

## **Deficiencies and Countermeasures in the Correspondence Procedures of Accounting Firms**

### **-- Based on the Analysis of SEC Administrative Penalties in 2020-2023**

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#### **Abstract**

Correspondence is an important means of verifying transactions in the annual report audit of accounting firms, which is more probative and persuasive due to its direct origin from a third party. However, in recent years, audit failure cases have frequently pointed out that there are many problems in the implementation of the correspondence program, which in turn increases the audit risk. Therefore, this paper analyzes the pain points in the correspondence process and their reasons, and puts forward corresponding suggestions by analyzing the 26 administrative penalty notices issued by the China Securities Regulatory Commission (CSRC) to accounting firms from 2020 to 2023, and combining them with the specific provisions of China Auditing Standard for Certified Public Accountants (CASC) No. 1312 - Correspondence, with a view to providing guidance and assistance for the effective implementation of the correspondence procedures, and put forward corresponding suggestions, with a view to providing guidance and assistance for the effective implementation of the correspondence process.

#### **Keywords**

Accounting Firms; Correspondence Procedures; SEC Administrative Penalties; CPAs.

### **1. Introduction**

Correspondence refers to the process of obtaining and evaluating audit evidence by a certified public accountant in order to obtain information on items affecting the financial statements or related disclosure determinations, and to obtain statements from third parties about the information and existing status. The Ministry of Finance (MOF) issued the "China Auditing Standard for Certified Public Accountants No. 1312 - Correspondence" (hereinafter referred to as "Correspondence") in 2006 to regulate a series of behaviors of certified public accountants in designing and executing correspondence procedures. However, judging from the audit failures that have occurred in recent years, problems in the implementation of correspondence procedures are quite common. Improper implementation of correspondence procedures, not only difficult to play out the inherent utility of correspondence, accompanied by a reduction in audit efficiency, increased audit costs, audit risk will also be substantially increased, this phenomenon has caused widespread concern among professional scholars. Keyin He (2020) [1] pointed out that the incomplete selection of correspondence subjects and the failure to document the reasons for not writing letters in audit drafts are also risky issues in the implementation of correspondence procedures by auditors. According to Hongjun Quan (2018) [2], firms do not pay enough attention to bank correspondence procedures, which fundamentally increases the risk of failure or reduced effectiveness of correspondence procedures. Li Zhang (2012) [3] analyzes that in auditing practice, when there is an

interconnection of interests between the audited entity and the party to be corresponded to, this association may make the reliability of the accounts receivable letter of return more risky. Qingzhong Jiang (2011)[4] points out that in accounts receivable correspondence, auditors fail to perform the procedures in full compliance with the requirements of the standard, which leads to many problems of non-standardized implementation in practical application.

## 2. Analysis of Improperly Implemented Correspondence Procedures based on SEC Penalty Decision Letters

This paper selects the administrative penalty announcements on accounting firms and CPAs by CSRC for the years 2020-2023 for statistical purposes, and the information is obtained from the official website of CSRC. Statistically, during this period, the CSRC website issued a total of 26 decisions on administrative penalties against accounting firms and CPAs, of which 17 explicitly pointed out that CPAs violated the provisions of Correspondence, a proportion as high as 66%, and one pointed out that the auditing process involved improper implementation of Correspondence. For the administrative penalty announcement issued by the SEC mentioned the specific performance of improper implementation of correspondence, this paper in accordance with the three stages before, during and after the issuance of the letter process will be divided into the specific performance of improper correspondence correspondence procedures decision-making, implementation and evaluation of the three segments, see [Table 1](#).

**Table 1.** Specific manifestations of improper correspondence and number of occurrences

Correspondence procedure session	concrete expression	Number of occurrences	percentage
correspondence decision-making	Incompleteness of the subject or content of the correspondence	4	12%
	Failure to maintain professional skepticism about anomalies in outgoing information	6	18.2%
Correspondence implementation	Incoming and outgoing correspondence is done by the auditee	4	12%
	Failure to maintain controls over the correspondence process	1	3%
Correspondence evaluation	Failure to perform further audit procedures on exceptions to the response letter	12	36.4%
	Failure to implement effective alternative procedures for non-response correspondence	4	12%
	Control records of incoming and outgoing correspondence were not maintained on drafts	2	6%

### 2.1. Failure to Make Appropriate Correspondence Decisions

Correspondence decision-making belongs to the stage before the issuance of a letter, where the audited entity provides relevant correspondence information, and the CPA should adequately verify the authenticity of such information and select the correspondence object and design the content of the correspondence based on the assessed risk of material misstatement at the deemed level. Statistically, among the above penalty announcements involving improper correspondence, there are 10 cases of loss of control at the decision-making stage of correspondence, including:

Correspondence object or content is incomplete 4 cases, such as accounts receivable and other current accounts not on the large transaction customer correspondence; according to the listed company audit failure case investigation evidence shows that financial fraud often leads to the main reason for audit failure, and among the many fraudulent means, revenue fraud is particularly common. Therefore, revenue audit is often the annual report audit focus on the project. In the above case, part of the audit project team in the risk assessment seems to be only in the form of surface, not based on the results of the assessment of the development of the correspondence audit plan, to determine the time and scope of the correspondence, resulting in the correspondence decision-making to omit the due content of the correspondence, the lack of due diligence.

Failure to maintain professional skepticism about the anomalies of the information in the letters sent in six cases, accounting for as much as 18.2%. Specifically, the accounts receivable did not check the information in detail before sending the letter, and failed to recognize the false bank statement, which led to the failure to discover the discrepancy between the audited unit's accounts and the actual accounts. In practice, some auditors blindly rely on the information provided by listed companies without testing whether it is true or not, failing to detect the falsification of the letter information, resulting in auditors gullibly trusting the information of the audited unit such errors are frequently mentioned in the SEC penalty announcement.

## **2.2. Failure to Maintain the Necessary Controls During the Execution of Correspondence**

The implementation of correspondence means that in the process of sending letters, the CPA should be able to do so independently of sending and receiving letters, and maintain control over the whole process of correspondence. Statistically, among the above penalty announcements involving improper correspondence, six cases involve the CPA's failure to maintain control over the letter of inquiry. The major cases include:

The sending and receiving of the letter is completed by the audited unit in 4 cases, for example, the auditor will give the letter of inquiry to the audited unit accounting staff, to the letter issued the whole process, there is no participation and supervision, resulting in failure to discover the fact of fictitious sales. In the annual report audit, some listed companies have a large number of bank accounts or current accounts, and the number of accounts that the certified public accountants should issue letters is naturally larger, thus neglecting the control of the correspondence procedure, relying on the listed companies and handing over the letters of inquiry on their behalf without confirming whether the letters are executed or not, and relying on the replies forwarded by the listed companies without checking whether the replies are true or not, which led to the decrease in the degree of reliability of the external evidence.

There was one case of failure to maintain control over the correspondence process, which was manifested in the fact that the personnel of the audited entity, when accompanying the auditors to conduct on-site bank correspondence, replaced the confirmation page of the letter of inquiry that required the bank to respond with a stamp with the original confirmation page of the letter in the name of the internal auditor, and thus forged the reply letter of the letter of inquiry confirmed by the bank to be in order. CPAs should not lose control of the correspondence by placing it out of their sight when conducting on-site correspondence.

## **2.3. Failure to Properly Evaluate and Take Appropriate Action on Correspondence Responses**

Correspondence evaluation belongs to the post-correspondence stage, and it has been counted that among the above penalty notices involving improper correspondence, there were as many

as 18 instances of improper implementation at the correspondence evaluation stage. These include:

There were 12 cases of failure to perform further auditing procedures in respect of unusual circumstances in response to letters of inquiry, with a proportion as high as 36.4 per cent, which was the main reason for the irregularities in the execution of the procedures for letters of inquiry. The main circumstances included that the auditors did not pay due attention to the unusual circumstances such as the person responding to the letter of inquiry being different from the contact person recorded in the audit draft, or the address of the letter of response being different from the address of the registered client; and that they did not investigate the unusual circumstances such as the inconsistency between the information in the letter of response and the information in the letter of issuance, and so on. The standards of the Letter of Correspondence have made mandatory requirements for the evaluation of letters: CPAs should evaluate the results of letters and should evaluate the return letters.

There were four cases of non-execution of effective alternative procedures for letters of non-response, with specific circumstances such as lack of attention to the low rate of response to accounts receivable and the risk of non-response from major customers. There were 56 customers who did not respond to the letter of credit for accounts receivable, and the Firm selected only 36 customers who did not respond to the letter to implement alternative procedures. It is clearly stipulated in the standard of "Correspondence" that the CPA should implement alternative auditing procedures if no response is received from the inquired parties. In practice, some auditors, when implementing alternative procedures, tend to sample only the current account incurred vouchers or extract part of the unanswered correspondence for reissuing the letter as an alternative procedure, but neglect the review of the key terms of the contract, in-depth examination of post-period matters, consideration of the reasons for the unanswered letter and other effective procedures, which results in the alternative procedures for correspondence can not support the authenticity of the balance of the current account and the accuracy of the audit conclusions.

There were two cases in which the drafts did not keep records of the control of incoming and outgoing correspondence; the drafts directly lacked audit evidence of the control of some of the correspondence, and it was doubtful whether the correspondence had been implemented in full, and the implementation was superficial. In the audit, in order to save time, some auditors exist in accordance with the draft template to fill out the draft, that is, "brush the draft" situation exists. When the drafts become formal evidence, it is difficult to achieve the purpose of identifying problems through the implementation of audit procedures.

### **3. Response Measures for the Effective Implementation of the Correspondence Procedure**

#### **3.1. Optimizing the Execution of CPA Correspondence Procedures**

Optimize and improve the execution of correspondence procedures, including but not limited to: (1) Enhancing the verification of information provided by the audited entity prior to correspondence. (2) The reliability and independence of the response letter must be evaluated. During the audit process, even if the auditor maintains control over the whole process of correspondence, when there is an abnormal situation similar to a higher rate of return and a higher confirmation of no error in the return letter, the auditor should still maintain due professional skepticism, and further analyze whether there is a situation where the unit being corresponded to and the subject of the audit have a greater interest in each other, or where there is a false response to the letter in conjunction with the characteristics of the subject of the letter. When the certified public accountant has doubts about the letter of response, he or she should implement further audit procedures to eliminate the doubts, and when the doubts

cannot be eliminated or the implementation is limited, he or she should also consider the impact on the type of audit opinion.(3) Improvement of alternative procedures for correspondence. On the one hand, for the unanswered bank correspondence, can't simply only use the bank statement provided by the enterprise as the test object of alternative procedures, should reflect the additional details of risk control. On the other hand, for the unanswered correspondence of current accounts, the certified public accountant should check the current account ledger and vouchers at the same time, respectively, on the borrowing and crediting of both sides of the incurred amount of the sampling, if necessary, combined with the current account of the post-period matters to analyze.

### **3.2. Accounting Firms Should Improve Their Professionalism Requirements for Auditors**

Accounting firms must strengthen the training of correspondence procedures in order to improve the professional competence and professionalism of their auditors. For example: (1) The recruitment threshold of accounting firms should require relevant practicing certificates before they are allowed to take up the job, and they should attach great importance to the education of risk awareness of the auditors in their daily work. (2) Enhance the training for new recruits. (3) Strengthen practice supervision in practical work. In the annual audit work, if newcomers or interns are arranged to be responsible for correspondence work, even if special training on correspondence has been carried out, a senior staff should still be arranged to carry out inspection and guidance.

### **3.3. Strengthening the Responsibilities of Supervisory Bodies and Taking Multiple Initiatives to Combat Financial Fraud**

In order to prevent and combat financial malpractices more effectively, we must clarify and pressurize the duties of the regulatory bodies, and once a thunderstorm breaks out at a later stage, investigations must be launched immediately, and even the regulatory bodies that have failed to perform their duties must be held accountable. Only by detecting financial malpractice as early as possible and imposing penalties as soon as possible can we minimize the losses of investors and reduce the negative impact on the capital market. In addition, we should also adopt a variety of means, including but not limited to administrative penalties, civil lawsuits to settle claims or criminal prosecution and sentencing, and other measures to combat financial fraud parties, to eliminate the financial fraudsters' sense of fluke, but also to other potential offenders to play a warning role.

## **4. Conclusion**

This paper combines the 2020-2023 China Securities Regulatory Commission (CSRC) administrative penalty announcements on accounting firms and certified public accountants to explore the deficiencies of accounting firms' correspondence procedures, and the results of the study found that: the main problem of the correspondence procedures is that the certified public accountants do not perform further auditing procedures for the anomalies in the response letters, which shows that some auditors treat the evaluation of the correspondence in a negative way, only issuing the letter of inquiry to show the completion of the procedure, regardless of the quality of the response letter lack of due continuous investigation. This shows that some auditors are lax in evaluating the letter, and only issue the letter of inquiry to show that the procedure is completed, regardless of the quality of the letter of return, and lack of due continuous investigation. Based on the results of the above research, the optimization of the implementation process of the correspondence procedure, the improvement of the quality of the auditors, and the compaction of the responsibilities of the regulatory bodies are considered to help the effective implementation of the correspondence procedure of accounting firms.

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