

## **Audit Manipulation: the Analysis of Modified Audit Opinions and Subsequent Audit Opinions' Statements in China**

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**Abstract:** Audit opinion is the core outcome of auditors and it is the final judgement on whether the audited company's financial report is in accordance with the legion of accounting standards. Usually once the audit opinion is issued, it can't be roll back or withdrew. But we find that in recent years there are several audit opinions were rolled back throught the subsequent statements on modified audit opinions. So our paper studied on the phenomenon of audit opinion rollback based on a full sample of most recent five years. We found that considering the relative short time duration between the issuance of MAO and subsequent assurance, and the nature of the used matters to modify the audit opinion, it is more likely that the CPA firm and its client, before the audit report is even issued, have already strategically planned for the type of audit opinion and the possible subsequent moves to favor the client. That is, the CPA firm issues the MAO and the special statement about the modifying matter first, and then rolls back the impact of the afore mentioned matter in the follow-up assurance. In this way, the auditors can shield themselves from the risk from issuing un-proper opinion, and the client can get rid of the negative impact of the MAO. Such kind of things should be paid more attention by the regulators, auditors themselves and the investors. We may take measures on prohibiting those things happen to let the stock market well operated.

### **1. Introduction**

Mar15, 2018, the Dahua accounting firm issued the auditing report of Hanyu listed company of China with the unqualified opinion & EOM, and the EOM is related to pending lawsuit of quality of products deficiencies. But quickly the next day it issued the revise statements on audit opinion which point out that the former things can't have effect on audit opinion. Such kind of things undoubtedly give rise on investors and regulators. Can audit opinion been changed so easily? In fact this thing is not fresh at all. As early as 2013, the qualified audit opinion of Ningxia Zhongyin Cashmere Co., Ltd., a listed firm in Shenzhen stock Exchange, was essentially overturned when its audit firm issued a follow-up supplementary statement two months later to dismiss the matter that modified the opinion. In recent years, we have observed an increasing number of similar audit-opinion-rollback events, where the CPA firm issues a modified audit opinion (MAO) first and then dismisses the related matter that has given rise to the modification by providing further subsequent assurance information to the audit report. According to the China's stock market regulation rules on modified audit opinions, The subsequent assurance information can be offered in the following approaches: (1) issue a supplementary explanation; (2) issue an interim review report to dismiss the modified matter'ssignificant impact; (3) respond to the comment letter from regulators. Such a modify-and-then-dismiss scheme can create a win-win situation for CPAs and their clients during audit engagements. In particular, the CPA firm gets to officially document its concern through the MAO on the report day and to protect itself from the risk from directly issuing an unqualified opinion, and the subsequent assurance essentially changes the original unfavorable audit conclusion and

breaks the client out of the negative impact of the MAO. There is a possibility that CPAs and their clients have intentionally taken the advantage of the existing auditing policies to roll back MAOs to their clients' favor without bearing any legal consequences.

## **2. Review of the Related Regulatory Rules on Modified Audit Opinions**

To improve the quality of information disclosure by public firms, regulate the use of non-standard audit opinion (MAO), and protect the investors' interest, China Securities Regulatory Commission issued Rules No. 14 on the *Preparation of Information Disclosure Documents by Companies That Offer Securities to the Public—Modified Opinions and Handling of the Matters Involved* (*Rules No. 14* hereafter) (CSRC 2001) in December 2001. According to *Rules No. 14*, CPAs are prohibited from substituting qualified audit opinions with unqualified opinions and additional communication (explanatory paragraphs), or substituting adverse with qualified opinions. When a non-standard audit opinion is issued, in the audit report, the auditor should also include the reason and basis for forming the opinion, estimate the impact of the relevant matter that gives rise to the modification on the financial statements of the client and provide the reason if the impact cannot be reasonably estimated. Further, *Rules No. 14* specifies the consequence of non-standard audit opinion when modifications are due to manifest violations of accounting principles, standards or information disclosure guidelines. If the client refuses to adjust the violating items or if its auditor determines that the adjusted items are still in violation, then the stock exchange should suspend the stock trading immediately until after the violations are corrected. In the meantime, the CSRC should initiate an investigation on the relevant matters. Both Shenzhen and Shanghai Stock Exchanges have provided similar guidelines on implementing *Rules No. 14*. For example, Shanghai Stock Exchange mandates that a special statement should be filed by the audit firm with the modified opinion. The special statement should contain but not limited to: the reason and basis for the modified opinion, specific impacts of the matters to which the modified opinion relates on financial position and performance results of the company for the reporting period, and whether the involved matters have clearly violated accounting principles, standards or information disclosure guidelines. This requirement on special statement was created to curb the abuse of unqualified opinions modified with explanatory paragraph to replace qualified opinions.

For many years, the focal point of regulations by CSRC, stock exchanges, the Ministry of Finance and CICPA *had been auditor turnover and opinion shopping*, until 2012, continuing on the former emphasis, CSRC add the specific regulatory on the quality control of the audit project by mandating that either chief partner or engagement CPA should sign off the MAO. In academia, the research on modified audit opinion has been largely based on opinion shopping, that is, the likelihood of auditor turnover following MAOs (lu & tong, 2003; li & wu, 2002; huang, 2010) [1,2,3]. Shen and Song (2016) [4], using a case study, bring forth the possibility that the company bought favorable explanatory statements from its auditor to lessen and even annul the negative impact of the original qualified audit opinion. They treat the issuance of MAO and subsequent supplementary explanation as two independent events.

Our paper is the first empirical study on the phenomenon of audit opinion rollback based on a full sample of most recent five years. Considering the relative short time duration between the issuance of MAO and subsequent assurance, and the nature of the used matters to modify the audit opinion, it is more likely that the CPA firm and its client, before the audit report is even issued, have already strategically planned for the type of audit opinion and the possible subsequent moves to favor the client. That is, the CPA firm issues the MAO and the special statement about the modifying matter first, and then rolls back the impact of the aforementioned matter in the follow-up assurance. In this way, the auditors can shield themselves from the risk from issuing un-proper opinion, and the client can get rid of the negative impact of the MAO thanks to the opinion rollback.

### 3. Review on the Issued Modified Audit Opinions from 2012-2016.

We examine the type of audit opinion for individual firms in each year from all listed firms on the listed firm of China between 2012 and 2016 (see table1). After excluding the clean (standard unqualified) opinions, there are about 100 MAOs annually, representing 3.52% of the total issued audit opinions in the market. From that we can say auditors are still seldom give unstandard opinions,so that to the investors they have less oppoutunities to distinguish the good or the bad companies when they are look almost the same in audit opinions.Which probably means averagely our auditors can't play an efficient role as what the market designed. Furtherly looking into the limited qualified audit opinions, we find more problems that even if auditors issues the qualified opinions they still use uncertainties as the excuses whereas exactly point out the real matters.

Table 1 A list on Audit Opinions of listed companies from 2012-2016

Year	All Opinions	Standard Unqualified (Clean)	Non-Standard	% of Non-Standard	Unqualified & EOM	Qualified	Adverse	Disclaimer
2012	2471	2382	89	3.60%	71	15	0	3
2013	2534	2450	84	3.31%	57	22	0	5
2014	2667	2569	98	3.67%	71	18	0	9
2015	2842	2738	104	3.66%	82	16	0	6
2016	3136	3031	105	3.35%	75	20	0	10
total	13650	13170	480	3.52%	356	91		33

We check the matters in the audit reports that gave rise to the modifications and locate 570 counts(see table2,more than 480, it is the reason of each company sometimes not only is reported just one problem matters ), in which 252 are related to significant uncertainty in the ability to continue as a going concern, 80 related to violations of securities laws, 45 related to significant uncertainty due to pending litigations or arbitrations, and 100 related to inability to obtain sufficient appropriate audit evidence. (these three types made up the 66.14% of all the MAO matters).As we can see the ability to continue ,the investigation of the securities and the pending litigations or arbitrations ,which one can't tell the exact outcome or the influences at the statements' day, they are the high uncertainty to auditors, they are always out of control of the auditor's. But we should say that such kind of opinions means that the audited companies are in pending situation, and the financial reports users should alert or pay attention to when they analysis the financial statements.

Also we can see that inability to obtain the sufficient evidence is made up to 17.54%,which means not to give clearly conclusion .To the outside investors, we couldn't tell it is the real inability or just the excuse of the auditors .According to china's audit independence quo, usually auditors want to maintain the relationship with their customs. Then no attitude is better than directly pointing out the problem. What's more,this type is very subjective and usually within the auditors' control. And they are relatively likely to be selected as excuses to modify audit opinions, to make the following remedies easier.

Table 2 Audid Matters of Modified Audit Opinons from 2012-2016

Audit Matters	Uncertainty of Going on Concern		Pending to the investigation of SEC		Uncertainty of the Lawsuit or Arbitration		Lack of the Sufficent and Suitable Evidence		Others		Total
	quantity	percentage	quantity	percentag e	quantity	percentage	quantity	percentage	quantity	percentage	quantit y
2012	57	56.44%	5	4.95%	5	4.95%	15	14.85%	19	18.81%	101
2013	39	39.39%	15	15.15%	9	9.09%	20	20.20%	16	16.16%	99
2014	52	44.83%	18	15.52%	8	6.90%	19	16.38%	19	16.38%	116
2015	55	44.35%	19	15.32%	10	8.06%	18	14.52%	22	17.74%	124
2016	49	37.69%	23	17.69%	13	10.00%	28	21.54%	17	13.08%	130
total	252	44.21%	80	14.04%	45	7.89%	100	17.54%	93	16.32%	570

### 4. Review on the Subsequent Statements on the Modified Audit Opinions

According to Rules No. 14, CPA firms should file a special statement with the MAO to provide

details about the matters that modify the opinion. In reality unfortunately, such a rule was not executed or enforced effectively. Over the sample period, only 75 listed firms subsequent assurance information are found(see table3), in which 25 are for the matters emphasized in unqualified audit opinions, 37 for the matters mentioned in qualified opinions, 13 for the matters in disclaimers, and none for adverse opinions. From that we can tell the Rule No.14 hasn't been excuted very well. Even if we can't calculate the unqualified & EOM opinions there are less half  $(50(37+13)/124(91+33)=40\%)$  qualified and disclaimer opinions haven't the subsequent statements.

Table 3 Subsequent Statements on Modified Audit Opinons from 2012-2016

Audit Opinion types	Unqualified & EOM		Qualified		Adverse		Disclaimer		Total Un-standard	
year	quantit y	percentage	quantity	percentage	quantity	percentage	quantity	percentage	quantity	percentage
2012	1	1.41%	2	13.33%	0	0.00%	0	0.00%	3	3.37%
2013	3	5.26%	10	40.91%	0	0.00%	1	20.00%	14	15.48%
2014	3	4.23%	8	44.44%	0	0.00%	5	55.56%	16	16.33%
2015	6	7.32%	5	31.25%	0	0.00%	3	50.00%	14	13.46%
2016	12	16.00%	13	65.00%	0	0.00%	4	40.00%	29	27.62%
Total	25	7.02%	37	40.66%	0	0.00%	13	39.39%	75	15.63%

In order to find if subsequent moves are taken to change the original modified audit opinions, we track all occurrences of assurance provided by the CPA firm for each subsequent assurance information and found 85 activates, in which 11 are supplementary explanatory statements, 30 are review reports and 44 are responses to CSRC or exchanges's comment letters(see table4).

Table 4 Thet types of subsequent statements on modified audit opinons from 2012-2016

Types	2012	2013	2014	2015	2016	Total
Supplementary Explanation	0	3	2	3	3	11
Response to Comment Letter	1	4	3	7	29	44
Elimination Review Report	2	6	13	6	3	30
Total	3	13	18	16	35	85

we read all the assurance documents and decide if they have essentially changed the original audit opinions to favor the clients. Here is what we find(see table5): (1) all supplementary statements dismiss the matters that modified the audit opinions; (2) all review reports eliminate the significant impact of the matters that modified the audit opinions; (3) 25% (11 counts out of 44) responses to regulators' comment letters dismiss the matters that modified the audit opinions. Therefore, of all the subsequent assurance events, about 62% (52 out of 44) roll back the original MAOs, and all supplementary statements and review reports are in favor of the clients.

Table 5 Thet departure from the original audit opinion from 2012-2016

Year	Supplementary Explanation	Departure from Original Audit Opinion	Elimination Review Report	Departure from Original Audit Opinion	Response to Comment Letter	Departure from Original Audit Opinion
2012	0	0	2	2	1	0
2013	3	3	6	6	4	2
2014	2	2	13	12	3	2
2015	3	3	6	6	7	1
2016	3	3	3	3	29	6
Total	11	11	30	29	44	11

## 5. Summary

In summary, the preliminary evidence indicates that during 2012-2016 many companies and CPA firms took the advantage of policy loopholes and regulatory negligence to roll back relatively

unfavorable audit opinions by steps. The majority of the moves employed, in the form of supplementary statements, review reports or responses to comment letters, were able to lessen or negate the impact of the original MAOs. However, we do find that when a regulatory body was involved as in the case of responses to comment letters from regulators, the original MAOs were not changed in favor of the client most of the time.

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