

# Case Study of Audit Failure of Soling Shares

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**Abstract:** With the rapid development of the capital market, the competition of listed companies is intensifying, the pressure faced by enterprises is becoming more and more obvious, financial fraud is also emerging, and the problem of related party capital occupation is becoming increasingly prominent. The increasing number of financial frauds has not only reduced the fairness of capital markets, but also triggered a crisis of public confidence in the effectiveness of accounting firm audits. Therefore, how to audit the appropriation of funds by related parties and reduce audit failures is of research significance to the future audit work of accounting firms in China. Taking the failure of the audit of Soling shares as an example, this paper studies the failure of the audit of the use of equity pledge by the major shareholder and the failure of the audit of the appropriation of funds by related parties, analyzes the problems existing in the audit process of Ruihua Law Firm, and puts forward conclusions and suggestions based on the analysis.

**Keywords:** Appropriation of related party funds, Audit failure, Ruihua Office.

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## 1. Introduction

In recent years, financial fraud cases have emerged in listed companies, and there have also been many undetectable fraud methods. With the increase of fraud incidents, the degree of harm is also increasing, causing continuous harm to the interests of investors, and also affecting the fairness and development prospects of the capital market, so financial fraud has gradually attracted people's attention. However, in practice, the means of related party capital occupation are complex and diverse, and the relationship between related parties is difficult to identify and define, and related parties usually occupy funds in the form of loans, related party purchases and sales, guarantees, etc., and it is difficult for certified public accountants to discover such hidden fraud methods during auditing, so related party fraud constitutes a major problem in audit work.

This paper takes Ruihua Firm's audit of Soling as the research object, analyzes the problems and causes in the audit process of Ruihua Firm, and puts forward corresponding suggestions. Through the analysis and research of relevant cases, auditors can enhance their risk awareness, so that they can continuously improve their professional quality in future work, and continuously improve the audit methods for the use of related party funds, so as to ensure timely and accurate supervision of the use of related party funds, so as to ensure the health and stability of audit work.

## 2. Literature Review

### 2.1. Related party transactions

While listed companies achieve profitability and meet the financing needs of enterprises, they also have the motivation to occupy the funds of related parties. An Xin (2016) believes that there are two reasons for the frequent fraud of related party transactions: one is the concealment of related party transactions, and the other is the complexity of related party transactions. Huang Qiuju (2019) From the perspective of funds, some enterprises choose financing to solve the problem of capital shortage, which increases the risk of related parties' capital occupation. Hou Yongpu (2020) believes that the capital occupation of related parties of listed companies is

inversely proportional to the efficiency of working capital management, and the low efficiency of working capital management is an important reason for the capital occupation of related parties. Qi Wenhui (2021) analyzed the reasons for the occupation of funds by related parties from the perspective of the company's internal control, mainly including the company's internal management deficiencies, insufficient external supervision, and low illegal costs. Hou Deshuai et al. (2019) analyzed from the perspective of economic policy, arguing that if macro-control policies are frequently and unexpectedly adjusted, the company's operation will face considerable uncertainty, and related parties may also take the opportunity to encroach on the company's interests.

### 2.2. Related party audit risks

Wang Yuhan (2017) believes that with the continuous development of related party transactions, there are more and more ways to conduct transactions between enterprises, but this also brings difficulties to supervision and auditing. Liu Guangrui (2019) believes that the internal control of the audited entity, the complex business process of the audited entity, the lack of professional knowledge of the auditors, and the insufficient audit procedures and methods for related party transactions are all reasons why private audits fail to effectively audit.

Ji Danyang (2016) believes that the level of corporate governance is inversely proportional to audit risk, and the sound corporate governance structure can reduce audit risk. Hao Xia (2017) found that related party transactions are more concerned than other types of audit methods, transaction number, transaction type, and transaction amount, so auditors often rely on appropriate audit processes to obtain more accurate audit evidence. According to the analysis of Xia Yun and Zeng Dandan (2017), it is believed that in order to effectively control risks, a reasonable shareholding structure must be established, and the degree of concentration of control is directly proportional to the probability of unfair related party transactions.

### 3. Case Introduction

#### 3.1. Company profile

Shenzhen Soling Industrial Co., Ltd. (hereinafter referred to as Soling Co., Ltd.), in October 2010 to carry out the shareholding reform, formally established Shenzhen Industrial Co., Ltd., is a collection of auto parts research and development, production, sales, service as one of the high-tech electronic information technology enterprises, the main car audio and video navigation system, intelligent information system, anti-theft system, intelligent trajectory reversing system and other products, is the leading domestic manufacturer of vehicle electronic systems, known as a national high-tech enterprise. On June 11, 2015, the company was listed on the A-share small and medium-sized board of the Shenzhen Stock Exchange.

#### 3.2. Review of fraud incidents

On April 26, 2019, the China Securities Regulatory Commission officially launched an investigation into Soling shares. On December 8, 2020, he received a market ban decision issued by the China Securities Regulatory Commission and publicly criticized it. The criticism pointed out that Shenzhen Soling inflated its profit of 279 million yuan in 2016, 350 million yuan in 2017 and 220 million yuan in 2018. On September 6, 2021, Ruihua Law Firm was

punished by the China Securities Regulatory Commission (CSRC), alleging that it failed to perform its duties during the period of providing services to Soling Shares, failed to discover material deficiencies in Soling Shares' internal control in a timely manner, and finally issued a false audit report. The CSRC ordered Shenzhen Soling to make corrections, gave a warning and imposed a fine of 600,000 yuan. Chairman Xiao Xing was also given a warning and fined 900,000 yuan. ordered Ruihua Accounting Firm to make corrections, confiscated Ruihua Accounting Firm's business income of RMB1.6 million, and imposed a fine of RMB3.2 million; Certified public accountants Yin Jianmin and Kuang Ao were given warnings and fined 50,000 yuan each.

### 4. Analysis of Financial Fraud Methods

#### 4.1. Occupation of funds by related parties

The data in the table show that prepaid accounts and other receivables did not change much in 2014 and 2015, but prepaid accounts surged by 338.85% in 2016, from 7.1288 million yuan to 31.2848 million yuan. In 2017, the prepaid accounts increased by 113.21% year-on-year compared with 2016, and other receivables directly surged by 4290.99%, from 16.6517 million yuan to 729.509 million yuan. Such a huge change is staggering, but Soling's corporate strategy has not changed during this period.

**Table 1.** Statement of prepaid accounts and other receivables of Soling from 2014 to 2018

	Prepaid Accounts (million yuan)	Magnitude Of Change(%)	Other Receivables(million yuan)	Magnitude Of Change(%)
2014	751.69		1187.92	
2015	712.88	-5.16	1045.03	-12.03
2016	3128.48	338.85	1665.17	420.99
2017	6670.10	113.21	72950.90	4280.99
2018	4706.15	-29.44	137602.11	88.62

Soling shares violated the guarantee in 2017. The affiliations of the four guaranteed companies have been disclosed in the company's financial reports, two as related parties and two as subsidiaries. Lono Plastic, which is not disclosed in the financial report, is closely related to Soling Technology, and the contact information on the annual reports of the two is the same. Soling Technology is a wholly-owned subsidiary of Xiao Xingye, indicating that Longrui Plastic and Xiao Xing are also related. In 2017, Soling had 772 million yuan of illegal external guarantees, and its guarantee amount exceeded 50% of its net assets in that year. In this case, Soling shares will have a great debt crisis. According to the 2018 financial statements, Soling has received a number of lawsuits due to breach of guarantees, resulting in an estimated liability of 565 million yuan.

Related party transactions are complex. Among the outsourcing transactions that occurred during the company's IPO, the first outsourcing processing supplier of the company was a company called "Shenzhen Longrui Plastic Electronics", and the transaction volume between Soling shares and it basically accounted for 50%~70% of the entire outsourcing processing costs. Through the inquiry of Tianyancha, the registered telephone number and registered

email address of this enterprise are consistent with Shenzhen Soling Technology, a branch of the actual controller of Soling Co., Ltd. Secondly, several dealer companies and customer companies related to Soling have been cancelled one after another after their listing, and none of them have paid up their registered capital, and the number of insured persons is also less than 5.

#### 4.2. Cashing out of equity pledge funds

The shareholding structure is unreasonable. As shown in Table 2, Xiao Xing, as the actual controller, chairman and general manager and legal representative of Soling Co., Ltd., holds 33.99% of the shares in Soling Co., Ltd., and the sum of the shareholding ratios of the second to fifth shareholders is only 19.57%, and Xiao Xing also occupies an absolute controlling position. According to the CSRC's penalty announcement, Xiao Xing, as a major shareholder, also embezzled the company's funds up to tens of millions of dollars in 2018 to pay interest on its fixed stock borrowings and compensate employees for the loss of equity investment projects. Due to unreasonable shareholding structure, it creates opportunities for fraud.

**Table 2.** Equity distribution of Soling shares

Name of the shareholder	Number of shares held (shares)	Shareholding ratio
Xiao Xingye	143,334,030	33.99%
Zhongshan Lexing Enterprise Management Consulting Co., Ltd	47,778,010	11.33%
Liu Jie	18,450,200	4.37%
Peng Hanguang	8,377,800	1.99%
Li Meifang	7,922,200	1.88%

Xiao Xing, the major shareholder of Soling Shares, also obtained 1.679 billion yuan by pledging 99.71% of its shares, all of which were also used by Xiao Xing for investment and personal consumption. As a result, Soling's performance declined in 2018, which in turn will stimulate further encroachment by controlling shareholders, and there is a vicious circle between the two. Xiao Xing also cashed out 950 million yuan by transferring 1/4 of the shares to Zhongshan Lexing at a price higher than the market price.

### 4.3. Accounting firm audit process issues

#### 1. The audit quality control system is not perfect

Ruihua Law Firm has developed a three-level quality control system, first the reviewer checks the drafts and information documents provided by the auditors, then the project manager starts the second-level review, and finally the partners review, discuss and review. However, Ruihua did not pay enough attention to the major transactions and huge guarantees of the audited units, and the subjective initiative in the whole audit process was poor. In addition, after obtaining the audit evidence, Ruihua did not clearly stipulate the specific audit procedures, and the quality review and implementation of the audit report were also deficient. During the whole audit process, Ruihua Law Firm did not adjust the audit quality of related party funds accordingly, and Ruihua Firm's auditors lacked subjective initiative, resulting in audit failure.

#### 2. Failure to maintain due professional suspicion

Due to the hidden and complex nature of the way related party funds are occupied, accountants should always maintain a professional skeptical attitude in audit work. When Ruihua audited Soling shares, it did not have professional skepticism about abnormal changes in material financial data. Failed to identify the fictitious accounts receivable of 45 million yuan between it and its subsidiary Soling Technology in 2017 by issuing commercial acceptance drafts for false business. In addition, no non-compliance was found in the related party transactions between Soling and the three related parties totaling more than 80 million yuan in 2016 and 2017. Ruihua's auditors did not focus on the overseas business of Shenzhen Soling, and the auditors failed to maintain the vigilance that auditors should have for inflated business income, did not send letters to overseas customers to inquire, and did not conduct flow checks on bank accounts related to overseas business, which was a serious audit error.

#### 3. Lack of attention to the effectiveness of relevant internal controls

When an accounting firm conducts an audit of a listed company, it is important to fully understand the effectiveness of the internal control of the audited entity related to the occupation of funds by related parties. In the process of understanding the internal control of Soling Shares, Ruihua Firm did not detect the problem of material deficiencies in Soling Shares' internal control, nor did it disclose the relevant

deficiencies. The auditors did not strictly examine the approval and borrowing of their major funds, and did not pay enough attention to the correspondence of the company's bank account number. There are major deficiencies in the internal control related to the capital occupation of related parties of Soling Shares, and Xiao Xing also holds much higher shareholding ratio than other shareholders in Soling Shares, and has an absolute advantage among all shareholders. From 2016 to 2018, Xiao Xingye held the two important positions of chairman and general manager, and lacked checks and balances of power, which created conditions for him to assist related parties in capital occupation.

#### 4. Issuing inappropriate audit opinions

Ruihua Firm, which was responsible for the audit of Soling's annual reports in 2016 and 2017, was rehired in 2018 to be responsible for the audit of its annual reports, and the Asia-Pacific firm issued an inability to express an opinion on its financial statements in 2018. Prior to the change to Asia Pacific Office, Ruihua Firm had provided annual report audits for Soling for 9 years, during which time, Soling's audit reports were unqualified. In addition, Ruihua Law Firm also provided internal control and assurance services, and gave opinions in 2016 and 2017 indicating that Soling shares did not have major defects. However, in 2018, when the Asia Pacific Office provided internal control and assurance services to Soling Shares, it found that there were major internal control deficiencies in its fund management, data management and approval system.

#### 5. The auditor cannot obtain relevant evidence

From 2015 to 2018, the management of Shenzhen Soling Company continued to leave, and Ruihua Law Firm could not obtain audit evidence from the company's operating level and continuous operation ability through inquiries and conversations during the audit process. Shenzhen Soling's capital chain has been broken in the past three years, unable to repay the huge amount of arrears, and the maturity of the huge debt has caused the court to freeze Shenzhen Soling's bank account, which has dealt a deeper blow to Shenzhen Soling's operation. In these cases, due to the departure of senior executives, the financial personnel did not properly keep the financial data when handing over, and the auditors could not accurately obtain relevant information, resulting in the auditors lacking audit evidence.

## 5. Case Enlightenment

### 5.1. Strict implementation of risk assessment procedures

#### 1. In-depth understanding of the association relationship of the audited unit

Related party appropriation usually takes two forms. One is the failure to truthfully disclose the capital items in the statement, usually the audited unit will conceal the existence of violations of the fund occupation of related parties by

falsely reporting the balance of monetary funds or choosing not to disclose the restricted funds; The other is to realize the appropriation of funds in transactions, through fictitious transactions or false bill exchange business.

The explicit correlation relationship between the audited unit can usually be collected and sorted out through the big data website. For the hidden relationship between the audited entity, auditors shall pay special attention to abnormal transaction prices and large unrecorded transactions when conducting audits of the related party's capital occupation, and focus on identifying the background of such transaction customers. Focus on the information of relevant personnel who are related to the governance of the audited unit, analyze whether they have control over other companies, and evaluate whether they are related to the audited unit.

2. Strictly implement the related party information disclosure audit process

Information asymmetry is an important reason for the occupation of related party funds by listed companies, and guarantee business has become a means for many enterprises to occupy related party funds. In order to prevent the audited entity from using the above methods to make illegal disclosure, the certified public accountant should standardize the audit procedures for information disclosure of related parties. Before the audit, conduct a sufficient investigation of the background of the audited entity to understand whether the guarantor and the guaranteed party are related parties, so as to verify whether the information disclosure of the related party is complete. Pay attention to the matters and amount of the guarantee, and check whether the disclosure by related parties is accurate. Auditors shall carry out further audit procedures to check relevant contracts, vouchers, etc., to confirm whether they have concealed the purpose of occupying the funds of related parties.

## **5.2. Pay attention to the internal control of the audited entity**

1. Pay attention to the internal control system of the audited unit

These include the review of major funds, internal control structure, etc., if the internal control design of the audited unit is not perfect, it will inevitably lead to difficulties in audit work, and there are problems such as untimely collection of audit evidence. Secondly, the excessive concentration of power in management is also one of the factors that lead to the failure of internal control. The internal control system will not only have an impact on the audit process and audit environment, but will further have an impact on the audit opinion.

2. Identify and prevent relevant risk factors

In audit work, attention should be paid to the analysis of fraud to ensure the effectiveness and quality of audit work. First, understand whether the audited entity has taken measures to identify and prevent fraud, and whether there is a risk of related party funds being occupied. Secondly, the certified public accountant should focus on the related parties and major related party transactions in the audited entity, and consider whether there is a related party's capital appropriation behavior for transactions that exceed normal conditions. Auditors should effectively use substantive analysis procedures to identify related party fund occupation problems that are difficult to identify during routine audits, and prevent relevant audit risks.

## **5.3. Improve the ability of certified public accountants**

1. Improve the ability of auditors to identify related parties

The analysis of the audit failure cases of Ruihua Law Firm shows that auditors can better determine the related party funds of the audited entity when they fully grasp the existence of related parties of the audited entity. Since the audited entity deliberately conceals the funds of related parties, the audit is more difficult, and the auditor should not only limit the internal information provided by the audited entity, but also obtain other audit evidence to gain an in-depth understanding of the actual situation. Secondly, for the audit of the occupation of funds by related parties, auditors must not only have rich work experience, but also have the ability to be flexible and judge the situation. Certified public accountants can improve their ability to identify related parties by participating in specific training, learn methods to effectively identify the capital occupation of related parties, and summarize the experience of identifying the capital occupation of related parties in combination with actual conditions.

2. Improve the professional knowledge system of auditors

Certified public accountants must not only have a certain theoretical foundation, but also have certain professional qualities. In particular, the audited entity deliberately conceals the illegal appropriation of funds by related parties, coupled with the variety of means, which increases the barriers for auditors to discover fraud by the audited unit. Before submitting the audit opinion, the project team should conduct full discussion, always maintain prudence, and comprehensively consider whether the submitted report is appropriate, whether it meets the audit results, whether the audit evidence is true, and whether it is in line with the development trend of the industry, so as to improve the quality of the audit opinion.

3. Improve the professional ethics of auditors

The key to ensuring audit quality is to ensure that the CPA performs its own level of professional ethics. During the audit process, auditors may be pressured by all parties and may even face temptations to assist in concealing fraud and issuing inappropriate audit opinions. Auditors should be vigilant throughout the audit process, take it seriously and strictly abide by professional ethics. In addition, accounting firms should assume the responsibility of improving the professional ethics of auditors and improve the professional ethics of auditors through training, experience exchange, case analysis and other forms.

## **5.4. Strengthen the internal management of accounting firms**

1. Develop a detailed audit plan for each stage

Accounting firms shall, based on the audit risks identified as possible appropriation of related parties' funds, formulate reasonable and effective audit plans at each stage to avoid the occurrence of audit failures. It is necessary to deeply understand the shareholding structure of the audited entity and the relationship between the management governance layer, focusing on understanding the counterparties with large transactions with the audited entity. Strengthen the review of acceptances and guarantees of large notes to verify whether there is a relationship between them.

2. Pay attention to the overall analysis and review of the capital occupation of related parties

The overall analysis and review procedure is an important part of identifying abnormal fluctuations in financial statement items, continuously reviewing through dynamic updates, and discovering loopholes in the audit plan in a timely manner. Therefore, the firm should pay enough attention to the review of the working papers related to the occupation of funds by related parties. In the process of analysis, new audit evidence or neglected information is found, and deficiencies in previous audit work should be corrected.

### 3. Improve business quality control system

A sound and well-implemented quality control system can restrain the subjective behavior of auditors, ensure the quality of practice, and avoid auditors from issuing unfair audit opinions in violation of auditing standards. Accounting firms must strengthen the construction of business quality control system, ensure the strict implementation of business control system, and ensure the efficient completion of audit work. The audit of related party capital occupation is cumbersome and complicated, and accounting firms must be down-to-earth in the process of business quality control, and cannot be perfunctory in their responsibilities, and build a sound business quality control system. Some accounting firms have reached lower fee agreements in order to seize market share, but the undesirable consequence is the deterioration of audit quality. Accounting firms strictly control audit quality, abide by auditing standards, and must not change audit opinions due to customer needs.

## 6. Conclusion

Compared with conventional fraud, related party fund occupation fraud is more concealed, and there are various transaction methods, and the audit methods should also be optimized according to the characteristics of related party fund occupation, and the related party fund occupation risk assessment procedures must be strictly implemented. When the company's internal control fails, it is difficult for the majority shareholder to empty the company's operating funds out of profit behavior, so in order to prevent the major shareholder from damaging the company, the company

should disclose the information in the annual report and ensure that the internal control system operates effectively. Audit procedures are difficult to identify, and auditors need to continuously improve their professional ability through training, carefully evaluate audit evidence, and remain vigilant against emerging signs of misstatement to ensure the smooth development of audit work.

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