

Audit Failures In Small and Medium Sized Accounting Firms Under China's Revised Securities Law

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Abstract. After China's new Securities Law shifted securities related audit entry from an approval to a filing regime, small and medium sized accounting firms gained easier market access, but audit quality risks increased. Drawing on information asymmetry and audit collusion theories, this study uses a case analysis of Zhongtian Huamao's audit of ST Wangli to reconstruct the failure process and identify key deficiencies, including impaired independence, inadequate procedures and evidence for fixed assets, insufficient follow up on prior qualified opinion issues, and false statements in audit documents. The findings suggest that greater scope for collusion under the filing system, together with insufficient due diligence and professional competence, contributed to the failure. Policy implications include strengthening auditor ethics and firm independence, improving capability building, and moving toward more preventive and continuous regulatory oversight.

Keywords: New Securities Law; Filing system; Audit failure; Audit collusion.

1. Introduction

This paper takes the institutional shift from an approval-based regime to a filing-based regime for securities service businesses following the implementation of China's revised Securities Law as its starting point. It argues that the filing system has lowered entry barriers for small and medium-sized accounting firms to participate in the securities service market. Meanwhile, against the backdrop of the rollout of the registration-based IPO system and expanding demand for listings, the supply of audit services and the exposure to audit risk may rise simultaneously. Accordingly, the paper focuses on the practical issue of audit failures among small and medium-sized firms, selecting the case of Zhongtian Huamao Certified Public Accountants' audit of ST NetPosa as an illustrative example. It seeks to reconstruct the chain of events leading to the audit failure and to identify the key institutional and practice-level drivers underlying it.

2. Analysis of the Case

2.1. Timeline and Key Events of the ST NetPosa Audit Failure

On March 1, 2020, China's revised Securities Law officially came into force, substantially increasing the legal liabilities borne by accounting firms and further raising the costs of violations and noncompliance. As a result, some ST-designated firms encountered difficulties in securing an accounting firm willing to undertake their annual report audits. Meanwhile, the revised Securities Law replaced the approval-based administration of accounting firms' securities service business with a filing-based regime. This change encouraged many small and medium-sized accounting firms that previously lacked securities service qualifications to enter the securities audit market. Consequently, some ST companies and smaller accounting firms found common ground and formed cooperative relationships. Against this backdrop, ST NetPosa engaged Zhongtian Huamao Certified Public Accountants to conduct the audit of its 2020 annual report.

This audit failure case began on February 23, 2021, when ST NetPosa switched its auditor to Zhongtian Huamao, and lasted until May 9, 2022, when ST NetPosa again changed its auditor to

ShineWing Certified Public Accountants. Over a period of nearly one year, regulators issued multiple rounds of inquiries and conducted ongoing supervisory scrutiny.

2.2. Problems in Zhongtian Huamao's Audit Engagement

2.2.1. The audit related documents issued by the firm contained false statements

According to the CSRC's investigation, ST NetPosa's 2020 annual report contained materially false statements, including the overstatement of fixed assets and the use of circular fund flows lacking commercial substance to eliminate the basis for a qualified opinion.

Zhongtian Huamao provided audit services for ST NetPosa's 2020 annual financial statements and issued an unqualified audit opinion with an Emphasis of Matter paragraph on material uncertainty related to going concern. The signing certified public accountants were Xie Xiaoli and Yang Ming. Zhongtian Huamao received an audit fee of RMB 1.55 million (tax inclusive) paid by ST NetPosa.

2.2.2. Compromised Auditor Independence

According to the CSRC's investigation, Zhongtian Huamao and ST NetPosa were suspected of having contingent fee arrangements, and Zhongtian Huamao failed to maintain the required auditor independence during the engagement.

At the same time as ST NetPosa signed an audit engagement letter with Zhongtian Huamao for the audit of its 2020 annual financial statements, it also entered into a separate engagement letter with Zhongtian Huamao for audit services related to a private placement. In addition, ST NetPosa signed a consulting engagement letter, an internal control self-assessment service engagement letter, and a supplementary agreement to the internal control self-assessment engagement letter with Duchang County Fengyuan Business Consulting Service Co., Ltd. In substance, these contracts were used as channels for ST NetPosa to pay the audit fee for the 2020 financial statement audit to Zhongtian Huamao. Notably, the consulting engagement letter and the supplementary internal control agreement between ST NetPosa and Duchang Fengyuan specified contingent fee terms, under which payment was conditional upon Zhongtian Huamao issuing an unqualified audit opinion. Such arrangements violated the independence requirements.

Furthermore, Qiu Wenxing, a certified public accountant at Zhongtian Huamao who was responsible for the firm's business operations and management, arranged and coordinated the contingent fee arrangement with ST NetPosa in the name of Duchang Fengyuan. During communications with Mr. Zhao, ST NetPosa's then chairman, Qiu reportedly stated that the firm was acting at the risk of regulatory sanctions and that, at worst, his small firm could simply shut down. These statements indicate the existence of unlawful conduct and suggest that Qiu was aware of the relevant violations and their potential legal consequences.

2.2.3. Fixed Asset Audit Deficiencies

In December 2020, ST NetPosa reclassified RMB 14.728 million in advance payments that its subsidiary, NetPosa (Suzhou) Intelligent Technology Co., Ltd., had made for asset purchases from Suzhou Jiangheng Network Technology Co., Ltd., as fixed assets. During the audit, Zhongtian Huamao failed to give sufficient attention to multiple red flags related to the recognition of these fixed assets. Specifically, the relevant accounting vouchers supporting capitalization were not accompanied by invoices, and the supporting documents consisted only of a form showing that fixed asset codes had been generated, rather than original goods receipt or warehouse entry documents. In addition, the specifications and models of the assets recorded in the 2020 Inventory Checklist for Funded Project Assets were materially inconsistent with the terms set out in the related amendment agreement. Zhongtian Huamao did not maintain professional skepticism or perform appropriate audit procedures, and its related audit conclusions were not supported by sufficient and appropriate audit evidence.

2.2.4. Deficiencies in Auditing Matters Underlying the Prior-Year Qualified Opinion

Tianzhi International Certified Public Accountants (Special General Partnership) issued a qualified audit opinion on ST NetPosa's 2019 annual financial statements. The basis for the qualification involved matters related to advance payments, other receivables, and other non-current financial assets. Zhongtian Huamao's audit work on the matters underlying the prior-year qualified opinion was deficient. Specifically, it failed to maintain professional skepticism and did not perform appropriate audit procedures, and its audit conclusions were not supported by sufficient and appropriate audit evidence. These deficiencies were reflected in three aspects.

First, as of the end of 2020, ST NetPosa reported advance payment balances totaling RMB 129.0746 million to three counterparties, namely Beijing Yintai Jinhong Technology Co., Ltd., Beijing Hongjiafu Technology Co., Ltd., and Beijing Guotai Yijia Technology Development Co., Ltd. Zhongtian Huamao did not obtain sufficient and appropriate audit evidence regarding the actual use or purpose of these advance payments.

Second, ST NetPosa extended a loan of RMB 280.00 million to Jining Hengdexin International Trade Co., Ltd. through a trust plan and recognized a full impairment allowance on the loan. Zhongtian Huamao did not obtain sufficient and appropriate audit evidence regarding the actual use of the loan proceeds.

Third, ST NetPosa invested RMB 120.00 million to increase its capital in Shenzhen Weifu Robotics Technology Co., Ltd. and RMB 70.00 million to increase its capital in Beijing Yunxiaoyao Network Technology Co., Ltd., yet the corresponding equity interests were not registered through the agreed industrial and commercial registration change procedures. In 2020, ST NetPosa sold these investments to external parties for a consideration of RMB 72.65 million. Zhongtian Huamao did not perform appropriate audit procedures on the opening balances of these investments, did not evaluate the work of management's experts, and failed to maintain professional skepticism regarding the authenticity and reasonableness of the investment and disposal transactions, thereby failing to obtain sufficient and appropriate audit evidence.

2.3. Causes of the Audit Failure in ST NetPosa

2.3.1. The Revised Securities Law and the Greater Operational Scope for Audit Collusion

In its 2019 annual report, Tianzhi Certified Public Accountants issued a qualified audit opinion on ST NetPosa's financial statements. After the qualified opinion was issued, ST NetPosa replaced its auditor at the end of 2019 on the grounds of its operating conditions and the needs of the 2020 annual report audit. This change represented a downward switch. Given that Zhongtian Huamao had never previously undertaken the annual report audit of a listed company, the engagement entailed substantial audit risk, which was sufficient to attract close regulatory attention. It can therefore be inferred that ST NetPosa replaced Tianzhi, its audit partner of seven years, in order to achieve audit opinion shopping, namely to obtain a cleaner audit opinion through auditor switching and other forms of auditor management collusion.

The revised Securities Law lowered the entry threshold for securities related professional services, which provided the basic conditions for Zhongtian Huamao to engage in collusion with ST NetPosa. Driven by business expansion or the pursuit of excess returns, Zhongtian Huamao's incentives could align with those of ST NetPosa, thereby facilitating an auditor client collusive relationship and ultimately contributing to the audit failure.

Maintaining proper independence between accounting firms, certified public accountants, and audited entities is one of the key prerequisites for the healthy functioning of capital markets. Only with such independence can audit reports reflect the true operating and financial condition of a firm and support the issuance of an appropriate audit opinion, thereby protecting investors and the public from harm. Under the revised Securities Law, a company may face suspension of listing if it receives audit reports with a disclaimer of opinion or an adverse opinion for two consecutive years. Accordingly, some

listed companies that received an adverse opinion or a disclaimer in the prior year may attempt to avoid delisting by engaging in financial misstatements or by purchasing audit opinions.

At the same time, by lowering the threshold for securities service business, the revised Securities Law enabled many small and medium sized firms that previously lacked the relevant qualifications to enter the capital market. In the early stage of market entry, such firms often have a strong desire to expand in scale, capture market share, and take on securities service engagements, which can make their objectives more likely to converge with those of listed companies and, in turn, give rise to auditor client collusion. Some scholars argue that audit opinion shopping is commonly implemented through a negative auditor switch, namely switching to a lower tier auditor. Therefore, it cannot be ruled out that certain listed companies may exploit gaps in the current policy environment and collude with smaller firms to mitigate delisting risk. In this sense, the reduced entry threshold under the revised Securities Law has, to some extent, increased both the likelihood and the operational feasibility of collusion between listed companies and accounting firms.

In this case, after obtaining the qualification to provide securities related services through the filing process, Zhongtian Huamao may, on the one hand, have colluded with ST NetPosa for the purpose of expanding its securities practice, implicitly committing not to issue an adverse opinion or a disclaimer and thus issuing an audit opinion that did not reflect the underlying reality, leading to the audit failure. On the other hand, ST NetPosa may have purchased an audit opinion at a high price, and Zhongtian Huamao, motivated by financial interests, colluded with ST NetPosa to issue a false audit opinion. According to available data, Zhongtian Huamao's audit revenue in 2020 was only RMB 3.6321 million, while ST NetPosa paid an audit fee of RMB 1.55 million for the 2020 annual audit, accounting for about 42.7 percent of the firm's prior year audit revenue.

In summary, given that the revised Securities Law increased the operational feasibility of auditor client collusion, Zhongtian Huamao, whether motivated by business expansion or by the pursuit of economic gains, faced a material risk of colluding with ST NetPosa, which meant that independence may have been impaired even before substantive audit work began. Once independence is compromised, audit personnel are less able to maintain professional skepticism, the selection and execution of audit procedures are more likely to be distorted, and the risk of audit failure increases accordingly.

2.3.2. Deficiencies in Due Diligence and Professional Care under the Revised Securities Law

During the audit engagement, Zhongtian Huamao did not perform further audit procedures in response to identified anomalies to obtain sufficient audit evidence and reduce audit risk. The engagement team lacked the necessary prudence and professional skepticism and failed to exercise due diligence, which ultimately contributed to the audit failure.

Under China's revised Securities Law, securities service providers, including accounting firms, are required to act with due diligence and fulfill their duties, providing services for securities transactions and related activities in accordance with applicable business rules. The CSRC has summarized common manifestations of a lack of due diligence in audit practice, including audits that become mere formalities, insufficient audit evidence that results in inadequate implementation of auditing standards, failure to maintain necessary professional skepticism during audit planning and performance, ineffective identification of or response to anomalies and even indications of fraud, and unreasonable professional judgment leading to inappropriate audit opinions.

In this case, Zhongtian Huamao and the signing certified public accountants failed to meet the due diligence requirement. They did not maintain a prudent and skeptical professional mindset, relied excessively on accounting documentation, failed to question abnormal financial information, and did not obtain sufficient and appropriate audit evidence. As a result, the issued audit report contained false statements, culminating in an audit failure.

First, when auditing fixed assets, Zhongtian Huamao did not adequately address multiple red flags, including the absence of invoices for the accounting vouchers supporting the capitalization of fixed

assets, supporting documents limited to a form showing that fixed asset codes had been generated rather than original goods receipt or warehouse entry documents, and material inconsistencies between the specifications and models recorded in the 2020 Inventory Checklist for Funded Project Assets and those stipulated in the relevant amendment agreement. The auditors neither maintained professional skepticism nor performed appropriate audit procedures.

Second, Zhongtian Huamao likewise failed to maintain professional skepticism or perform appropriate audit procedures with respect to the matters underlying the prior-year qualified audit opinion issued by Tianzhi International.

Taken together, certified public accountants should comply with the revised Securities Law's due diligence requirements by maintaining prudence and professional skepticism throughout the audit and by obtaining sufficient and reliable audit evidence, both of which are critical determinants of audit quality. Zhongtian Huamao's audit failure reflects deficiencies on these two dimensions; audit work based on incorrect or incomplete evidence is therefore likely to result in an audit failure.

3. Practical Implications and Recommendations Based on the ST NetPosa Case

3.1. Regulatory Authorities Shift Their Supervisory Approach

The implementation of China's revised Securities Law is intended to further advance the streamlining of administration and the delegation of power, combined with improved regulation and service, in the certified public accountant profession. The shift of accounting firms' eligibility for securities service business from an approval-based regime to a filing-based regime was designed to stimulate industry vitality and promote more level competition, thereby supporting high-quality development of the profession. The revised Securities Law has released substantial audit demand while simultaneously expanding the supply of service providers, intensifying competition across the audit market. For regulators, this means that a large number of practitioners will enter the market in the future, including small and medium-sized firms with limited experience such as Zhongtian Huamao. This trend raises new requirements for regulatory oversight, as a purely ex post supervisory approach can no longer meet regulatory needs under the current policy environment.

In the ST NetPosa case, regulators issued a letter of concern immediately after the company switched its auditor to Zhongtian Huamao. This suggests that dynamic, ongoing supervision has become one of the key regulatory approaches. Regulatory intervention effectively begins at the point when a listed company appoints an accounting firm and evolves in a timely manner as the audit engagement progresses, with supervisory measures adjusted dynamically in response to emerging risks.

3.2. Heightened Attention to Audit Firm Capacity and Quality Control

In China's capital market, many firms similar to ST NetPosa, due to financial distress and other pressures, seek to obtain cleaner audit opinions through audit opinion shopping. Before the implementation of the revised Securities Law, securities service qualifications were subject to an approval-based regime with relatively high entry thresholds. As a result, a large number of small and medium-sized accounting firms in China were not eligible to undertake securities related engagements, which also placed certain survival pressures on these smaller firms. After the revised Securities Law took effect, however, many small and medium-sized firms were eager to enter the securities service market and capture market share. This urgency can align the interests of smaller audit firms with those of ST-designated and other troubled firms, facilitating cooperative relationships in which smaller firms issue audit reports tailored to the needs of such clients.

In the longer run, even if listed companies are able to find auditors willing to accept their engagements after the relaxation of entry barriers, the market will still form its own judgments about firm fundamentals. In particular, when a troubled company switches to a less experienced small or medium-sized audit firm, it may send a negative signal to the capital market and trigger investors' concerns about heightened risks of material misstatement and possible audit opinion shopping.

Therefore, in the near term, cases in which listed companies engage small and medium-sized firms that previously lacked securities service qualifications may not occur frequently. Instead, audit firm scale, quality, and reputation are likely to become increasingly important considerations for listed companies when selecting auditors.

4. Recommendations for Preventing Audit Failures under the Revised Securities Law

4.1. Certified Public Accountants' Preventive Measures

Only by upholding strong professional ethics can certified public accountants gain recognition from the public and secure sustainable opportunities for development in capital markets. Therefore, CPAs should continually remind themselves to maintain a fair, independent, and objective stance in their work and to regulate their professional conduct in accordance with ethical standards.

Strengthening professional ethics begins with effective ethics education, together with enhanced supervision and enforcement of ethical requirements. Ethics training should not be treated as a one-off exercise; rather, it should run throughout a CPA's entire career. In addition to expanding ethics-related coursework in university programs, ethics should carry greater weight in qualification examinations and in subsequent continuing professional development. Raising CPAs' ethical standards helps ensure that they are not driven by economic incentives, that they consistently maintain independence, and that they improve professional competence by refraining from accepting engagements that exceed their expertise and capacity. At the firm level, accounting firms should also reinforce internal communication and training on ethical standards. They should avoid pressuring CPAs, for profit-related reasons, to undertake high-risk engagements beyond their capabilities, thereby elevating the ethical culture of the organization and strengthening the firm's reputation and brand image.

4.2. Audit Firms' Preventive Measures

4.2.1. Ensuring Audit Independence and Strengthening an Internal Culture of Independence

For an accounting firm to achieve long-term development and remain viable, it must, above all, maintain objectivity, fairness, and independence. Once an accounting firm loses its independence, it will also lose the trust of the capital market. When a company engages an audit firm that is not trusted by the market, it sends a negative signal to external stakeholders. Accordingly, if an audit firm fails to preserve independence, it may ultimately be unable to secure engagements and will drift toward decline. This point is particularly salient for small and medium-sized firms: independence is one of the prerequisites for establishing a foothold in the capital market and entering the securities audit market. Only by ensuring independent audits can such firms gain investor trust and thereby obtain opportunities to audit more listed companies. To safeguard the independence of both the firm and its certified public accountants, the following measures are recommended.

First, firms should prioritize building a culture of independence and cultivate an organizational image grounded in integrity and independence. Culture provides the foundation for governance; therefore, the construction of an independence culture must be implemented in a concrete and enforceable manner. CPAs should be required to consistently adhere to independence requirements throughout the engagement and to conduct audit work strictly in accordance with applicable auditing standards. Even when facing unreasonable requests from the audited entity, auditors should refuse to comply and avoid any form of collusion, issuing audit opinions that are objective, fair, and independent. In this way, independence becomes the basis for establishing a credible and trustworthy firm image.

Second, firms should strengthen internal independence training to foster CPAs' independence awareness. Through ongoing training and education, accounting firms can help CPAs develop and sustain an independence mindset. Independence training should be institutionalized as a routine component of the firm's professional development program. Using multiple formats, such as case-based learning and blended online–offline training, firms should ensure that all personnel thoroughly

understand the core requirements of independence and can internalize and apply them in practice. In addition, independence assessments can serve as an effective tool for reinforcing independence awareness. Appropriate disciplinary measures for those who fail such assessments may also be considered to enhance deterrence and compliance.

4.2.2. Emphasizing Brand Building and Exercising Prudence in Accepting Securities Service Engagements

The introduction of the revised Securities Law has created an unprecedented opportunity for the development of small and medium-sized accounting firms. These firms can seize the opportunity to enter the securities services market, expand their scale, and generate additional economic benefits. To capture this opportunity, however, firms should first build a strong brand image on the basis of improving both audit efficiency and audit quality. A credible brand can increase a firm's visibility in the capital market and help it secure more high-quality annual report audit engagements from listed companies.

A core element of brand building is prudent client selection. Firms should avoid blindly taking on high-risk audit engagements merely to achieve rapid expansion. Before accepting securities-related engagements, particularly those involving ST-designated companies, firms should conduct thorough client due diligence, including assessments of the client's integrity and operating condition. Given the large number of small and medium-sized firms competing for securities business, intensified competition often weakens their bargaining power, making them more vulnerable to pressure from listed clients. Under such pressure, auditors may be induced to assist in financial statement manipulation, increasing the likelihood of audit failure. Yet any involvement in helping a listed company embellish its financial reporting is likely to be exposed eventually, causing irreparable damage to the firm's reputation and potentially dealing a fatal blow to smaller firms. Therefore, small and medium-sized firms should approach securities engagements with prudence and build their market standing through sustained improvements in professional competence and audit quality, rather than through opportunistic expansion.

4.3. Preventive Measures by Regulatory Authorities

Regulatory authorities play a critical role in maintaining capital market order and safeguarding the sound development of the capital market, and the implementation of the revised Securities Law likewise depends on effective regulatory enforcement. In this context, pursuing a pathway toward targeted and risk-based supervision is one approach to ensuring the stable and healthy development of the CPA profession.

To achieve more targeted regulation, regulators should first strengthen oversight of firms newly entering the securities services market. Because the revised Securities Law has lowered entry thresholds for securities-related services, a large number of small and medium-sized accounting firms that previously lacked eligibility, have limited securities audit experience, possessed insufficient professional competence, and had relatively weak capacity to bear civil liability may enter the market. This trend substantially increases the difficulty of regulatory oversight. Regulators should therefore enhance supervision of such newly participating firms by assessing their professional competence and eligibility and by providing ex ante guidance, education, and warnings. Regulators should also strengthen in-process supervision by identifying risk points during the audit and requiring explanations and disclosures through regulatory inquiries. In addition, ex post oversight remains necessary: regulators should carefully evaluate whether reports issued by newly participating firms reflect objectivity and fairness.

Second, one of the goals of the revised Securities Law is to encourage reputable, high-quality accounting firms to grow stronger and larger. Accordingly, regulators should advocate that listed companies and companies listed on the National Equities Exchange and Quotations (NEEQ) select accounting firms with substantial experience, strong reputations, and credible brands associated with objectivity and fairness. Regulators should also encourage listed companies to conduct enhanced due

diligence before engaging newly participating firms, for example by reviewing any records of dishonesty or misconduct. Moreover, where a company that received a non-standard unqualified audit opinion in the prior year, or otherwise faces potential suspension of listing, switches to a newly participating firm for its annual report audit, regulators should treat such engagements as higher-risk cases and apply heightened scrutiny. Regulators may further consider periodically publishing a list of high-quality accounting firms to assist listed companies in making informed auditor selection decisions. Such measures can expand opportunities for firms with strong brand reputations and support a virtuous cycle in the industry ecosystem.

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