

# Analysis on the Lack of Audit Independence in China under the Market Economy

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**Abstract.** In recent years, there have been frequent audit failure cases around the world, which seriously affected the market order. The independence of the audit is becoming more and more important. If the independence of the audit is lacking, the certified public accountant will issue a false audit report, which will adversely affect all stakeholders. However, my country's market economy started relatively late, and audit independence will inevitably have some problems in practice. This paper focuses on the lack of audit independence under the market economy, and analyzes the reasons and some of my own thoughts. It has certain implications for preventing the lack of audit independence. Reference meaning.

**Keywords:** Audit; independence; listed company; accounting firm .

## 1. Introduction

Forty years of my country's reform and opening up, the market economy has flourished, and auditing, as an indispensable part of the company's financial statements every year, plays an irreplaceable role in maintaining market stability and eliminating the information gap between investors and investees. effect. There are also cases of large-scale financial fraud and audit failures around the world, causing turmoil in the securities market. Among them, the lack of audit independence is the key to many audit failure cases. Exploring the factors behind the lack of audit independence and strengthening audit independence are also the top priorities for us to strengthen audit quality.

## 2. Brief Introduction to China's Auditing Industry

### 2.1 Development brief

China is an ancient civilization with a long history. The term "audit" appeared in our country as early as the Southern Song Dynasty. However, the "audit" in the feudal society is more similar to our government audit today, and the absence of a market economy also means that we have nurtured a true modern enterprise audit. Compared with Western capitalist countries - modern auditing originated in Italy, formed with the formation of British joint-stock companies, and continued to improve in the development of the US capital market, our market economy developed relatively late. It was not until the end of the 1980s that the CPA system was initially rebuilt, and the auditing standards were officially promulgated in 1995, which was a long time later than that of Western capitalist countries.

### 2.2 The inherent deficiency of the lack of audit independence

Due to the special nature of our country's securities market, the speculative and opportunism of our country's securities investors account for the majority. Many investors do not have the ability to correctly understand the legal knowledge and financial knowledge of securities, which leads to the lack of awareness of the disclosure of financial fraud and the disclosure of securities market audits

by social investors in our country, and they are not fully aware of the independence of auditing. Compared with Western countries, our audit market is slightly weaker in public supervision.

In addition, the emergence of auditing itself is produced under the conditions of the development of commodity economy due to the separation of management rights and control rights. However, under the national conditions of our country, state-owned shares in many listed companies occupy a relatively large share, and a large number of Listed companies are directly or indirectly controlled by the government, which also leads to relatively few tradable shares. Therefore, in the corporate governance structure of many companies, there is a situation in which major shareholders are relatively controlling and one company dominates, which is less common in Western capitalist countries, its unique advantages in the company make the independence of auditors greatly affected by the distorted corporate governance system.

### **2.3 The special embarrassment of audit independence in China**

Influenced by traditional culture and the short period of market economy development in my country, the development of external auditing of enterprises in our country for decades is insufficient and imperfect. The "favor" culture of our society has made the development of third-party auditing subject to some resistance, and the independence required to be maintained in form and substance is somewhat difficult in the humane society.

Our country's audit market obviously has the problem of excessive competition, which affects the normal development of my country's audit market. The high fee range in the auditing market is almost monopolized by the Big Four accounting firms. The market of more than 20 million yuan is completely untouched by non-Big Four firms, while the remaining domestic firms are mostly concentrated in those with less fees than the Big Four. In the interval, some smaller listed companies and unlisted companies have become the main client groups of domestic firms, which makes the competition in the audit market tend to be vicious. In such a market, it is very easy to "buy audit opinions", which seriously affects the independence of audit. From the perspective of contractual economics, the power and responsibility in which management chooses to purchase the audit business is asymmetric, when the management can use its unique advantages in the buyer's market to exert pressure, but an audit report that loses its independence for the management, the losses are far less than the gains, and it is impossible to achieve the unity of personal interests and social interests. In addition, my country's entry threshold for the audit market is relatively low. In the audit industry, it has become an indisputable fact that the audit fee is lowered and the vicious competition for customers

## **3. Viewing Audit Independence from Audit Fees**

### **3.1 Audit Fees and Audit Independence**

The audit fee is the most direct and objective quantitative data in the business entrustment agreement during the audit process. On the positive side, the audited entity affects the audit independence of the firm through the audit fee, which affects the appropriateness of the audit procedure at light level, and the behavior of purchasing audit opinion at worst. On the other hand, audit independence can be reflected through audit fees. Professor Li Sineng once pointed out in his empirical analysis that there is a significant negative correlation between audit opinions in the previous period and changes in accounting firms, that is, companies that were issued non-standard audit opinions in the previous period are more likely to change accounting firms. The accounting firm will communicate with the audited unit before issuing the audit opinion, and only when the accounting firm considers that the risk of misstatement is significant will it issue a qualified opinion. At this time, it seems that audit independence will receive a certain degree of confidence no matter what influence.

As of the end of 2019, there were more than 100,000 certified public accountants practicing members. In the face of such a huge competition, in order to ensure the number of clients, major

accounting firms will inevitably affect their independence. In this market with slightly unbalanced supply, how to realize the realization of personal interests and promote the realization of social interests should be an issue that both suppliers and regulatory authorities should consider. From the perspective of demand orientation, accounting firms should give priority to report users, make appropriate audit procedures to prevent fraud, and stop opportunism towards clients in time. However, in audit practice, the balance between customer needs and social needs inevitably tilts toward customer needs. The requirements of audit information quality are difficult to measure with exact standards in the demand-oriented theory, and even the determination of the importance level is not immune to the influence of multiple factors.

The lack of audit independence is a key factor in many audit failure cases, and audit independence is related to many factors of the audit process during the audit process. Lack of independence will seriously affect the professional skepticism and audit quality of auditors. During the audit process, many audit procedures were improper and also affected by the lack of independence. In the Kangmei Pharmaceutical case, the audit project manager even colluded with the audited unit to intercept and inquire letters and other behaviors that completely lost independence. Even if the rotation period system is nominally implemented, a long-term cooperative relationship between an accounting firm and the auditee will inevitably generate hidden interests. Even when the auditee is placed on file for investigation, the firm will still issue an unqualified opinion. audit report. However, for long-term business relationships, the China Securities Regulatory Commission does not have relevant regulations on the mandatory change of firms. How to effectively supervise the integrity of audit independence in this long-term business relationship and even establish a more effective method for audit independence should be reflected on.

### 3.2 From the point of view of failure cases

As the entrusted firm of Kangmei Pharmaceutical, GP Certified Public Accountants has provided audit services for nearly 20 years. Under such circumstances, it must be very clear about the various assets and income of Kangmei Pharmaceutical. Financial fraud can be detected without so much audit evidence from the outside world to the firm. And reported to the China Securities Regulatory Commission that GP Certified Public Accountants had issued an unqualified opinion on Kangmei Pharmaceutical before it released its 2017 annual report.

Obviously, in the case that the central GP Certified Public Accountants provides both internal audit and external audit, the adverse impact caused by such self-evaluation has not been well guarded. As shown in the figure below, the rise and fall of audit fees of Nanjing Pharmaceutical and Kangmei Pharmaceutical respectively. What is worth our attention is that kangmei Pharmaceutical changed its accounting firm after the financial fraud issue was registered, and the original GP Certified Public Accountants was replaced by Shu Lun Pan Certified Public Accountants. However, in the two years of cooperation with Shu Lun Pan Certified Public Accountants, its audit reports were all unqualified opinions. However, even after kangmei Pharmaceutical was placed under investigation for several years, the audit cost continued to rise year after year, and even in the case of continuous losses, Kangmei Pharmaceutical still maintained a high growth rate of audit cost. According to the 2019 securities audit market analysis report released by the CSRC, the market growth rate of audit fees in 2019 was 7%, while the audit fees of Kangmei Pharmaceutical rose as high as 25%. Compared with the smooth audit cost of Nanjing pharmaceutical, Kangmei pharmaceutical in the audit cost of this index appears to be full of tricky.



Figure 1. Total audit fees for Nanjing Pharmaceutical

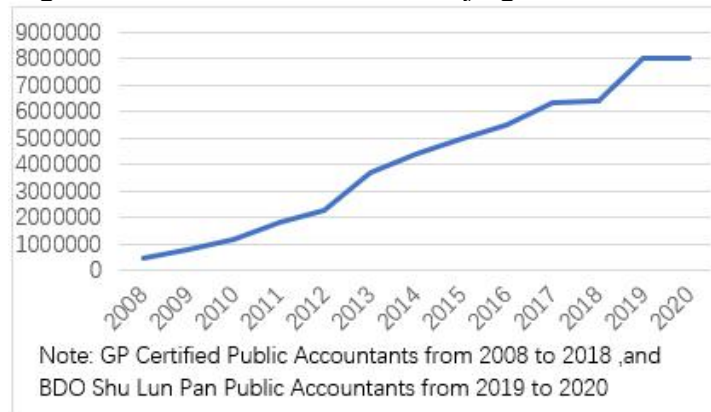


Figure 2. Total audit fees of Kangmei Pharmaceutical

Even in the years before Kangmei Pharmaceutical was investigated, the audit fee of Kangmei Pharmaceutical still increased at a relatively high rate. This year, Kangmei Pharmaceutical changed its firm again after experiencing many unqualified opinions, and again greatly increased the audit fee. Under such circumstances, it is difficult for the outside world to maintain sufficient confidence in the independence of the audit.

Similar to this is the failed audit of Health-south in the United States. According to the "Statement of Collective Voting Rights" submitted by Health-south to the SEC, in 2000 and 2001, Health-south paid Ernst & Young the audit fees of \$3.68 million and \$3.67 million respectively. Dollar. And among the audit fees in 2001, the non-audit business fees actually exceeded the financial statement audit fees. At the same time, many scholars have also mentioned the "clean audit" related fees of Health-south. Such an unbelievable phenomenon was naturally caused at that time. The skepticism of U.S. capital market investors.

Undoubtedly, audit fees, as an incision for us to observe audit independence, can provide us with a better perspective for analyzing problems, whether from the positive side or the negative side.

## 4. The Restriction of Internal Defects on Auditing Independence

### 4.1 Lack of Internal Oversight and Internal Audit

In recent years, among listed companies, administrative power has pushed state-owned enterprises to restructure, and state-owned shares are too powerful. Although the proportion of tradable shares has increased in recent years, the abuse of control rights by major shareholders is still very serious. The role of the board of supervisors in the corporate governance system is very limited. We can find that in recent years, there have been cases of financial fraud, improper transactions with related parties, and audit failures, which are rarely reported by the company's board of supervisors. Of course, this is also mentioned above. The reason for the excessive

proportion of state-owned shares in the past is that although the management and the board of supervisors are side by side in the corporate governance system, the rights and responsibilities of the board of supervisors in institutional arrangements do not match. At the same time, the more supervisory means of the board of supervisors are to attend the board of directors or make suggestions. The rotation period is too short (3 years), and the rotation period of the external audit partners has been five years. Is it too short?

After the Enron incident, Section 404 of the Sarbanes-Oxley Act promulgated in the United States in 2002 imposed mandatory requirements on the disclosure of internal control information of public companies, and required auditors to attest it. This has had an impact on securities markets around the world. However, the internal control in our country is still congenitally insufficient and acquired deformities. Among the problems of Luckin's financial fraud, Muddy Waters, as an external short-selling company, is generally very cautious when selecting targets. However, the entire short-selling process, and Muddy Waters' ability to disregard the cost of input costs, must show that from the external information released by Luckin already has a high degree of confidence in obtaining fraudulent information. As an external third party, Muddy Waters can find clues from the information that Luckin has released, so how much information has Luckin's internal control and internal audit ignored? Chairman Lu Zhengyao beneficially holds 969,703 ordinary shares, with a shareholding ratio of 30.53%; Qian Zhiya, the founder and CEO of the company, beneficially holds 625,000 ordinary shares, with a shareholding ratio of 19.68%. Human control, internal supervision and internal audit are seriously lacking. Due to the imperfect corporate governance structure and other reasons, the internal audit and supervision in the information superiority make it difficult to compete with the fraudulent forces under the internal human control. Before the announcement of the Muddy Waters short-selling report, Ernst & Young did not disclose or explain financial frauds such as related-party transactions of Luckin. The lack of independence is also worthy of our deep consideration.

#### **4.2 Constraints on Audit Independence**

It is the lack of internal supervision and internal control that will seriously affect the independence of the audit. In the absence of effective internal supervision and control, and the company's equity distribution is relatively loose, the company's management will enjoy excessive control over the company. At this time, if the management has financial fraud or fraud, it is very likely that the accounting firm will In the employment and dismissal of the firm, some actions are taken to protect its own interests and damage the interests of society, by raising audit fees, giving gifts or threatening certified public accountants, etc.; when the ownership structure is excessively concentrated, the major shareholders will have actual control over the company, For the sake of their own interests, they choose the wrong basis for preparing financial statements or undermine internal control, and major shareholders threaten certified public accountants by hiring and dismissing accounting firms for illegal asset plundering or other purposes, which has a very negative impact on the independence of auditing.

According to the 2020 annual securities audit market analysis report released by the China Securities Regulatory Commission, 259 companies have changed places according to actual controllers, shareholders' requirements or the company's own development needs, while 398 listed companies have changed exchanges in 2020. The proportion accounted for 65.07%, which is quite alarming for the entire audit market, and many of the listed companies that did not change places for this reason were caused by the "kangmei" case in 2020, so there is a certain proportion of this proportion. underestimated in the sense. Regarding the act of changing firms, the CSRC's regulations are very loose, and the almost complete market-oriented behavior has caused a relatively large impact on the independence of audit. Both internal supervision and external supervision cannot effectively control this link, and the independence of auditing is obviously severely restricted.

## **5. Strengthening the independence of auditing——Thinking about incorporating enterprise auditing into government control**

### **5.1 The relationship between government audit and certified public accountant audit**

Article 30 of my country's "Audit Law" stipulates: "Where a unit audited by a social audit institution falls under the audit supervision object of the audit institution in accordance with the law, the audit institution shall, in accordance with the provisions of the State Council, have the right to verify the relevant audit reports issued by the social audit institution." From the perspective of our country's legislation, the relationship between government audit and external audit of enterprises is from top to bottom, and government audit is the highest level, which is the relationship between supervision and being supervised. However, in practice, government auditing and CPA auditing have their own service targets. CPA auditing is aimed at enterprises in the market economy, and government auditing is aimed at administrative institutions at all levels, which is a parallel relationship. However, there are almost no cases of audit failure in government auditing, so can some of the advantages of government auditing be transferred to CPA auditing?

### **5.2 The Feasibility of Government Unified Control of Audit Independence**

In a sense, the role of accounting is to disclose information to eliminate the information gap between investors and the investee. As an independent third party, certified public accountants should conduct independent and fair audits on the above process to make it legal Fair. But on the other hand, how should we confirm the legality and fairness of the auditor's auditing process? From my point of view, the fundamental contradiction of the lack of audit independence lies in the unbreakable "interest relationship" between the auditee and the accounting firm, which is determined by the market economy. It seems that this is an endless cycle, and it is difficult for us to find a particularly credible legal entity in the market economy to make this cycle achieve a closed effect like the separation of powers in the United States. Therefore, I naturally turned my attention to the government. The only one that has the ability to execute and has credibility in our country is the government. Therefore, the government can select accounting firms and collect audit fees in a unified manner (taxes etc.). Minimize the cost of entrustment and the information gap in the middle, and make the audit opinion more transparent, so as to avoid the impact of the audited unit on the auditing independence of the accounting firm. The government should establish an evaluation system composed of multiple evaluation indicators such as enterprise assets, income, internal control perfection, annual taxation, internal governance structure, etc. The accounting firm is directly responsible to the government to ensure the formation of the relationship between the accounting firm and the auditee. Less colluding of interests, strengthening the independence of the audit.

Most of the listed companies in our country are dominated by state-owned shares, and changing the market leader will be more conducive to protecting the rights and interests of minority shareholders. The government-led audit market system will establish a professional review and match companies with accounting firms of the corresponding magnitude, so as to avoid the audit market being dominated by customer needs and affecting audit independence. According to the Hand formula, the government and the market are clearly "B<PL" in eliminating the impact of audit failure cases caused by the loss of audit independence, such as Enron, Yinguangxia, etc., and the cost of approval in advance is far greater Much less than the price paid for the turmoil in the securities market after the fact.

### **5.3 Problems with this system**

However, the above-mentioned new system will inevitably bring new problems. First, the government's acquisition and assignment of accounting firms does not match the principle of my country's market economy. In the early stage of my country's reform and opening up, China's policy was to break the "separation of government and enterprise". such a situation. If auditing is included

in government control and dispatched by the government, it will undoubtedly strengthen the government's intervention in the market economy, which is contrary to our original intention of strengthening the basic position of market competition. The State Council has put forward requirements for deepening the reform of "delegating power, delegating power, regulating services" in many meetings, requiring that efforts should be put on pre-approval and post-event supervision. Reconstructing the system will also easily nourish government and enterprise corruption, and individual government and business collusion.

Secondly, the new system will lead to new independence problems. Although the unified control of the government will eliminate the impact of the lack of audit independence on audit failures, but in this case, the government has assumed the function of selection and supervision. At the same time, it assumes the responsibility of charging fees, which will directly transfer the original contradiction between the market and the government. Where will the issue of independence in the middle go?

Third, if there is a case of financial fraud and audit failure in the audit report after the government's review, or even an Enron-level securities market earthquake, then the impact on the government's credibility will be very huge. The price is unbearable for us. At that point, the system will fall apart. Moreover, for future litigation issues, new regulations will be required legally.

Finally, when the client is changed from the enterprise to the government, the market competition mechanism will be destroyed to a certain extent, and the vitality and motivation of the accounting firm to improve the audit quality will be destroyed to a certain extent. And how to build a really efficient organization that can complete the allocation of accounting firms in a relatively short period of time is also a problem that needs to be considered.

It is undeniable that this system will be of great help to the current lack of independence of some auditing services. Although there are no foreign models for us to learn from, we can reduce the problems caused by the lack of audit independence in light of our national conditions. The turmoil brought by the market is still feasible.

## 6. Conclusion

As the "gatekeeper" of the securities market, the audit industry plays an irreplaceable role in maintaining the stability of the securities market and the financial industry. The independence of the audit is the key to determine the success of the audit. In many audit failure cases, the lack of audit independence is the most critical factor. It can be said that strengthening audit independence is an essential and important measure for us to maintain the vigorous development of the market economy.

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