ISSN 2616-5902 Vol. 8, Issue 7: 1-6, DOI: 10.25236/AJBM.2026.080701

Causes and Responses to Audit Risks in Accounting Firms under the Registration-Based IPO System: A Case Study of Deloitte

Yin Yidan[1,a,*]

[1]University of Shanghai for Science and Technology, Shanghai, China
[a]1366320180@qq.com
**Corresponding author*

Abstract: *During the implementation of the registration-based initial public offering (IPO) system, China's capital market has encountered new development opportunities, while also presenting unprecedented challenges to the audit work of accounting firms. With the adoption of this system, listing conditions for enterprises have been relaxed and information disclosure requirements have been lowered, yet the demand for transparency and accuracy in financial statements has increased, thereby heightening audit difficulty and audit risk for accounting firms. This study aims to systematically review the theoretical framework of audit risk, clarify its definition, classification, and influencing factors based on a review of relevant literature. Using a case study approach, the paper examines the audit of Huarong Company by Deloitte as a focal case, exploring the causes of audit risks faced by accounting firms under the registration-based IPO system and corresponding countermeasures from multiple perspectives.*

Keywords: *Registration-based IPO system; accounting firm; audit risk*

1. Introduction

With the gradual implementation of the registration-based IPO system, China's capital market is embracing new development opportunities, while accounting firms are facing a series of unprecedented challenges. The core of the registration-based system lies in information disclosure, reinforcing the accountability and risk awareness of market participants, which inevitably increases the audit responsibilities and risks of accounting firms. Against this backdrop, theoretical research and practical exploration of audit risk have become a focal point in both academic and professional circles.

Audit risk, as a key factor affecting audit quality, has complex and diverse causes. These causes relate not only to the internal management, audit procedures, and methods of accounting firms but also to the governance structure, internal controls, and external environmental factors of the audited entities. Therefore, in-depth research into the causes and countermeasures for audit risk is of great significance for improving audit quality, protecting investor interests, and maintaining capital market stability.

This study systematically reviews the theoretical framework of audit risk, clarifying its definition, classification, and influencing factors. Using the audit of Huarong Company by Deloitte as a case study, it explores the causes and responses to audit risks faced by accounting firms under the registration-based IPO system. Through this research, the study aims to provide useful references for accounting firms to improve audit quality and reduce audit risk.

2. Theoretical Framework of Audit Risk

2.1 Definition of Audit Risk

Audit risk refers to the risk that an auditor may issue an inappropriate audit opinion due to failure to detect material misstatements or omissions during the execution of financial statement audits. This concept encompasses both the uncertainties inherent in the audit process and the potential consequences arising therefrom.

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2.2 Impact of the Registration-Based IPO System on Audit Risk

As a major reform of the capital market, the registration-based IPO system has profoundly affected the audit risks of accounting firms. Under this system, listing standards have become more market-oriented, with increasing emphasis on the truthfulness, accuracy, and completeness of information disclosure. This reform has prompted accounting firms to strengthen their scrutiny of corporate financial statements to ensure compliance with listing requirements.

The registration-based system raises the standards for accounting information quality, requiring auditors to pay greater attention to the truthfulness, accuracy, and completeness of such information during the audit process. This undoubtedly increases the workload and difficulty for auditors, thereby heightening audit risk.

Under the registration-based system, the detail and transparency of corporate disclosures have improved, providing auditors with richer audit clues. However, this also imposes higher demands on the professional competence and skills of auditors to effectively identify and assess potential audit risks.

The reform has intensified competition in the audit market. Some accounting firms, in pursuit of market share, may neglect audit quality, thereby exacerbating audit risk. Therefore, under the registration-based system, accounting firms must pay more attention to quality control and risk management to mitigate audit risk.

2.3 Discussion on Accounting Information Quality and Accounting Fraud

Accounting information quality is an important indicator reflecting a company’s financial position and operating results and is of critical significance to stakeholders such as investors and creditors. High-quality accounting information helps reduce information asymmetry, improve market efficiency, and protect investor rights. However, in practice, some companies, driven by various motives—such as beautifying performance, concealing losses, or avoiding regulation—may engage in accounting fraud, leading to distorted accounting information. Such behavior not only impairs the quality of accounting information but may also have serious negative effects on the capital market.

The consequences of accounting fraud are severe. It may lead investors to make investment decisions based on incorrect information, resulting in financial losses. Accounting fraud undermines the fairness and integrity of the market, damaging its reputation and stability. It may also trigger legal disputes and regulatory penalties, imposing serious legal and economic consequences on the company and related responsible people.

Companies should attach great importance to accounting information quality, strengthen internal controls and risk management, and prevent the occurrence of accounting fraud. At the same time, accounting firms and regulatory authorities should enhance their supervision and review of accounting information to ensure its truthfulness, accuracy, and completeness.

3. Case Background

Deloitte, as an internationally renowned professional services firm, has extensive experience in auditing large enterprises. The audit risk incident involving Huarong Company between 2014 and 2019 was a financial scandal that shocked the industry, involving multiple complex processes and intricate interests.

The trigger for the incident was the financial statements published by Huarong Company. These reports should have truthfully and objectively reflected the company’s financial and operational results. However, during Deloitte’s audit process, auditors identified numerous anomalies, including inconsistencies in financial data, opacity of key transactions, and weaknesses in internal controls.

Deloitte’s auditors conducted in-depth investigations and detailed analyses of these anomalies, uncovering further issues. They found that Huarong Company might have engaged in serious violations such as fabricating revenues, concealing liabilities, and abusing accounting estimates. These actions not only violated accounting standards and regulations but also harmed investor interests.

Facing these serious issues, Deloitte questioned Huarong Company and requested reasonable explanations and supplementary evidence. However, Huarong’s responses failed to alleviate the auditors’ concerns, instead triggering more disputes and doubts. As the incident unfolded, regulatory authorities

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intervened. After a series of investigations and evidence-gathering efforts, regulators ultimately determined that Huarong Company had engaged in serious financial violations and imposed corresponding penalties. At the same time, Deloitte was also sanctioned by regulators for its negligence and improper conduct during the audit.

4. Analysis of the Causes of Audit Risk in Deloitte's Audit of Huarong

4.1 Internal Factors

In examining the internal causes of audit risk at Deloitte, we first note its quality control system. Although Deloitte has established a rigorous quality control framework, operational constraints—such as resource shortages or time pressures—may have prevented the system from functioning effectively, resulting in inadequate implementation of quality control measures. Additionally, communication barriers or conflicts of interest between quality control personnel and audit teams may negatively affect quality control outcomes.

Professional competence and experience are also important factors influencing Deloitte's audit risk. Although Deloitte employs many professionals, the audit team's expertise and accumulated experience may still be insufficient when dealing with specific industries or complex transactions. This deficiency may hinder auditors' ability to identify and assess potential risks, thereby increasing audit risk.

We cannot overlook the impact of internal ethical and integrity culture on audit risk. Ethics and integrity are the cornerstones of auditing. If Deloitte experiences ethical lapses or integrity issues—such as auditors accepting bribes from clients or breaching confidentiality obligations—this would seriously undermine audit independence and objectivity, thereby increasing audit risk.

4.1.1 Lack of Independence

Table 1 Audit and Non-Audit Fees Paid by Huarong to Deloitte (2015–2019, in ten thousand RMB)

Year	Statutory Audit and Interim Review	Other Audit Services	Tax Consulting Services	Total
2015	1140	200	3950	5290
2016	2050	2250	50	4350
2017	2610	1560	10	4180
2018	3660	2030	50	5740
2019	3170	960	80	4210
Total	12630	7000	4140	23770

Over an eight-year cooperation period, Deloitte may have faced impaired independence in its audit services with Huarong. This deep relationship may have created a potential blind spot, making it difficult for Deloitte to maintain sharp insight into Huarong's potential risks and issues. From Table1, reviewing the audit fee data from 2015 to 2019, we find that the total fees Deloitte received from Huarong for audit and non-audit services amounted to RMB 237.7 million, of which audit fees alone accounted for RMB 126.3 million. This high and increasing revenue stream may have created excessive economic dependence on Huarong, threatening the independence and objectivity of Deloitte's audit work. In 2018, Huarong's audit fees represented a significant proportion of Deloitte's total fees from the client. This strong economic tie undoubtedly increased the risk that Deloitte might overlook potential issues to maintain a long-term client relationship. Therefore, Deloitte must remain vigilant about this potential independence risk and ensure adherence to objective, impartial, and independent principles during the audit.

4.1.2 Audit Negligence

The consistency of audit opinions warrants further investigation. Although Deloitte Hua Yong and Deloitte Kwan Wong Chen Fang used different auditing standards (Chinese and international, respectively) in their audits of Huarong, both issued standard unqualified audit opinions for several consecutive years. This unusual consistency may indicate that the two firms failed to fully disclose Huarong's potential financial risks and issues, suggesting a risk of inappropriate audit opinions. Furthermore, the risk of inadequate audit procedures cannot be ignored. China's Ministry of Finance pointed out that Deloitte had omissions in its audit process, implying that audit procedures may not have been sufficiently or appropriately executed.

4.1.3 Quality Control

The Ministry of Finance's investigation report revealed other deficiencies in Deloitte's audit practices.

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Deloitte failed to conduct in-depth analysis of many of Huarong's core businesses, did not perform deep-level investigations into the actual condition of underlying assets, and paid insufficient attention to the regularity of major investment projects [1]. These deficiencies undoubtedly increased audit risk, making it difficult for the final audit results to fully and truthfully reflect Huarong's financial position and potential risks.

4.2 External Factors

Regarding external factors, changes in laws and regulations significantly affect Deloitte's audit risk. As global economies and financial markets evolve, relevant laws and regulations are continuously updated. If Deloitte fails to keep pace with these legal changes, it may violate regulations during the audit process, exposing itself to legal risk.

Different industry risk characteristics also pose challenges to Deloitte's audit work. For example, the financial industry entails high market and credit risks, while the technology industry involves rapid technological updates and intense competition. Deloitte must possess a deep understanding and accurate assessment of industry risks during the audit process. Failure to do so may increase audit risk.

4.2.1 Industry Risk

One significant industry risk Deloitte faced in auditing Huarong is the continuously strengthening and evolving regulatory environment. In recent years, with the deepening of the registration-based accounting system, regulatory authorities have intensified oversight of the audit industry. Notably, the Measures for the Supervision and Inspection of Accounting Firms issued by the Ministry of Finance in 2022, and the Opinions on Further Strengthening Financial and Accounting Supervision jointly issued by the General Office of the CPC Central Committee and the General Office of the State Council in February 2023, have significantly enhanced the stringency and systematic nature of financial and accounting supervision [2]. These policies aim to establish a more robust and efficient financial supervision system by improving working mechanisms and strengthening the crackdown on financial and accounting violations. This escalating regulatory environment has become a primary industry risk that Deloitte cannot ignore in its audit of Huarong.

4.2.2 Inherent Risk

Table 2: Summary of Huarong's Key Financial Data (2015–2019)

Year	Total Assets	Total Liabilities	Net Profit	Operating Cash Flow	Investing Cash Flow	Financing Cash Flow
2015	5,369,271	4,634,116	(66.63 million)	(1,456,252)	53,261	4,260,387
2016	22,284,727	21.0 billion	550,914	(10,465,613)	(5,016,283)	13,398,248
2017	46,324,769	422,261,947	1,005,643	(612,186)	(11,311,927)	14,346,512
2018	35,023,844	32.95 billion	(1,482,139)	3,342,694	3,040,666	(7,412,196)
2019	22.93 billion	20.32 billion	(2.86 billion)	8,678,673	1,568,105	9,687,662

Note: Data compiled from Huarong's annual financial statements (2015–2019). Amounts are in thousand HKD unless otherwise indicated.

From Table 2 we know that Huarong's profitability grew steadily from 2015 to 2017 but then incurred massive losses for two consecutive years in 2018 and 2019, each exceeding HKD 1.4 billion.

Particularly striking is the rapid growth in assets and liabilities from 2015 to 2017. This unusually fast growth suggests the company may have adopted a high-risk expansion strategy, thereby increasing audit risk. Additionally, the consecutive years of huge losses reflect significant changes in the company's operating strategy or market environment, adding uncertainty to the assessment of the company's financial health. Although operating cash flow recovered somewhat in 2018 and 2019, overall cash flow remained unstable, increasing both the company's financial risk and the audit risk associated with assessing cash flow stability. Moreover, the aggressive operating strategies and investment decisions during Lai Xiaomin's tenure likely increased inherent risk.

4.2.3 Governance Risk

Board Negligence Risk: The Ministry of Finance reported that Huarong's board failed to fulfill its duties adequately, leading to serious governance issues. As the auditor, Deloitte may have failed to fully identify and assess the risks arising from board negligence, affecting the accuracy and reliability of its audit conclusions.

Aggressive Expansion Risk: During Lai Xiaomin's tenure, Huarong engaged in aggressive and indiscriminate expansion, leading to rapid asset growth and a sharp increase in the number of non-financial subsidiaries and international business assets, culminating in the "417" incident [3]. Such aggressive expansion may lead to financial instability and increased operational risk. Deloitte failed to adequately assess the risks associated with this expansion, resulting in governance risk.

Management Non-Compliance Risk: Lai Xiaomin, as a key figure at Huarong, directly influenced the company's governance structure and operational decisions through his behavior. Deloitte failed to pay sufficient attention to management actions and decisions during the audit, and did not timely identify or report Lai's violations, thereby exposing governance risk.

5. Responses to Audit Risk

5.1 Deepening the Registration-Based IPO System to Mitigate Audit Risk

Based on the above causes of risk, deepening the registration-based system requires clearly defining and strengthening information disclosure standards. Policymakers should specify the content and standards for corporate disclosures to ensure truthfulness, completeness, and timeliness. This will help auditors more accurately grasp a company's financial and operational status, reducing uncertainty in the audit process.

Deloitte should pay attention to establishing a sound accountability mechanism. Individuals and companies that violate disclosure regulations should be subject to strict accountability and increased penalties. This will raise the cost of non-compliance, reduce violations, and deter potential violators, further lowering audit risk.

Improving the regulatory system is also indispensable. Establishing a robust regulatory system, strengthening routine supervision and regular inspections, can help detect and address violations in a timely manner, effectively preventing and controlling audit risk.

5.2 Strengthening Internal Management of Accounting Firms

Improving the Quality Control System: Establish clear quality control standards and procedures to ensure every step of the audit complies with professional norms. We can strengthen the training and management of quality control personnel to improve their professional competence and sense of responsibility, so as to guarantee the effective functioning of the quality control system.

Establishing a Risk Assessment Mechanism: Develop customized risk assessment models for different types of clients and projects to quantitatively assess audit risk. Risk assessment can more accurately identify potential risk points and provide strong support for developing targeted responses.

Enhancing Internal Communication and Collaboration: Establish a sound internal communication mechanism to ensure smooth information flow among departments, creating synergy to address audit risks.

5.3 Enhancing Professional Competence of Auditors

Based on data on current experts and committee members at the "Big Four" accounting firms in 2022, Deloitte had 66, far fewer than Ernst & Young's 154, ranking last among the Big Four. Therefore:

Strengthening Professional Training: Regularly organize professional skills training to enhance auditors' knowledge and skills, equipping them with effective methods and techniques to improve audit accuracy and efficiency.

Raising Professional Ethics: Strengthen ethics education to guide auditors in developing correct professional values and conduct, enhancing their sense of integrity and responsibility, and reducing non-compliant behavior.

Establishing Incentive Mechanisms: Use reasonable incentives to recognize and reward high-performing auditors, motivating them and improving audit quality and efficiency.

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5.4 Strengthening Regulatory Oversight to Regulate the Audit Market

Enhancing Regulatory Cooperation: Establish close cooperative relationships with regulatory authorities to jointly formulate and implement audit supervision policies, form regulatory synergy and improving regulatory effectiveness.

Establishing Information Sharing Mechanisms: Work with regulatory authorities to create information sharing mechanisms, timely transmitting audit information and risk conditions. This helps regulators fully understand audit market dynamics and risks, enabling prompt responses.

Increasing Penalties: Impose severe penalties on accounting firms and personnel that violate audit regulations, creating an effective deterrent, regulating audit market order, and reducing audit risk.

6. Conclusion

The comprehensive implementation of the registration-based IPO system takes information disclosure as the core supervision standard, which greatly increases audit risks for accounting firms. Taking Deloitte’s audit failure of Huarong as the research case, this paper sorts out the theoretical framework of audit risk and systematically analyzes its internal and external causes.

Internally, the audit risks mainly stem from impaired audit independence caused by excessive economic dependence on clients, inadequate audit implementation, and ineffective internal quality control. Insufficient professional capabilities and weak ethical awareness among auditors further amplify hidden risks. Externally, tightened regulatory policies, high inherent risks inherent to the financial industry, and severe corporate governance defects such as reckless expansion and board dereliction jointly raise audit difficulties, which can be clearly reflected in Huarong’s drastic fluctuations in assets, profits and cash flow.

Joint governance by multiple parties is required to reduce audit risks. Regulators need to perfect information disclosure standards, strengthen accountability and routine supervision. Accounting firms should improve internal management: optimize quality control systems, strengthen training for quality control staff, build differentiated risk assessment models, and integrate professional skill training with ethics education. Meanwhile, regulators shall promote cross-departmental coordination and information sharing, and impose heavier penalties on audit violations to form effective deterrence.

This paper puts forward targeted risk prevention suggestions for accounting firms under the registration-based system. However, relying only on a single financial enterprise case limits the generalizability of findings. Future research can expand cross-industry samples and adopt quantitative analysis for deeper exploration. In the long run, regulators, accounting firms and listed companies need to work together to give full play to auditors’ gatekeeping role, protect investors’ legitimate rights and interests, and promote the standardized development of China’s capital market under the registration-based system.

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