audit work. Audit regulations are only a framework, and the subjective thoughts as well as judgments of CPAs still play a dominated role. Therefore, the upholding of audit independence is very important to improve CPAs' practice ability and professional quality. Based on this, the CRA should attach greater importance to the CPA's ability to improve and conduct stage tests, regularly carry out corresponding professional ethics training, and cultivate high-quality auditors, thus providing a solid guarantee for the audit independence.

#### **4.1.2 Improve the Commissioning Model and Establish a Good Commissioning Mechanism**

In the current audit context in China, there is no real sense as a third-party audit client. This has a lot to do with the current economic system, where the actual subject of the enterprise or operator is the subject, which also leads to the embarrassing situation that the CPA is employed by the operator while supervising the operator. Therefore, based on the principal-agent theory, the factual right of the operator to choose the auditor can be withdrawn or weakened in order to protect the interests, thus improving the company's internal control as well as governance structure. Second, the establishment of a third-party audit committee is also an effective method. It is usually composed of the governance of the company, thus strengthening the supervision of the CPA's audit and improving the audit independence.

#### **4.1.3 Create a Good External Regulatory Environment and Strengthen External Control**

The inadequacy of audit-related laws and regulations makes CPAs rely excessively on subjective consciousness in specific audit, and even "exploit loopholes", which greatly endangers audit independence. Therefore, it is of great constructive to provide guarantee for audit independence from the institutional perspective. Firstly, the legal system related to audit independence should be strengthened in a timely manner, and secondly, the audit of CPAs should be strictly required to

provide a certain deterrent effect. Specifically, regulations on the conduct of CPAs in specific operations can be added to The Company Law. Finally, a sound complaint system should be established to provide litigation channels for those whose interests are damaged. Clear provisions at the legislative level are expected to make CPAs further aware of the importance of independence in the legal system and thus enhance audit independence.

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