

## Original Paper

# Analysis of Audit Failure of Yu Diamond by Asia Pacific Certified Public Accountants

Wanqi Wang<sup>1</sup>

<sup>1</sup> School of Economics and Management, Dalian University, Dalian City, Liaoning Province, China

Received: February 11, 2023    Accepted: January 02, 2024    Online Published: January 31, 2024

doi:10.22158/ibes.v6n1p117

URL: <http://dx.doi.org/10.22158/ibes.v6n1p117>

### **Abstract**

*Since the 18th National Congress of the Communist Party of China, China has always adhered to and deepened its unique financial roadmap to ensure the efficient operation and high-quality development of the financial industry. At the same time, we are also constantly improving our financial supervision and management system. With the establishment of the whole process registration system, the need for the legal construction and the later monitoring and control restrictions of the capital market has become more urgent. Because the capital market is established based on the openness and transparency of information, accounting firms play key roles in this field.—As “gatekeepers” to ensure the accuracy and integrity of financial information, which is of vital significance to maintaining the stable and healthy development of the capital market. This paper takes the audit case of Zhengzhou Huajing diamond by Asia-Pacific Accounting firm as the research object, according to the defects in the audit, and puts forward countermeasures and suggestions for the audit, aiming to provide certain reference value for reducing the audit failure.*

### **Keywords**

*audit failure, Yudiamond, Asia-Pacific accounting firm*

## **1. Case Introduction**

### *1.1 Background Profile*

On October 14, 2022, The Securities Regulatory Commission of the People’s Republic of China issued an administrative penalty decision on Zhengzhou Huajing Diamond Co., Ltd. (hereinafter referred to as “Yu Diamond”) and its 12 relevant responsible persons. The reason for the punishment is that Yudiamond falsely increased its operating income, total profit, inventory, fixed assets, non-current assets, etc., leading to false records in the 2017-2019 annual report. In the cumulative three years, the inflated profit reached hundreds of millions of yuan, and the external guarantees and related

transactions were not disclosed in accordance with the legal provisions, and the total amount exceeding more than 4 billion yuan. During this period, the actual controller also occupied the listed company funds of more than 2.3 billion yuan. Asia Pacific Accounting Firm (“Asia Pacific Firm”) issued a standard unqualified audit report on Yu Diamond in 2017 and 2018, and issued an inappropriate audit report with unqualified opinions in 2019. The CSRC punishment decision clearly pointed out that the Asia Pacific firm did not fulfill its due responsibility in the audit of Yudiament financial report, leading to the failure of the audit. Therefore, they were required to correct, and were required to confiscate the illegal income, and fined the firm and the relevant responsible persons.

### *1.2 Zhengzhou Huajing Diamond Co., LTD*

Zhengzhou Huajing Diamond Co., Ltd., founded in December 2004, was listed on the Growth Enterprise Market of Shenzhen Stock Exchange in March 2010. It is a backbone enterprise in the superhard material industry and the production base of Henan superhard material industry. Delisting in June 2022.

### *1.3 Asia-Pacific Accounting Firm*

Founded in 1984, Asia Pacific (Group) Accounting firm, located in Beijing, is a Chinese company with both qualifications in the field of securities and futures, and a member of the Association of Dealers in the China Interbank market. There are 34 branches in China, and the business scope covers the whole country. In 2022, the audit business revenue will reach 840 million yuan.

## **2. Specific Illegal Behavior of Zhengzhou Huajing Diamond Co., LTD**

### *2.1 Fictitious Sales Transaction and Equity Transfer Transaction, Fictitious Increase in Operating Income, Total Profit*

From 2017 to 2019, Yu Diamond and its subsidiaries traded with jewelry and non-jewelry, resulting in the three-year annual report of 313 million yuan, 212 million yuan and 397 million yuan respectively. At the same time, their profits also increased by 548 million yuan, 571 million yuan and 700 million yuan, which accounted for 20.98%, 44.01% and 0.14% of the total profits in the financial report of each period. In 2018, I fictitious the equity transfer transaction with Jin Yichen Investment Management Partnership, but did not obtain the consideration for the equity transfer of the subsidiary, and the counterparty personnel of the transaction were actually the employees of the company controlled by the actual controller of the company.

### *2.2 False Increase in Inventory, Fixed Assets, Non-Current Assets*

In 2019, the procurement transactions with a number of companies have no commercial substance and authenticity. According to the relevant accounting standards for enterprises, do not meet the conditions of inventory recognition, constitute an inflated inventory. The equipment transformation business occurring in the same year has many abnormal characteristics, which do not meet the confirmation conditions of fixed assets, and constitute the falsification of fixed assets. In a number of procurement transactions with Luoyang Qiming Superhard Material Co., Ltd., the amount of the paid but no

obtained equipment and related services was recorded as other non-current assets in the nature of advance payment, which constitutes an inflated non-current assets. When the project under construction is carried forward to fixed assets, the corresponding amount needs to be deducted, but Yu Diamond Company did not deduct it, forming an imaginary increase in the project under construction. Through the inflated fixed assets, inventory and non-current assets, Yu Diamond led to the inflated assets of 1.856 billion yuan at the end of 2019.

### *2.3 Improper Disclosure*

Yu Diamond provides funds to the actual controller and its affiliated parties in various forms, resulting in non-operational occupation of funds by the controlling shareholders and their affiliated parties. During the operation period, the procurement transactions were repeatedly used to transfer funds to the bank account controlled by the actual controller, but the related related transactions were not disclosed. In 2019, a non-operating occupation capital of 268 million yuan was formed, accounting for 15.63% of the net assets disclosed in that year. In terms of guarantee matters, there are also cases not disclosed in accordance with regulations. From 2016 to 2019, a total of 4.131 billion yuan was not disclosed in the annual report. The CSRC pointed out that there were major omissions in the periodic reports involved. At the same time, Yu Diamond is involved in many lawsuits and should bear the responsibility for the judgment. The estimated liabilities formed by the lawsuit were not disclosed in 2018, resulting in the false reduction of the estimated liabilities of 234 million yuan in 2018 and the inflated profit of 234 million yuan. The false profit increase accounted for 180.46% of the total disclosed profit in that year.

## **3. Analysis of the Reasons for the Failure of Yu Diamond Audit**

### *3.1 Regulatory Reasons of Relevant Institutions*

#### **3.1.1 There Is a lag in Regulation**

Yu Diamond has already started the financial fraud in 2017, and the relevant institutions began to notice the incident in 2019. There is a certain time gap between the punishment of audit failure cases and the occurrence of audit failure. During this period, it often takes a period of time before the punishment, which is easy for accounting firms and the audited units to have a lucky mind, and affects the actual role and deterrent power of supervision. At the same time, the CSRC for the administrative penalty limitation is 2 years, in the asia-pacific argument, citing liability limitation over 2 years trying from 2017 audit report signature accountants punishment, but the SFC announcement points out that the audit report for three consecutive years contains false content, it is seen as a whole and not more than 2 years limitation, it can be seen that auditors have fluky psychology, also prove that relevant institutions regulations and room for improvement.

### *3.2 Reasons for the Auditee*

#### **3.2.1 Performance Pressure**

In order to cope with the market expectations of Yu diamond Company, to avoid large fluctuations in the company's stock price, or even forced delisting, Yu diamond Company began to financial fraud.

According to the investigation results of the CSRC, the inflated net assets of Yulong Company at the end of 2019 was 1.856 billion yuan, while the annual report of Yulong Company disclosed that the net assets on December 31, 2019 was 1.721 billion yuan, which can be clearly seen that the company's business performance is poor, according to the risk of forced delisting according to the relevant regulations of the science and Technology Innovation Board.

### 3.2.2 Management is above Internal Control

The actual controller is "out of control". Yu Diamond provides funds to the actual controller and its affiliated parties by means of advance purchase payment, fictitious commodity purchase and direct loan, and transfers funds to the bank account controlled by the actual controller for many times, resulting in the actual controller and its affiliated companies forming large amounts of non-operational funds. In addition, in 2018, Yu Diamond in relevant legal proceedings, Yu Diamond, as a debtor, borrowed a total of 305 million yuan from individuals, Zhongrong Intelligent Manufacturing and Shenzhen JinLifu, but these funds were not recorded in the account. During the event, the actual controller occupied more than 2.3 billion yuan of funds of the listed company. From this, we can see that the internal control can no longer play its due role. Under the condition of effective internal control, it is impossible to transfer funds to the bank account controlled by the actual controller without the record.

### 3.2.3 Relevant Personnel Do not Fulfill Their Responsibilities and Obligations Due Diligence

When the relevant directors are aware of the false transaction, they shall sign at the relevant director meeting and participate in the illegal matters such as loan and external guarantee. Moreover, the then chairman of the Board of Supervisors, responsible for the management of official seals, the approval of the seal and the release of the official seal of the listed company, was brought out for many times, resulting in the signing of many illegal loan and guarantee contracts.

## 3.3 *Reasons for Accounting Firms and Certified Public Accountants*

### 3.3.1 Continuous Audit of the Loss of Independence

From 2011 to 2019, the Asia Pacific Institute provided audit services, and in 2020, Yu Diamond rehired other accounting firms. period, Standards issued by the Asia Pacific Institute from 2011 to 2018, In 2019, it issued reservations about Yu Diamond, Asia Pacific Institute has provided audit services for Yu diamond for many years, Both parties have a certain basis of their relationship, Auditors and enterprise internal personnel have a certain trust and dependence, It may also be influenced and stressed by the management of the auditee, Especially when companies are facing financial difficulties or industry pressures, Has an impact on audit independence, Are unable to guarantee adequate rigor in performing audit procedures, Credulous to the information provided by the auditee, Or deliberately turn a blind eye to some details.

### 3.3.2 Industry Competition Is Fierce

At present, there are more than 2,800 listed companies in China, and according to statistics, the number of registered accounting firms in China will exceed 10,000 by 2021. The serious mismatch between supply and demand quantity may affect the independence of the firm in order to obtain the business or

maintain the customer relationship to obtain the economic benefits.

### 3.3.3 CPAs Lack Professional Caution and Diligence

#### 3.3.3.1 No Abnormal Abnormalities Were Found

In the implementation of accounts receivable in Yu diamond Company, there are a variety of abnormal conditions. Among them, there are some confirmation personnel actual reply and audit work papers registration contact, there are also confirmation letter actual reply address and registered customer address, customer reply address consistent with supplier office address, these confirmation problems are obvious, but certified public accountants did not further communication confirmation, did not keep the professional doubt.

#### 3.3.3.2 The Audit Procedure Is Flawed

In the condition that the judicial organs have made judgments on the relevant cases involved in Yudiamond, the review records state that if Yudiamond does not provide and fully disclose the matters before the report, a reserved opinion will be issued. However, the actual situation is that a standard unqualified opinion audit report has been issued without obtaining the written judgment and case materials of the relevant cases. The review and implementation of accounts payable were not sufficient. There were a large number of non-operating capital transactions between Yu Diamond and Zhengzhou Hongzhan Superhard Materials Co., Ltd., Luoyang Allen Alloy Materials Co., Ltd., while the CPA did not maintain professional caution and did not conduct in-depth investigation.

## 4. Case Reflection and Suggestions

### 4.1 Relevant Regulatory Agencies

#### 4.1.1 We Will Improve the Ranking Mechanism of Accounting Firms

The current ranking of accounting firms consists of basic indicators and additional indicators. Among the 10 basic indicators, the weight of the income index is 40%, accounting for a relatively high weight, but the weight of the processing punishment index is 30%. Based on this, it is suggested to increase the weight of the punishment index by 10 percent. In order to improve or guarantee the ranking of accounting firms and obtain a better reputation, accounting firms will have to pay more attention to the legal compliance and caution in the process of business execution to avoid audit failure. At the same time, the rating mechanism will be gradually extended to individual certified public accountants to ensure the continuous progress of certified public accountants' ability, and the business complexity matches the business level and ability.

#### 4.4.1.1 We Will Strengthen Daily Supervision

Yu diamond financial fraud has occurred in 2017, and was punished in October 2022. Therefore, advice in the daily supervision attention by the enterprise, for such enterprise priority, problems timely investigation and processing, shorten the illegal behavior from discovery to processing cycle, before financial fraud, audit failure caused the influence of a wide range, killed in the bud, not to give fluky psychology illegal personnel have an opportunity. New "securities" issued has increased the accounting

firm not diligently penalties, this event, the Asia Pacific was fined 8.3 million yuan, but the incident of the audit, head of the event for the signature CPA penalty fine up to 250000 yuan is 100000 yuan, and did not give relevant forbidden measures to punish, is the impact of its personnel behavior, punishment amount obviously insufficient, difficult to play a warning role. Therefore, it is necessary to improve the punishment for individual certified public accountants, and increase the relevant provisions of civil compensation. If the circumstances are serious and have a huge impact, they can be investigated for criminal responsibility.

#### *4.2 Unit under Auditing*

##### *4.2.1 Improve the Internal Control System*

Good and effective internal control is an important guarantee for the sustainable development of enterprises. Pay attention to the construction of internal control, ensure that the system is perfect, the process is clear, and can play a practical and effective management role in the financial report, property safety, operating efficiency and so on. In terms of the financial system, it is necessary to clarify the responsibilities and authority of various departments and positions, realize clear rights and responsibilities and mutual checks and balances, and avoid the situation that the company's expenditure is not registered into the account. At the same time, the internal audit department, as an important part of internal control, should give enough attention to, give the corresponding supervision power, ensure that it has independent status and sufficient authority, improve the professional ability of relevant personnel, so that the internal audit department can play a practical role.

#### *4.3 Accounting Firms and Certified Public Accountants*

##### *4.3.1 Strengthen the Audit Quality Control of the Firm*

This event audit work papers, the execution of accounts receivable program, confirmation record has different customers by the same personnel reply, address or contact with the registration information, customer reply address for the actual supplier of abnormal situation, but these situations did not cause the attention of the audit quality review. All review personnel shall conscientiously perform the review duties, objectively evaluate the audit working papers, and ensure the authenticity and accuracy of the audit report. First of all, a perfect review system should be formulated to clarify the scope, process, responsibility and time node of the review. For different business types and risk levels, Formulate the corresponding review strategies and procedures to ensure the pertinence and effectiveness of the review work. Maintain good internal communication and cooperation. During the review process, the review personnel should maintain communication with the audit project team to ensure the accuracy and integrity of the audit evidence, audit papers and audit materials. At the same time, it is also necessary to conduct a regular evaluation of the audit review work, understand the implementation of the audit review system, as well as the problems and difficulties encountered by auditors in the work, and timely adjust the audit review strategies and measures according to the evaluation situation, so as to improve the audit quality. For the problems not found in the audit report, we should strengthen personnel training and selection, and do a good job of incentive and punishment. For the review

personnel, strengthen their understanding of responsibility, to ensure that they are serious and responsible in the review process, not perfunctory.

#### 4.3.2 The CPA Maintains Professional Suspicion and Caution

Keep professional doubt is the basic quality of auditors, professional doubt make auditors alert to possible errors or fraud, strictly implement the audit procedures, not because of other factors and trust the auditees, and help to find the potential problems of the auditees, also need to improve the professional quality of auditors and audit skills, in practice, the actual execution is consistent with the working paper records, truthfully record. Maintain the principle of caution in the whole process of the letter certificate, and take further measures in accordance with the abnormal situation of the reply letter in accordance with the requirements of the audit standards. Regularly update and improve audit methods, deal with reply exceptions, and constantly improve relevant audit procedures and measures.

#### Reference

- Bao, G. Discussion on the improper audit procedures of accounting firms. *Accounting and Communications*, 2022(09), 124-128.  
<http://dx.doi.org/10.16144/j.cnki.issn1002-8072.2022.09.021>
- Fu, L. (2019). Take Kanghua Agricultural backdoor Busen shares as an example. *Accounting and Communications*, 2019(19), 100-104.  
<http://dx.doi.org/10.16144/j.cnki.issn1002-8072.2019.19.022>
- Jiang, Y. Q. (2022). Analysis of the audit failure case of Steyr. *Cooperative economy and science and technology*, 2022(11), 147-149. <http://dx.doi.org/10.13665/j.cnki.hzjjykj.2022.11.040>
- Wang, J. quietly. (2016). The application of professional doubt in the audit from the audit failure case of Sinovel wind Power. *Finance and Accounting*, 2016(16), 42-44.
- Xia, G. (2022). Case study of revenue audit failure from a risk-oriented audit perspective—Take Yabbetter as an example. *Chinese CPA*, 2022(01), 118-123.  
<http://dx.doi.org/10.16292/j.cnki.issn1009-6345.2022.01.021>