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Research on Causes and Countermeasures of Audit Failure - Taking Huishan Dairy as an Example

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Abstract:
In recent years, the academic field has been saturated with research on audit failures, but the understanding of audit failures of agricultural companies still needs to be deepened due to the difficulty of field investigation and the close relationship between biological assets and the natural environment. This paper chooses the agricultural company - Huishan Dairy as an entry point, through the way of a case study, analyzes the audit failure problems and reasons, puts forward the targeted improvement measures for the audit of agricultural companies to bring some inspiration, in order to solve the practical problems encountered in the audit work.

Keywords:
Audit Failure, Huishan Dairy, Agricultural Audit

1.Introduction

In recent years, the frequency of financial fraud has increased the demand for audit capabilities. Especially in the context of China's "post-epidemic era", new auditing methods have brought new prospects for reducing misstatements and integrating data in depth. Auditing work should contribute to the implementation of the National "14th Five-Year Plan". Therefore, it is particularly important to actively explore the path of preventing audit failures in the new era. Since the 18th National Congress, issues relating to agriculture, rural areas and farmers have attracted a lot of attention, and the importance of agricultural auditing is becoming more and more prominent under the macro perspective of improving the level of audit quality.

At present, the research on audit failure cases in the academic field is already in a mature stage, but there are difficulties in the audit of agricultural companies objectively. For example, field surveys are difficult, biological assets are closely related to the natural environment, and the inventory of expendable biological assets is complicated. The case study of audit failure in agricultural companies still needs to be further explored. For the definition of the concept of audit failure, the mainstream view has the result view and the process view, in which most scholars will take the perspective of process theory to analyze. Sun Naizhong (2017) points out that the process theory measures the quality of the auditor's work in terms of auditing standards, which can promote the auditor's diligence. [1] Li Jie and Zuo Yan (2018) argued that the focus of the concept of audit failure is mainly on whether auditing standards are strictly followed, taking the entire business process into

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account. [2] For the aspect of audit failure in agricultural companies, Chen Qi and Wu Qiong (2015) believe that the high number of biological assets and the difficulty of inventory counting in agricultural listed companies are the important reasons for higher audit risk. [3] Zhang Xinling et al. (2020) pointed out that the increase in audit cost and risk is due to the large proportion of biological assets with biotransformation characteristics in agricultural companies, and the uncertainty and risk are increased accordingly. [4]

To summarize, this paper chooses an agricultural company, Huishan Dairy, as an entry point for a case study of audit failure from a "process view" perspective. Huishan Dairy was listed in 2013 and has long been a leader in China's dairy industry. Since its establishment, Huishan Dairy has always insisted on building its dairy brand, however, Huishan Dairy, which seems to have unlimited potential, was accused by Muddy Waters in December 2016, and KPMG admitted the audit failure immediately. This paper examines the case and puts forward some practical suggestions in order to help the auditing industry develop in the long term.

2.Materials and Methods

2.1. Case Selection

Located in Shenyang City, Huishan Dairy originated in the 1950s and was listed on The Stock Exchange of Hong Kong Ltd in 2013, enjoying a high reputation in Northeast China. The case of KPMG's audit failure of Huishan Dairy is selected as the object of this paper for the following reasons:

First, the selection of Huishan Dairy is necessary. China's modernization of agriculture and rural areas construction is an inevitable choice to steadily promote the Chinese path to modernization and achieve the goal of common wealth, and promoting agricultural modernization construction is always an important task. Food processing, grain and oil production, distribution of agricultural products, feed production, livestock breeding of agribusiness annual operating income of more than 1.1 billion yuan. These agricultural enterprises are known as the top 500 agricultural enterprises. The company totaled 378, accounting for 75.6%,[5] the distribution of the industry shows a diversified trend, bursting with strong vitality. Agribusiness industry distribution of the top five number of cases as shown in Table 1.

Table 1. Top 500 Agribusiness Industry Distribution Top 5 ①

Industry	animal husbandry	feed production	Distribution of agricultural products	Grain and oil production category	food processing industry
Number of enterprises	53	56	71	81	117

① Data from Farmers' Daily(https://szb.farmer.com.cn/

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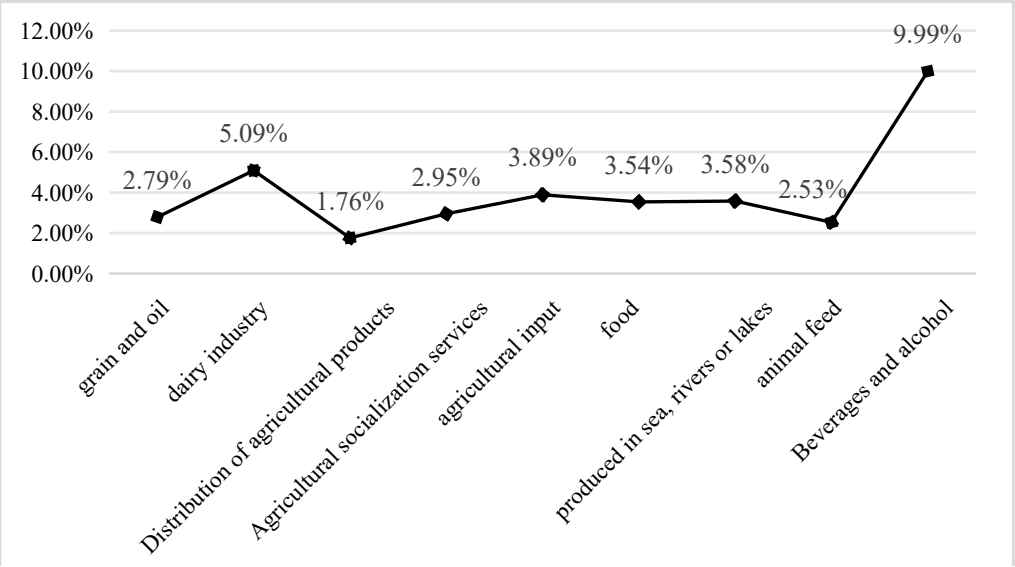


Figure 1. Top 500 Agribusiness Industry Profitability[②]

The industrial scale of agricultural companies is constantly expanding, and "linking farmers to the agricultural industry through various means and driving farmers to participate in the development of the agricultural industry" has become a new option for most enterprises to actively contribute to society while taking into account the company's development prospects. The development of agricultural companies is conducive to increasing employment and encouraging economic development. As can be seen from Figure 1, the profit margin of the dairy industry among the top 500 agricultural enterprises is 5.09%, second only to the profit margin of beverages and alcohol. The dairy industry plays an important role in generating income for agriculture. In order to help China's agricultural economy flourish, this paper selects Huishan Dairy as the case study of this paper. It analyzes the causes of audit failure of the firm and synthesizes the methods of auditing agricultural companies.

Secondary, the case of this audit failure is representative. In terms of audited objects, Huishan Dairy's branded products cover liquid milk, milk powder, etc., and its industrial layout includes agricultural cultivation, feed processing, and dairy cattle breeding. At the beginning of the listing of stock issuance became the top three listed dairy market capitalization enterprises in China, which can represent the situation of agricultural companies to a certain extent.

From the perspective of the main body of the audit, KPMG is one of the world's four largest firms, to a certain extent, can represent the audit level of the top accounting firms. KPMG has continuously audited Huishan Dairy for three consecutive years and always issued unqualified audit reports. It was not until 2016 when Huishan Dairy was accused by Muddy Waters that KPMG admitted the fact of its audit failure.

2.2. Data sources and analytical ideas

This paper mainly uses the financial statements of Huishan Dairy, the public offering book, the Muddy Waters report, and annual reports of The Stock Exchange of Hong Kong Ltd listed companies as the main sources of obtaining data. First, it describes the audit failure of Huishan Dairy. Secondly, it analyzes the prob-

② *Data from Farmers' Daily(https://szb.farmer.com.cn/)*

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lems of audit failure. The reasons for the failure are analyzed mainly from four dimensions, consisting of the audited company, CPA, accounting firm, and external regulation. Finally, the countermeasures and preventive measures are proposed based on the specific problems raised.

3.Case Study

3.1. Huishan Dairy Audit Failure Case Review

Huishan Dairy was listed on the Hong Kong Stock Exchange in 2013 and has claimed to have achieved large-scale self-sufficiency in alfalfa grass since 2014. KPMG issued an "unqualified" audit report on Huishan Dairy from its listing in 2013 until March 2016, when Muddy Waters issued a short-selling report in December 2016, claiming that the company's actual value was close to zero and that it relied heavily on foreign imports of alfalfa grass. Huishan Dairy immediately responded with a denial. Muddy Waters then released a second report claiming that Huishan Dairy was involved in tax issues, which Huishan Dairy also denied. Due to Huishan Dairy's quick response, these two reports did not have too much of an impact on Huishan Dairy, and by the time trading resumed on December 19, 2016, the stock price had recovered.

In March 2017, the incident reached a critical turning point. on March 23, the Liaoning Provincial People's Government convened a meeting attended by 23 financial institutions, including the Shenyang Municipal Government and the Liaoning Banking Regulatory Commission, at which Huishan Dairy admitted to the fact that its funds were broken. The Shenyang municipal government urged the company to restore its ability to pay interest and called on banks to ease the repayment schedule. On March 24 Huishan Dairy's share price saw a precipitous fall, with HK$30 billion evaporating in an instant. In November 2017, two subsidiaries of Huishan Dairy filed for bankruptcy, and in 2019 they were disqualified from listing.

3.2. Problems of Huishan Dairy

First, the shareholding structure of Huishan Dairy is unreasonable. The major shareholders of Huishan Dairy are Guan Feng Company Limited, Yang Kai, Ge Kun, and Ping An Bank Company Limited, accounting for 72.79%, 34.45%, 0.92%, and 0.01% respectively.[6] Ltd. is ultimately controlled by Yang Kai and Ge Kun and they are acting in concert. Yang Kai is also the chairman of the board of directors and CEO, Ge Kun is not only the major shareholder of Huishan Dairy, but also the executive director of Huishan Dairy. Yang Kai and Ge Kun total 73.72% of the shares, for Huishan Dairy has the absolute right to speak and control, this "one share" situation is not conducive to maintaining the interests of small and medium-sized shareholders.

Second, Huishan Dairy committed material financial malpractice. Huishan Dairy has long claimed that its self-sufficient alfalfa grass cultivation is the cornerstone of its ability to dominate the dairy industry and achieve high profit margins. Its main alfalfa grass production area is geographically located in Liaoning province, where the short supply chain allows alfalfa grass to preserve its nutrients to a large extent. This enhances the milk production of the cows. In fact, Huishan Dairy has been a major customer of US-based Anderson Hay & Grain since 2013, and it was later confirmed by Anderson's Chinese agent that Huishan Dairy did buy large quantities of alfalfa grass from overseas. Huishan Dairy falsely increased its operating income, reduced its operating costs, and improved its gross profit margin. As shown in Figure 2.

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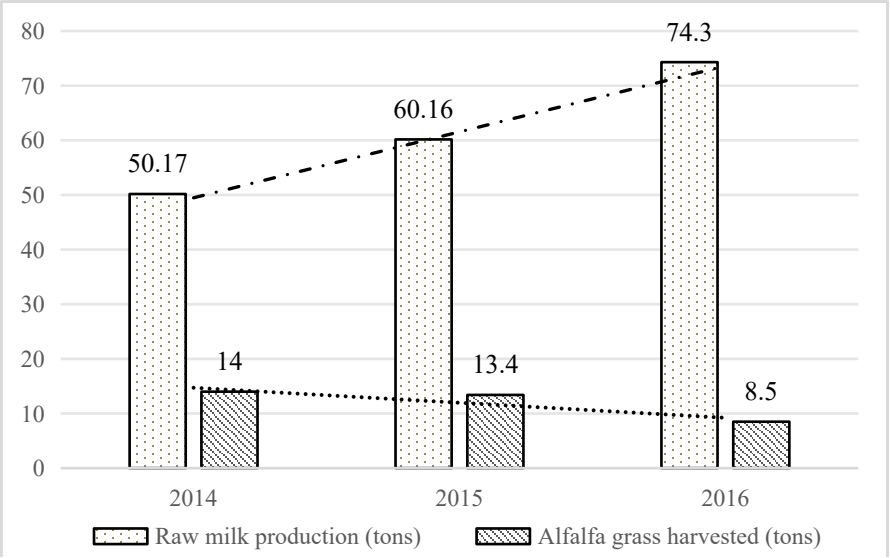


Figure 2. Huishan Dairy Raw Milk Production and Alfalfa Grass Harvesting[③]

Figure 2 reflects the comparison of alfalfa grass harvest and raw milk production of Huishan Dairy from 2014 to 2016.The harvest of alfalfa grass in 2016 decreased by 49,000 tons compared to last year, but the milk production of dairy cows increased by 141,400 tons compared to 2015. In addition, from the financial statement of Huishan Dairy, it can be seen that the number of lactating cows from 2014 to 2016 was 61,286, 74,389 and 96,339 respectively, which combined with Figure 2 shows that the increase in the number of lactating cows not only makes the grass consumption slower, but in this case the amount of milk production has increased. The number of lactating cows can keep growing while the supply is obviously lower, and the supply and demand are in an extremely unbalanced state. This shows that Huishan Dairy's alfalfa grass simply cannot reach a self-sufficient situation.

As can be gleaned from Muddy Waters' short-selling report, Huishan Dairy publicly stated in its public offering that it was about 45 new farms with an expected investment of $45 million, which accounted for 69% of the funds raised. However, based on projections from Huishan Dairy's financial statements from 2014 to 2016, the construction cost of each farm turned out to be as high as $89 million, nearly double the amount expected to be invested. The new farms, however, are not fully built and do not raise lactating cows, according to field visits and satellite images.

3.3. Problems with certified public accountants

Initially, the correspondence procedure was flawed. From the financial statements of Huishan Dairy, it can be learned that the prepaid and other receivables item has very huge ups and downs, from 1.022 billion in March 2015, while in March 2016 it did grow to 3.799 billion, while in September 2016 it changed to 1.931 billion.[④] For this unusual change, the auditor did not conduct correspondence with the current customers and still issued an unqualified opinion.

Second, CPAs do not have a full understanding of the overall industry level of the dairy industry. While the

[③] Data from Huishan Dairy's official website financial statements
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gross profit margin of the dairy industry usually remained between 30% and 40% [5]during the same period, Huishan Dairy often had a gross profit margin of up to 50% or more. The main factor affecting the gross profit margin is the operating income, which is closely related to the unit price and sales volume. According to the data of the online network platform, Huishan Dairy has a rise in sales volume, but the discount is strong, so the growth of operating income is doubtful. However, the CPA did not further check the purchase order and sales order to further confirm the authenticity and accuracy of the operating income, and failed to effectively implement the analysis procedure.

3.4. Problems with KPMG

First, KPMG's audit independence is lacking. The delisting of Huishan Dairy has caused quite a shock to KPMG, and even though KPMG has not been penalized too much, it has still suffered reputationally. Su Yonghai left KPMG after many years at the firm, becoming an executive director and then chief financial officer of Huishan Dairy from 2012. Most auditors who jump ship adopt a more relaxed audit attitude,[7] which raises doubts about KPMG's independence, as do Zhou Xiaosi and Jian Yuliang. The "revolving door" phenomenon can significantly affect the company's surplus management behavior,[8] accounting firms should give high priority to personnel arrangements. Too much contact between personnel can affect the rigor of the implementation of the program, which ultimately leads to audit failures.

Second, KPMG did not effectively implement an audit quality control system. For the purpose of accurately controlling the audit quality, the accounting firm should establish a quality control system. KPMG has designed a three-tier review system of project team review, departmental review, and firm review for quality control. However, KPMG's quality control system is in a state of virtual non-existence. They do not visit the field if they can check the information, and they do not put into practice if they can sign the documents. After checking that there were significant deficiencies in the company's management control mechanism, it did not take corresponding measures, but relied on inertia thinking that Huishan Dairy did not have problems. It was these weaknesses in the execution of audit procedures that directly contributed to the failure of Huishan Dairy's audit.

3.5. Problems with external regulation

The audit market environment is unhealthy. Firms tend to take cost into account when performing audit procedures, especially in a highly saturated audit market such as the one we have now, where market competition is fierce. Although KPMG has a good reputation, the firm will first pursue survival, while the quality of audit and the proper execution of audit procedures have become secondary tasks. Meanwhile, in recent years, the Securities and Futures Commission (SFC) has imposed administrative penalties, such as warnings, confiscation of business income, and fines, on most of the auditors or audit firms that have issued erroneous audit conclusions. In the case of Huishan Dairy, which has a large social impact, these penalties are nothing more than a slap on the wrist. The Ministry of Finance (MOF) has limited resources and cannot supervise every aspect of a firm. Even if the Chinese Institute of Certified Public Accountants (CICPA) finds that a firm may have problems, it does not have the power to control it, and the penalty for non-compliance is obviously not strong enough.

[5] Data from annual reports of companies listed on the Hong Kong Stock Exchange

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4.suggestion

4.1. Huishan Dairy should actively optimize its shareholding structure and cultivate a sense of integrity.

The financial fraud of Huishan Dairy in this case objectively caused the failure of the audit. Enterprises should avoid excessive concentration of equity and appropriately increase the degree of equity dispersion to enhance liquidity. At the same time, in terms of internal supervision of the company, the role of the supervisory board and independent directors should be utilized. The substantial independence of independent directors should be ensured to avoid the abuse of power by major shareholders, which may have a negative impact on corporate governance. In addition, the management of the audited entity should further enhance the sense of integrity. On the one hand, the management should exercise self-restraint, and on the other hand, the moral construction of the management should be strengthened. Avoid misappropriation of funds due to selfish desires to the detriment of the overall interests of the company.

4.2. The CPA should reasonably design and strictly perform audit procedures with due professional skepticism.

Substantive procedures include both substantive analytical procedures and tests of detail. Various data from the financial statements of the enterprise should be reviewed and analytical procedures should be used flexibly. For agricultural companies, it is possible to conduct correspondence with customers when identifying risks at the account identification level. To pay attention to the current customer correspondence, combined with the characteristics of the agricultural industry, the company statement data can be compared with the ring. In this case, for example, operating income, and gross margin indicators for year-on-year, for abnormal data can first consider the impact of ecological nature, a reasonable estimate. It is necessary to take targeted measures for abnormal changes and conduct detailed tests at the right time. For the overall level of agriculture does not match the focus of the project, especially for the biological assets in the inventory to focus on monitoring the inventory, combined with the actual situation for the audited unit to determine the number of samples, with the inventory turnover rate and other practical indicators to carry out the details of the inventory test. The accountant should be alert to matters that raise doubts. The certified public accountants should pay enough attention to the information disclosure of the company, and the possibility of fraud is higher if the information is not disclosed in accordance with the relevant laws and regulations or if the information is disclosed falsely, and the certified public accountants should take appropriate measures in time. For the agricultural industry, the certified public accountants should pay special attention to grasping the basic overview of the agricultural industry and have a basic understanding of the indicators of the agricultural industry.

4.3. Accounting firms should improve audit independence and implement multiple levels of quality review.

Accounting firms should improve audit independence. On the one hand, a recusal system can be set up. By improving the personal information of the auditors in advance and filing their interpersonal relationships, they should be appropriately recused in cases of kinship, classmates and hometown relationships. On the other hand, it should be reasonable to determine the cost of audit and establish a reasonable fee mechanism, with

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the system to improve the independence of the audit.

Firms should implement multi-level quality review in the audit process. First, the quality review system should be improved, not only in terms of organizational structure, but also to strengthen the assessment of the auditors. Secondly, the audit report should be checked in a timely manner, and the review of the working papers should be rigorous and serious. Third, larger firms can establish a specialized reviews body to strengthen the control of the entire audit process.

4.4. The government should actively create a favorable market environment, and the SFC should step up its regulatory efforts.

The government can use administrative means, through the way of financial subsidies to strengthen the help and support for the firm. Easing the financial pressure on firms can, to a certain extent, improve the quality of audits and create a market environment of healthy competition. The SFC has stepped up its regulatory efforts and implemented comprehensive inspections, which are conducive to improving the audit quality of accounting firms.[9]

5.Conclusions

This paper extracts the commonalities of agricultural companies, takes the audit failure of Huishan Dairy as the entry point, and analyzes the causes of the audit failure of Huishan Dairy from the company's internal, the CPA's point of view, the CPA firm and external factors in multiple dimensions. Four solutions are proposed: firstly, to address the problems of the audited entity, the audited entity should coordinate the shareholding structure and strengthen the ethical constraints. Second, for the problems of the CPAs, the CPAs should maintain due professional skepticism and actively comply with the recusal system. Third, for the problems of accounting firms, accounting firms should implement multi-level quality reviews, improve the audit quality control system, and enhance the independence of audit. Finally, for the problems of external factors, the government can optimize the business environment through financial and tax subsidies, and further increase the penalty of the Securities and Exchange Commission.

Author Contributions

Conceptualization: Jiao Yue; Methodology: Wang Xiaoyi; Software: Jiao Yue; Validation: Jiao Yue.; Formal analysis: Wang Xiaoyi; Investigation: Jiao Yue; Resources: Jiao Yue; Data Curation: Jiao Yue; Writing – original draft preparation: Jiao Yue.; Writing – review and editing: Wang Xiaoyi; Visualization:Jiao Yue ; Supervision: Wang Xiaoyi; Project administration: Wang Xiaoyi; Funding acquisition: Wang Xiaoyi.

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