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A Study on the Causes and Effects of Audit Failure -- a Case of Dahua Accounting Firm's Jintongling

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Abstract. As an important regulatory force in the capital market, the audit quality of accounting firms has a direct impact on market order and investor rights. However, in recent years, frequent audit failures have exposed deep-seated problems in the industry. This paper takes Dahua Accounting Firm's audit failure case involving Jintongling as the research object and uses qualitative research method to deeply analyze the causes and effects of audit failure. This paper has found that the three factors of insufficient professional quality of auditors, ineffective on-site inventory observation, and failure to effectively identify and manage fraud risks constitute a transmission chain of "capability deficiency - procedure failure - risk out of control", which are the main causes of audit failure; The effects of audit failure manifests as a triple crisis of business decline, talent loss, and market position collapse. This will seriously damage its reputation accumulated over the years in the industry, and its future development will also face numerous obstacles.

1 Introduction

As gatekeepers of the capital market, accounting firms play a pivotal role in safeguarding investor interests and ensuring market integrity. The quality and independence of their audit work are central to upholding public confidence. However, frequent audit failures in recent years have seriously undermined the credibility of accounting firms, diminished investor trust, and threatened overall market stability. Through the study of audit failure cases, we can understand its cause and effects more clearly. It can provide reference for improving audit quality, promote the healthy development of accounting firms, and ultimately safeguard the interests of investors and the stability of the capital market. This paper will take the Jintongling case of Dahua Accounting Firm as an example to deeply analyze the causes for audit failure of accounting firm and its effects.

2 Literature review

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The academic discourse on audit failure primarily examines the issue from the perspectives of accounting firms and audited entities, with a growing emphasis on regulatory factors. For instance, Weng Jianying explored the financial fraud case of Jiuhao Group, analyzing both the internal mechanisms of fraud and the audit failure at Lianda Accounting Firm, while also reflecting on the role of institutional investors and corporate governance structures [1]. Wang Shuguang and Dong Jie take Kangmei Pharmaceutical's financial fraud case as an example. The paper analyzes the financial fraud of Kangmei Pharmaceutical and the causes for the audit failure of Zhujiang Accounting Firm. It also expounds the strategies to prevent audit failure from three aspects: accounting firms, audited units and supervisors [2]. Li Shouxi and He Yibing based on the case of Aerospace Communication Company. The causes of audit failure are analyzed from two perspectives: aerospace communication company and accounting firm.And from two aspects of corporate governance and strengthening the supervision of accounting firms to expound the research implications [3]. Wang Jianxin and Wang Tao take the audit failure case of A company as an example. It not only analyzes the means of financial fraud in Company A, but also analyzes the problems existing in the audit process of Ruihua Accounting Firm [4].

In addition to the analysis from the perspective of accounting firms and auditees, some of the case studies on audit failures will also be explored from the regulatory level. For example: Fu Liang to Kanghua Agriculture backdoor Busen shares listing audit failure case as an example. The causes for audit failure are analyzed from two aspects: accounting firm, certified public accountant and external supervision. And put forward measures to prevent audit failure [5]. Wanqi Wang cited the failed audit of Zhengzhou Huajing Diamond Co., Ltd. by an Asia-Pacific accounting firm as an example. The causes of audit failure are analyzed from three aspects: the regulator, the auditee, the accounting firm and the certified public accountant. Suggestions for improvement are also put forward [6]. There are few studies on the effect of a single audit failure case on accounting firms. Liu Jing and Xing Yingyu take Ruihua Accounting Firm as an example. The impact of "case filing and immediate suspension" on accounting firms is analyzed. This study focuses on the impact of the policy of "case filing and immediate suspension" on accounting firms [7]. Yuan Hongqi et al. studied the impact of audit failures of accounting firms on their IPO clients' audit rejection rate. The subjects affected in this study are IPO clients, not accounting firms [8].

In sum, while previous studies have provided rich accounts of audit failure causes and preventive strategies, insufficient attention has been paid to the implications of a single audit failure case on the audit firm’s internal operations and industry standing. This paper seeks to fill this gap by analyzing the Jintongling case from Dahua Accounting Firm’s perspective, exploring the multifaceted causes of audit failure and its cascading effects on the firm.

3 Method

3.1 Case Introduction

Jintongling Technology Group Co., LTD., in the annual report of the period from 2017 to 2022, there were false records such as inflated or reduced operating income and total profit. As its auditor, Dahua Accounting Firm, failed to be diligent and responsible, and issued a standard unqualified opinion audit report for him for six consecutive years. On May 10, 2024, the Jiangsu Regulatory Bureau of the China Securities Regulatory Commission issued an administrative penalty decision against Dahua Accounting Firm, which clearly pointed out that it failed to perform its due duties during the audit of the annual financial statements of Jintongling Technology Group Co., LTD. In accordance with relevant regulations, the Jiangsu Regulatory Bureau ordered the Dahua Accounting Firm to rectify its practices, confiscated its business income of 6,886,792.14 yuan, imposed a fine of 34,433,960.70 yuan, and suspended its securities service business for six months.In addition, the three signed CPAs involved in the case were also punished accordingly [9]. This incident is now recognized as a landmark audit failure, exposing significant flaws in audit processes and intensifying public scrutiny of audit quality and auditor independence in China.

3.2 Analysis of the Causes of Audit Failure

3.2.1 The professional quality of auditors is insufficient

In 2017, when Dahua Accounting Firm undertook the annual report audit business of Jintongling Company for the first time, Jintongling Company adopted a method in violation of business accounting standards to recognize construction contract income. However, the auditors of the project team approved this violation. This is a serious failure of professional judgment on the part of auditors. During the audit of the 2017 annual report, the project manager and Jintongling Company had a major disagreement on the method of recognizing the actual input cost of the construction contract. However, the project manager did not inform Dahua Accounting Firm of the disagreement as required, which prevented the firm from taking the necessary countermeasures. At the same time, the auditors of the project team did not record this issue in the audit working papers. This is a clear violation of auditing standards. In addition, Dahua Accounting Firm claimed in its audit reports from 2017 to 2021 that it had implemented relevant internal control test procedures, but no corresponding records of internal control activities were found in the audit working papers of several years [9]. This indicates that the auditors may not have actually carried out the internal control test procedures claimed in the audit report, or there are improper records in the audit working papers. In either case, the auditors are failing in their work. This paper believes that the above three phenomena reflect the lack of professional quality of auditors in the Jintongling project, which is one of the causes for the audit failure.

3.2.2 Poor execution of on-site inventory observation

In 2017, when Dahua Accounting Firm conducted on-site inventory observation of Jingheyuan waste heat power generation project, the equipment list listed in the inventory table could not correspond to the project input on the book, the inventory observation record was incomplete, and some equipment did not record the quantity. In 2018, when Dahua Accounting Firm conducted on-site inventory observation of Hebei Shengtao project, the equipment list listed in the inventory table also did not match the book project investment, the inventory observation record was incomplete, and some equipment did not record the quantity. On March 29, 2018, Dahua Accounting Firm conducted on-site inventory observation of the Jingheyuan waste heat power generation project. At this time, it is nearly three months from the balance sheet date.Between the balance sheet date and the inventory date, there are cases of goods being shipped to the site of the project. However, Dahua Accounting Firm did not carry out the necessary audit procedures, and reasonably calculated the inventory observation of the inventory date to the balance sheet date [9]. Inventory observation is an important substantive procedure in auditing.The on-site inventory observation conducted by Dahua Accounting Firm on multiple occasions was ineffective, resulting in the inability to obtain sufficient and appropriate audit evidence and subsequently leading to audit failure.

3.2.3 Fraud risks are not effectively identified and managed

In 2017, Dahua Accounting Firm found that there was a significant difference between the on-site inventory of Jintongling's Daming project and the progress confirmed by the company's book. In the face of this abnormal situation, Dahua Accounting Firm only relied on the untrustworthy supplier's reply as the main audit evidence.They did not re-evaluate the integrity of the management, and did not take effective audit measures to deal with the potential risk of financial fraud. In 2018, Dahua Accounting Firm again found significant inconsistencies between the progress of the Jintongling Daming project site and revenue recognition. However, the firm still chose to use untrusted supplier responses as the main audit evidence.They did not re-evaluate the integrity of management, and did not conduct on-site inventory observation or visits to the Daming project to address the potential risk of significant fraud. In 2019, Dahua Accounting Firm learned that there was a significant difference between the progress of site construction and the progress confirmed by the audit, but it still did not arrange to implement audit procedures such as on-site inventory observation or visit. They continue to rely on untrustworthy supplier responses as the main audit evidence, fail to re-evaluate the integrity and financial fraud risks of management, and fail to take effective audit measures to deal with fraud risks [9].For three consecutive years, Dahua Accounting Firm failed to effectively identify and manage the possible fraud risks of the audited entity, which seriously affected the audit quality and was one of the causes leading to the audit failure.

3.3 Analysis of the effects of Audit Failure

3.3.1 The effect on audit service

Dahua’s client base experienced a dramatic contraction. By the end of 2024, over 70% of its clients terminated their engagements. Of 436 A-share listed clients, 306 transferred to other firms. The firm’s IPO project portfolio also suffered: after its suspension, the number of IPO projects under review dropped from 36 in May 2024 to 9 by July, all of which were frozen [10,11].

3.3.2 The effect on employees

After experiencing the audit failure, the staff turnover at Dahua Accounting Firm significantly intensified, with a substantial decline in the number of certified public accountants and partners. Between 2023 and 2024, the number of certified public accountants at Dahua Accounting Firm plummeted from 1,471 to 888, a decrease of nearly 40%; the number of partners also dropped from 270 to 150 [10]. This paper believes that such staff attrition not only weakened the firm's business execution capabilities but also led to a gap in team experience. Particularly, the departure of senior auditors and project leaders further exacerbated the decline in professional capabilities.

3.3.3 The effect on industry position

The audit failure had a serious impact on the reputation, ranking and competitiveness of Dahua Accounting Firm in the industry. In the 2023 annual report season, Dahua Accounting Firm issued audit reports for A total of 436 A-share companies, ranking third among all accounting firms [12]. In the "Comprehensive Evaluation of 100 Ranking Information of Accounting Firms in 2023" issued by the Chinese Institute of Certified Public Accountants, Dahua Accounting Firm ranks tenth and seventh among domestic accounting firm [13]. However, after being punished in 2024, its business was rapidly lost, its market share shrank sharply, and its personnel flow intensified. Dahua Accounting Firm is afraid that it will be difficult to maintain the top ten ranking, and the aura of "eight major domestic accounting firms" will fade. In addition, accounting firms such as Rongcheng and Dehao have rapidly risen by absorbing clients and core teams that left Dahua Accounting Firm, creating competition for the top market. This will further weaken the competitiveness of Dahua Certified Public Accountants.

4 Conclusion and enlightenment

Through the in-depth analysis of the Jintongling case of Dahua Accounting Firm, this paper draws the following conclusion: audit failure is a systemic risk out of control caused by multiple factors superposed. First, the deficiency in professional quality constitutes the underlying logic of audit failure. From the project manager's misjudgment of accounting standards to the non-standard record-keeping in working papers, it reflects the dual lack of professional competence and professional ethics. Second, the formalistic tendency in the execution of audit procedures creates operational loopholes. On-site inventory observation are superficial and risk response measures are rigid, leading to the breakage of the key audit evidence chain. Third, the failure of the risk response mechanism increases the probability of audit failure. Selectively ignoring and compromising with persistent fraud signals essentially condones financial fraud.This transmission mechanism of "capability defect - program failure - risk out of control" eventually leads to audit failure. In terms of impact dimension, audit failure causes firms to face the triple crisis of sharp decline in business, brain drain and collapse of market position. This will seriously damage its reputation accumulated over the years in the industry, and its future development will also face numerous obstacles.

While this study highlights the proximate causes and consequences of audit failure, it does not explore the internal control mechanisms within accounting firms that could mitigate such risks. Future research could investigate how internal governance structures, quality control reviews, and ethical compliance systems influence audit performance. Additionally, comparative studies between domestic and international audit regulatory environments may offer broader insights into improving audit quality and accountability.

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