Research on the Audit Risk and Risk Prevention of Enterprise M&A—Take Huarun Pharmaceutical Company as an Example

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Abstract

With the development of the times and economic, the construction of capital markets has gradually become mature, and more and more companies have chosen mergers and acquisitions (M&A) to seek development. Although M&A can make the enterprise scale and capital grow rapidly, its complexity and difficulty make the enterprise face all kinds of risks in this process. Among them, the most likely risk is to bring economic losses to the enterprise. This article takes China Huarun pharmaceutical company as an example to analyze the audit risks faced by the company during mergers and acquisitions. By studying the current status of mergers and acquisitions of the company, the audit risks are analyzed and corresponding prevention and control strategies are given. We hope that based on the theoretical basis of M&A audit risk, we will conduct research on the audit risks that may arise in transaction activities and propose countermeasures to reduce the overall audit risk to a controllable level.

Keywords

Huarun Pharmaceutical Company; M&A; Audit risk; Risk prevention

Research Background

In the past ten years in China, the number of companies that went into bankruptcy due to merger audit risks and improper operations has rapidly increased, and various financial fraud incidents have been exposed, causing investors to suffer serious economic losses. The emergence of the above-mentioned problems has made the society pay more attention to the exploration of audit risk and its management. Not only that, M&A are inherently high-risk activities, which also makes the company's audit responsibility significant.

With the rapid growth of China's economy, most enterprises rely on M&A to achieve growth in the loose market external environment. However, most are not going well. The failure of M&A will not only affect the production and operation of enterprises, but also affect their future development path. This requires us to

carefully study the current situation of M&A, analyze the existing problems and reasons of M&A, and put forward the corresponding prevention and control strategies. In order to reduce the risk of mergers and acquisitions, enterprises and internal audit have to pay efforts.

Research Significance

This article hopes to use the case of Huarun Pharmaceutical Company to summarize the problems and causes of the company's M&A, and to propose corresponding countermeasures, so as to enhance the company's operational management capabilities, enhance market competitiveness, and achieve its operational goals.

At the theoretical level, it is possible to thoroughly improve the theoretical system of corporate M&A audit risks and provide a basis for companies to conduct M&A audits. The audit history of China's CPA started late, and most theories have borrowed from western developed countries. Therefore, a complete theoretical system has not yet been constructed. At the practical level, it can play a positive role in reducing audit risks during mergers and acquisitions. Since most companies have no way to resist the temptation of "rapid expansion in a short period of time" and fail to prevent mergers and acquisitions, these can easily lead to mistakes in decision-making and suffer serious losses. Therefore, a systematic exploration of audit risks during company mergers and acquisitions will help audit subjects manage audit quality.

Literature Review

Chinese experts discuss the related concepts, influencing factors and countermeasures of corporate merger audit. Tang Lirong (2018) believes that M&A can help companies achieve further development. However, because the future benefits cannot be accurately estimated, it is easy to cause deviations between the company's true profit and the expected profit. Zheng Xinping (2020) pointed out in the "Measures for Auditing Risks in Listed Companies M&A" that in order to effectively deal with the risks of listed company mergers and acquisitions audits, we can design a series of risk prevention and control plans from the four dimensions: misreporting risks of accounting statements, inherent risks of mergers and acquisitions audits, control risks and inspection risks. Shi Juncheng (2016) and Luo Yulan (2016), from the perspective of auditors, put forward various risks faced by companies during M&A audits, their causes and countermeasures, hoping to encourage companies to improve the prevention, control and evaluation of related risks during M&A audits . Wang Manxia (2019) discussed in the article "Research on M&A Audit Risks of Listed Companies in the Pharmaceutical Industry" that the pharmaceutical industry has shown an upward trend in both the amount and the number of mergers and acquisitions in recent years. Not only the transaction amount is large, but the field of mergers and acquisitions also involves biopharmaceutical companies, medical service institutions, and so on.

Compared with China, many foreign developed countries have formed a relatively complete theoretical system, and conducted research on the concept, importance, influencing factors and how to improve the quality of audit quality control. K·H·Spencer Pickett (2004) clarified the issues related to internal audit control and capability. He suggested that the quality of internal audit should be measured in accordance with appropriate standards, and the corresponding brokerage business should be supervised, inspected and controlled. James

(2003) found through empirical analysis that internal audit played an important role in the operation and management of a company. If the audit committee pays attention to the quality control of the internal audit department, it will find more deficiencies. D·Bailey Jr (2006) suggested that the audit plan, staffing and control should be combined with the organization and management model to control separately. Kevinc K·Lam (2006) stated that it is necessary to analyze the internal audit quality control of enterprises from multiple angles, which is divided into organization layer and project layer. At the organizational level, quality management should focus on audit work plans and staffing, while also considering the company's own management model.

Theoretical Overview of Corporate Merger Audit

Corporate M&A mainly include two aspects: mergers and acquisitions. Mergers and acquisitions are companies that use their own advantages to transform stock assets into incremental assets, transfer stagnant capital, and realize capital appreciation. The essence is that one enterprise obtains the assets, equity, management or control rights of another enterprise.

M&A are a very risky investment activity. M&A audit risk is the risk that a company generates or may generate in the actual merger process. It mainly includes five aspects: audit risk brought by the macro environment, audit risk brought by the micro environment, corporate own risks, the common risk in the process of M&A, and the integration risk after M&A.

Chinese companies need to enter a stage of rapid development through M&A. The efficient integration of the company after the merger is very important. Therefore, the audit work in the post-merger phase of the company must focus on the integration of the old and new businesses and build a positive relationship with the original customers. Carry out effective coordination for the company's organizational structure, scope of rights and responsibilities, staffing and inter-departmental relations.

Analysis of the Background of Huarun Pharmaceutical Company and M&A Status Analysis

Basic Overview

At present, Huarun Pharmaceutical Company has established an industrial park in Beijing and established an innovation incubation department. In the entire industrial park, there are also many pharmaceutical companies under Huarun. Huarun Pharmaceutical's business scope covers the whole country, especially Beijing, Guangdong, and Shandong have very high market shares. At present, Huarun is an important manufacturer and supplier of Chinese patent medicines, natural medicines, synthetic medicines, health care products, and raw material intermediates in China. Not only that, the company also has dozens of modern production lines, all of which have passed GMP certification.

Analysis on the Present Situation of M&A

Year	Acquisition phase
2004	Huarun and Liaocheng State-owned Assets Supervision and Administration Bureau jointly funded the establishment of Huarun Donkey-hide Gelatin Co., Ltd. Huarun holds 51% of the company's shares.
2006	Huarun integrated Dong'e Donkey-hide Gelatin, Sanjiu Pharmaceutical and Huayuan Pharmaceutical, and established Huarun Pharmaceutical Group in Hong Kong. After Huarun implemented the reorganization of Sanjiu Enterprise, the company held 63.59% of the shares of Sanjiu Pharmaceutical Company, and the company was officially renamed as Huarun Sanjiu Pharmaceutical Company.
2008	Huarun Pharmaceutical Group acquired 56.62% of the equity of Huarun Dong'e, thereby controlling 23.14% of the equity of the listed company Dong'e Ejiao Co., Ltd. and becoming its actual controller.
2010	Huarun Pharmaceutical Group acquired half of the equity of Beijing Pharmaceutical Group, and Huarun Shuanghe became a non-wholly-owned subsidiary of Huarun Pharmaceutical Group. In July, Huarun Group and Beijing Municipal Government signed a merger agreement for Beijing Pharmaceutical Group. So far, the company has successively carried out mergers and acquisitions of 11 enterprises in 10 provinces including Beijing, Jiangsu, Henan, etc., to further develop the company's core business and increase its market share in the Chinese pharmaceutical market.
2011	Huarun Pharmaceutical Group and the Academy of Chinese Medical Sciences have established a long-term cooperative relationship. In October, Huarun Pharmaceutical Group and Beijing Pharmaceutical Group reorganized. Beijing Pharmaceutical Investment has also transformed into an important shareholder of Huarun.
2013	The total assets of Huarun Pharmaceutical Group have reached 100 billion HKD, and the corresponding total income has exceeded 100 billion HKD. Many products of Huarun Sanjiu, Dong'e, and Huarun Zizhu were listed in the second OTC Brand Communication Award.
2015	Huarun Pharmaceutical Group will transfer all the equity of Huarun Saike to Huarun Shuanghe and carry out asset restructuring. Huarun has also established a cooperative relationship with Hongye Pharmaceutical to jointly fund the establishment of a new company to further expand the company's business to Anhui.
2016	Huarun Pharmaceutical Group completed the acquisition of 100% equity of Huarun pharmaceutical retail group, that is, wholly owned by CRCare. CRCare is mainly engaged in retail pharmacy business in China mainland and Hong Kong.
2017	China Resources Sanjiu signed a merger agreement with Jilin Jinfukang Pharmaceutical. And it acquired 65% of the shares of Jinfukang Pharmaceutical and Shandong Shenghai. China Resources Shuanghe acquired all shares of Hainan Sinochem Pharmaceutical.
2018	China Resources Group and Jiangxi Province have established a cooperative relationship and will carry out asset restructuring of Jiangzhong Group. According to the agreement, China Resources Group will acquire 51% or more of Jiangzhong. China Resources medicine has become a constituent stock of Hong Kong's HSI. China Resources Sanjiu and Dong'e are listed in MSCI Emerging Market Index. China Resources Shuanghe acquired Xiangzhong pharmaceutical.

Problems in M&A

First, goodwill risk. As of June 2020, the total debt of Huarun is 55.225 billion RMB, including 86.98% of short-term debt, 148.01 billion RMB of credit line, 101.403 billion RMB of unused amount. Second, debt risk. China Resources Pharmaceuticals acquired Sanjiu in 2009. In comparison, the industrial structure of Sanjiu is very complex, including the pharmaceutical industry, manufacturing and entertainment industries, which to a certain extent hinders the development of asset restructuring. In addition, due to the failure of the diversified development strategy and the break of the capital chain, Sanjiu Group experienced a debt crisis. Third, fraud risk. According to the report released by the National Audit Office, in the process of merger and acquisition of Beijing Pharmaceutical Co., Ltd., China Resources Pharmaceutical Co., Ltd. has committed serious fraud, and the value of shareholders of Beijing Pharmaceutical Co., Ltd. has been inflated by 420 million yuan. At the same time, the company also has a lot of non-compliance in accounting, internal control and management.

Cause Analysis

First, the expansion of business scale and development strategy. China Resources Pharmaceutical has carried out a series of strategic mergers and integration reorganizations within 10 years and has developed into a leading pharmaceutical platform in China. In the future, the group will rely on its own advantages to strengthen international cooperation and expand its scale through strategic mergers and acquisitions. Based on the traditional pharmaceutical circulation business, China Resources Pharmaceutical Business has continuously innovated its thinking and business models, and has established a good market reputation. For example, China Resources acquired Dong'e, which has a certain brand power and market foundation.

Second, the Chinese government encourages M&A in the pharmaceutical industry. Since 2020, M&A in the pharmaceutical industry have been characterized by urgency, extensive and large amounts of capital. With the reform of the pharmaceutical industry, especially the new drug registration system, the time cost of obtaining new products is very high. Through M&A, companies can quickly acquire new products, which is the core driving force of mergers and acquisitions. In such an industry context, policies are also encouraging greater industry concentration, and M&A in the pharmaceutical industry will be more active.

Third, expand sales channels and gradually form complementarity. For example, China Resources Pharmaceutical acquired Jiangzhong Pharmaceutical in 2018 because the two could form a complementary relationship in the fields of digestive medicine and throat lozenges. From the perspective of channels, Jiangzhong Pharmaceuticals has established a complete sales network in non-prescription drugs and health products. At the same time, it has signed sales contracts with thousands of distributors in China and completed the channel precision control system, covering the entire country. China Resources Pharmaceutical and Jiangzhong Pharmaceutical can complement each other in channels and develop together.

China Resources Pharmaceutical Company M&A Audit Risk

Audit Risk in the Preparatory Phase

In the preparatory stage of M&A, the company is faced with the environmental risk. This kind of risk can be divided into external and internal parts. External environment, such as politics, industry, policy and so on. If we compare the M&A situation of China Resources pharmaceutical company with the overall situation in China (see Table 1), we can find that the number of M&A transactions in China has increased steadily, and reached the peak in 2017. And the trend of China Resources medicine is exactly consistent with the domestic trend.

Table 1. 2013-2018 China Resources Pharmaceutical M&A and China's overall situation comparison table

Year	2013	2014	2015	2016	2017	2018
Total domestic transactions	2704	4180	4821	4870	5111	4778
Total number of China Resources Pharmaceutical transactions	0	0	1	1	3	1

In the early stage of M&A, in order to get a higher premium, enterprises usually exaggerate their assets and enhance their strength to maximize the benefit of M&A. In this way, it is easy to make a wrong judgment on the evaluation of enterprise strength and bring risks to the audit work.

Audit Risk in Implementation Phase

The purpose of valuation is to clarify the value of the acquisition target. Companies typically select a firm for the appraisal, after which the CPA firm conducts an audit based on the appraisal report. The evaluation of enterprise value will be affected by some factors: the target side's accounting statement is single and lacks accuracy; the method of value evaluation has limitation; the company's future profitability is not easy to evaluate. In addition, with the change of policy and evaluation method, accountants should also pay attention to the choice of method.

Audit Risk in Integration Phase

M&A may cause the loss of personnel, company secrets, and customers. Therefore, personnel placement is very important for both parties to the merger. In the course of business operations, if the two companies fail to reach a strategic agreement, it will affect the company's subsequent operations and even lead to a financial crisis. In addition, since each corporate culture is different, M&A will cause a collision between the corporate cultures of both parties. If there is greater friction between the two parties in cultural identity, it will also lead to the failure of M&A transactions.

AuditRisk in the Inspection Phase

Due to the particularity of the pharmaceutical industry, M&A auditing will involve multiple links and is extremely complex. If the audit fails, it will be difficult for the company to obtain risk funds as agreed. For this reason, auditors must have excellent professionalism and professional judgment, detect financial fraud in

time, and be able to withstand pressure and maintain independence.

Prevention Strategies for M&A Audit Risks of Huarun Pharmaceutical Company

(1) In the preparation stage of M&A, auditors should fully understand the internal and external environment of both sides. For example, get familiar with the current development trend by consulting enterprise information, government policies or industry rules. Or we can use inquiry, observation and analysis to deeply understand the internal environment and hidden risks of the enterprise. As for the external environment, we should pay attention to predict the risk of material misstatement, and design the response plan as soon as possible. In addition, it is necessary to clarify the review object and inspection risk, and limit the risk below the tolerable level as far as possible.

(2) During the implementation phase of M&A, the cost of M&A will be affected by asset valuation. If the audit of assets appraisal is not reasonable, it may cause the M&A side to pay more cost. Auditors should have knowledge of asset evaluation, and should actively learn and update relevant knowledge. In the course of providing its services, Certified Public Accountant should make clear its position and responsibility, and provide advice to its clients instead of making decisions for both parties. It is the responsibility of the Certified Public Accountant to inform both parties to the transaction of accounting policies and practices, as well as the consequences and risks associated with them. In order to solve the risk of M&A audit, the firm should construct more strict quality control system and internal control system of M&A audit. First of all, carry out a scientific three-level or multi-level review mechanism for M&A audit. Then carry out the supervision to the whole process of the M&A audit, provide the guidance for carrying out the audit responsibility, and ensure the audit quality. Secondly, the implementation of review review system for major projects, M&A period of goodwill and other major difficulties to carry out the audit, reduce audit risks.

(3) In view of the audit risk in the integration phase of M&A, auditors should understand the risk of human resources integration and monitor and feedback the turnover as far as possible. To understand the two sides of the business model, clear integration program, and financial considerations. It is also necessary to find a balance between the cultures of the two sides so as to make preparations for their integrated development in the future. In addition, it is necessary to have a good grasp of the audit object and the M&A environment, which is a continuous process of collecting, improving and researching information, covering all aspects of the audit, and then effectively identifying and evaluating the risk of misstatement, develop and implement appropriate audit procedures. Using the control test, the auditor can evaluate the completeness and credibility of the information materials, such as accounting records, and evaluate the dependability of internal control.

(4) In the inspection phase of M&A, first of all, industry organizations can be allowed to carry out talent training activities in the field of M&A audit in China and select some relatively young audit talents with strong professional competence from all over the country as training objects. Secondly, we should take the initiative to introduce and refer to the latest foreign M&A auditing theory and relevant practical experience, and invite foreign brand firms and professionals in M&A auditing to provide guidance to our auditors, so as to improve the comprehensive quality of domestic audit practitioners. On the other hand, the establishment of

a professional M&A audit department, M&A audit risk analysis, audit risk identification and consulting services as the core, comprehensive services for the audit staff.

Guarantee Mechanism

Improve the Commercial Insurance System.

As a result of small scale, the firm's ability to resist risk is relatively poor, so the cultivation and promotion of audit commercial insurance has become a general trend. It is urgent to perfect and popularize audit commercial insurance. First of all, we must expand the scope of audit failure insurance, which can effectively reduce the concerns of audit workers and enhance the small firms' risk resistance. Secondly, the auditing commercial insurance system should be reformed. Along with the diversification of economic business, there are many other business besides M&A audit, which requires insurance institutions to continuously expand and innovate their business.

Improve the Laws and Regulations of M&A Audit

First, we should improve the laws and regulations related to M&A, and speed up the construction of laws on M&A auditing. Secondly, the audit activities of audit workers should be standardized, while increasing the penalties for violators. Because of profit-seeking psychology, both sides of M&A will try all kinds of means to lure auditors, and then cause audit risk. Therefore, in order to minimize such risks, relevant departments need to speed up the improvement of legal norms relating to merger and acquisition audit, while increasing the cost of illegal acts.

Conclusion

Nowadays, with economic development, more and more companies are eager to choose mergers and acquisitions to achieve expansion. However, before conducting mergers and acquisitions, companies must make full preparations, carefully study new industrial policies, forecast the development prospects of the industry, understand the actual situation of themselves and the other party, and formulate a reasonable merger plan. At the same time, during mergers and acquisitions, we must learn to avoid and reduce risk incentives. In the integration of mergers and acquisitions, the corporate culture and business model of both parties must be well integrated. In the merger inspection, the relevant auditors need to have certain professional skills and independence to ensure that the risks of merger audits are reduced. Finally, we must pay attention to the details of M&A activities, expand the scope of audit evidence, rationally assess the company's environmental risks, management risks, and business risks, grasp the audit quality, and actively participate in the M&A process. Combining management theory with the actual situation of the company, continuously improve and adjust audit methods to ensure audit quality and efficiency.

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