



X Holding's Delisting: A Probing Internal Audit Analysis and Organizational Structure Innovations in Internal Audit

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Abstract: X Holding has been punished by CSRC and forced to delist by SSE due to its regulatory violations. This study delves into issues existing in X Holding from an incisive perspective of internal audit, such as irregular decision-making process, unreasonable use of funds, the phenomenon of one person holding two positions, insufficient establishment and functioning of the supervisory board, and irregularities in the recruitment of external audit. Combining with the practical experience, the study emphasizes the decentralized power of enterprises and the establishment of mutually restrictive and well-functioning internal audit organizational structure, and its importance to the independence, authenticity and impartiality of internal audit. Concluding several items that auditors need to pay particular attention to in the process of internal audit. Furthermore, the study researches the organizational structures of internal audit commonly adopted in practice by Chinese enterprises and concludes a well-functioning internal audit organizational structure. Ultimately, the study provides a prospective on audit under the background of the new Securities Law.

Keywords: internal audit perspective; internal audit organizational structure; centralized power

1. Introduction

The role of internal audit in enterprises is to ensure the transparency and compliance of corporate governance, providing independent and objective oversight and advice to management in order to promote risk control and steady operations. Looking worldwide, with the constant revelation of industry scandals, it has become an urgent issue to conduct more effective internal audits in enterprises to avoid risks and achieve stable operations. In the new era, how Chinese enterprises' internal audit departments play their roles and maintain their independence better is a subject worthy of our research. The implementation of the new Securities Law has also brought new opportunities for auditors to carry out their work.

X Holding is a industrial investment holding listed company, which was jointly founded by a ceramics factory, acting as the lead initiator, along with four other industrial companies on 1998. X Holding made its debut on Shanghai Stock Exchange in 1999. After six name changes, it was finally renamed to its current moniker in January 2021. Until the 2020 annual reporting period, X Holding' s main business operations had not yet fully recovered, and its revenue was primarily derived from the investment property rental income held by its controlled subsidiary, H. And X Holding identified two business development directions: fine chemicals and gig economy. It plans to build around these two main businesses in the future and continue to seek new assets.

X Holding declared to have received the Notice of Prior Notification of Administrative Penalty in January 2021, and the Prior Notice of Administrative Punishment and Market Ban in October 2021 from the CSRC. Due to X Holding 's violation of relevant provisions of the Measures for the Implementation of Forced Delisting for Major Violations, Shanghai Stock Exchange decided to terminate the listing of X Holding 's shares. X Holding received the decision on the termination of the listing of its shares from Shanghai Stock Exchange on the evening of March 22, 2022. According to relevant regulations, starting from five trading days after the decision, in other words, from March 30, 2022, X Holding 's shares will enter the delisting consolidation period.

This paper endeavors to conduct an in-depth analysis of the delisting of X Holding from the perspective of internal audit. Furthermore, it aims to delve into the complex relationship between corporate centralization and the innovation of internal audit organizational structure. The forced delisting case of X Holding, as the first case under the implementation of the new Securities Law, coupled with the punishment of auditors, offers a highly illustrative and representative case study.

The main work of this paper is to use the X Holding's delisting as a springboard to delve deeply into the issues that should be paid special attention to in the internal audit process, as well as the centralized power of enterprises and the innovation of their internal audit organizational structure. Ultimately, our objectives also include providing universally applicable optimization recommendations.

The primary aim of this paper is to contribute to the existing literature on internal audit and corporate governance by providing insights on how to clarify and strengthen internal audit functions in a centralized power environment. In order to accomplish this, we concentrate our efforts on specific issues and innovations in organizational structures of internal audit. The ultimate objective is to maintain stability in the context of changing backgrounds and policies, in order to prevent corporate risks and ensure the long-term sustainability of business operations.

2. Issues in X holding from an incisive perspective of internal audit

2.1 Lack of Internal Audit Institutions

X Holding has not established an internal audit department, lacks full-time internal auditors, and has not engaged any third-party institutions to conduct internal audits. It was only after engaging TT Accounting Firm in 2020, which is the first recruitment under the new Securities Law, that X Holding disclosed an internal control audit report.

2.2 Irregular Decision-Making Process

In 2012, without the approval of the board of directors and shareholders' meeting, the former chairman and general manager of X Holding, Zhou, utilized his authority to sign financing agreements on behalf of the company through the SY platform. He successively established four limited partnerships, raising a total of 1.02 billion yuan in debt financing. Among these, 746 million yuan was directly transferred to X Holding's account. However, this fund was not used for the company's production and operation, but was illegally misappropriated by Zhou.

2.3 Unreasonable Use of Funds

After implementing bankruptcy restructuring in 2015, X Holding absorbed 1.447 billion yuan in restructuring funds. In 2016, X holding's monetary funds reached 561 million yuan, a significant increase compared to 2014. However, this fund was almost entirely utilized in the first year after restructuring. In 2017, the monetary funds were reported as 879,100 yuan, and by 2020, the company only had 398,800 yuan remaining.

Starting in 2016, X Holding signed purchase contracts totaling nearly 1.2 billion yuan with multiple suppliers and paid 500 million yuan in advance. This advance payment accounted for 90% of the company's monetary funds. Some of the suppliers that signed contracts with X Holding had similar establishment dates to the contract signing dates, and these companies were small-scale with registered capital far below the contract amount. In particular, SZZSY Technology signed a large contract almost immediately after its establishment but ultimately failed to fulfill the contract. The company did not receive the goods as scheduled, and the significant outflow of restructuring funds did not bring any development to the company, instead leading to a large amount of funds being occupied and hindering the company's production and operation.

Table 1. The specifics of the contract signed between X Holding and the suppliers.

Supplier Name	Contract Signing Date	Establishment Date	Contract Amount	Registered Capital
SZZSY Tech	March 10, 2016	March, 2016	30 million yuan	7 million yuan
	April 20, 2016		60 million yuan	
CCMS Trading	April 25, 2016	January, 2016	40 million yuan	2 million yuan
	April 30, 2016		50 million yuan	
SZNPX Tech	May 4, 2016	March, 2016	47 million yuan	10 million yuan

2.4 the Phenomenon of One Person Holding Two Positions

The secretary of the board of directors plays an important role in the internal governance of the company. In 2015, 2016 and 2017, the director of the board of directors served as the general manager and the secretary of the board of directors, and in 2020, the chairman Huang served as the secretary of the board of directors and the financial person in charge of the company, taking sole control of the power and excessive concentration of power distribution.

2.5 Insufficient Establishment and Functioning of the Supervisory Board

The supervisory board of X Holding has a relatively small number of members, and there are significant changes in the directors, supervisors, and senior executives almost every year, with frequent collective resignations among senior executives. In 2010, without holding a re-election, the directors, supervisors, and senior executives of X Holding collectively resigned. From 2016 to 2019, when X Holding was suspended from trading, the resignations slightly eased, but in the year of 2020 when X Holding resumed trading, another five directors, supervisors, and senior executives resigned consecutively.

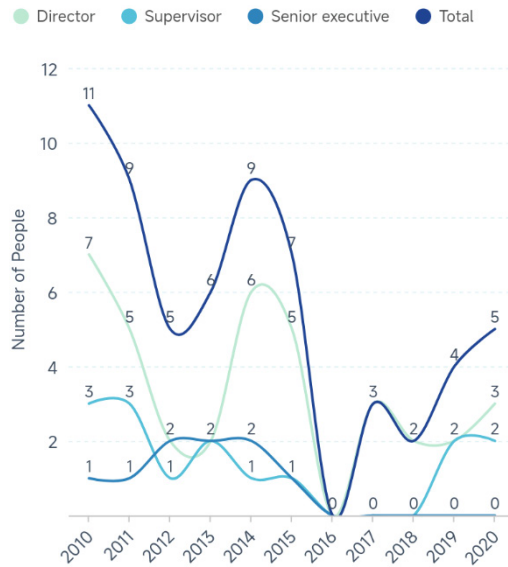


Figure 1. The resignations of directors, supervisors, and senior executives of X Holding from 2010 to 2020.

2.6 Irregularities in the Recruitment of External Audit Institutions

In terms of the compliance of hiring external audit institutions, X Holding has frequently changed its accounting firms since 2017. In March 2020, X Holding claimed that due to the lack of a new accounting firm to undertake the audit work, it was unable to disclose its 2019 annual report on time. On March 1, 2020, when the new Securities Law came into effect, stipulating that accounting firms no longer need to apply to relevant departments to engage in securities audit work. X Holding promptly announced on March 27, less than a month later, that it had hired TT Accounting Firm to undertake the audit work.

TT Accounting Firm has no experience in audit work in the capital market, and its registered capital and scale are less than one-tenth of that of HX Accounting Firm. However, X Holding still offered an audit fee of 1.2 million yuan, which is higher than TT's registered capital. Moreover, compared to the previously relatively stable audit fee of 0.8 million yuan, the audit fee offered to TT Accounting Firm suddenly rose to 1.2 million yuan.

Table 2. Accounting Firms and their audit opinions of X Holding from 2015 to 2019 annual reporting period.

Year	Accounting Firm	Audit Opinion
2015	DH Accounting Firm	An unqualified opinion with emphasis on matter paragraph
2016	DH Accounting Firm	A qualified opinion
2017	DH Accounting Firm	A qualified opinion
2018	HX Accounting Firm	A disclaimer of opinion
2019	TT Accounting Firm	A qualified opinion

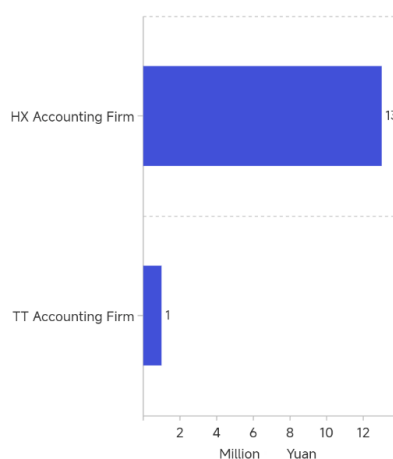


Figure 2. Registered capital of HX and TT Accounting Firm.

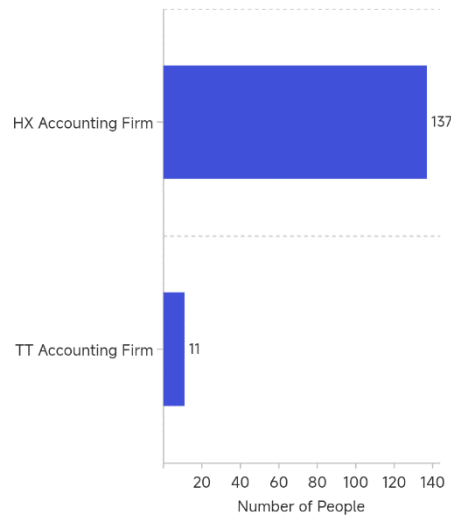


Figure 3. Certified public accountants of HX and TT Accounting Firm.

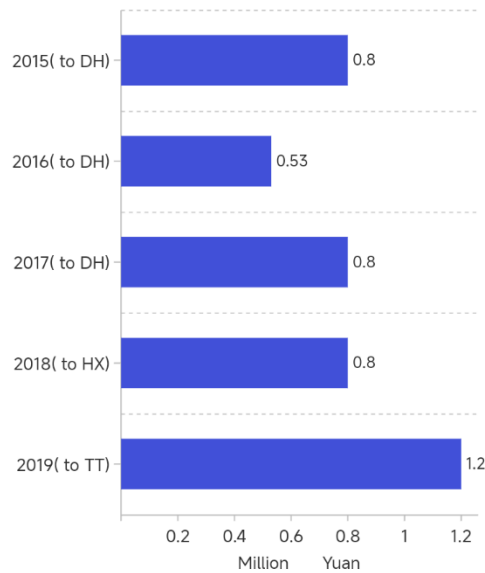


Figure 4. Audit fee that X Holding paid to accounting firm from 2015 to 2019 annual reporting period.

3. Internal audit organizational structure

Based on our practical experience in other enterprises. When internal auditors uncover issues, some enterprises adopt a resolute and incorruptible attitude, fully adhering to the law. When personnel fraud reaches the statutory amount, the personnel involved will be summoned for a talk, and if the conversation fails, the police will be immediately notified to escort the relevant personnel to the police station. Additionally, the internal auditors and the audited parties are separated except for necessary interactions, thus minimizing any potential impact on the independence, authenticity, and fairness of internal audits. In contrast, in some hierarchical enterprises, particularly those with an internal audit organizational structure where the internal audit department is subordinate to the financial accounting department, problematic personnel and departments are not punished. Instead, the internal auditors who uncover the issues may face unwarranted threats and punishments. After the turmoil subsides, it seems as if the problems uncovered by the internal audit department have never been detected. It is unclear whether the enterprise leaders adopt such a handling approach due to considerations of the company's image or other undisclosed factors. While the surface appears calm, there are numerous loopholes beneath. Ultimately, the law will prevail. We are of the opinion that the reason for such contrasting situations is related to the degree of power concentration in enterprises. Therefore, corporate decentralization and the establishment of a well-functioning internal audit organizational structure with mutual checks and balances are crucial.

In practice, Chinese enterprises commonly adopt the following organizational structures for internal audit departments: they are affiliated with the financial accounting department, the discipline inspection commission, the general manager, the board of supervisors, or the board of directors.

Specifically, when the internal audit department is affiliated with the financial accounting department, the independence of internal audit will be significantly compromised, potentially rendering it unable to objectively evaluate and scrutinize financial accounting activities, thereby affecting the fairness and accuracy of audit results. When the internal audit department is affiliated with the disciplinary inspection commission, its supervisory function is emphasized, but it tends to overlook the internal control and consulting functions, and is generally applicable only to state-owned enterprises and some private enterprises. When the internal audit department is under the direct supervision of the general manager, it holds a similar status to other functional departments and possesses relative independence. However, this setup limits the ability of the internal audit department to oversee the decision-making behavior of the general manager and its subordinate departments. When the internal audit department is affiliated with the board of supervisors, it possesses a certain degree of independence, but it tends to have an insufficient understanding of the operational and management status of the enterprise. When the internal audit department is under the direct supervision of the board of directors, it processes a strong independence. However, due to the infrequent collective discussions at board meetings, the work reporting and execution of the internal audit department are prone to being influenced.

Consequently, combining the advantages and disadvantages of the commonly adopted organizational structures of internal audit departments in Chinese enterprises, we believe that a well-functioning internal audit organizational structure typically comprises an internal audit department, an audit committee, and a board of supervisors. In this structure, the internal audit department is affiliated with the board of directors, processing strong independence and status. The audit committee, also under the board of directors, independently, fairly, and effectively evaluates the company's internal audit level by integrating internal and external audit resources. The board of supervisors, as a standing supervisory organ under the leadership of the shareholders' general meeting, independently exercises supervisory power over the board of directors, the general manager, senior managers, and the entire company, fulfilling its supervisory functions. These entities together form a mutually restraining and comprehensive internal audit organizational structure.

4. Conclusions

In the process of internal audit, based on the practical experience, particular attention should be paid to the decision-making norms and justification of fund usage, whether the company's various decisions and business practices are compliant, and whether the internal audit process is independent.

These issues of concern have broad applicability, not limited to X Holding alone. Their profoundness and universality render them equally applicable to other enterprises. As an integral part of corporate governance, internal auditing plays an indispensable role. By paying particular attention to the norms and rationales behind decisions on fund utilization, as well as the compliance of the company's various decisions and business practices, enterprises can promptly identify potential problems and take corresponding measures to rectify them, thus ensuring the stable operation of the enterprise. The impairment of internal audit independence, a prevalent issue in many enterprises, occurs when the power of the internal audit department is weakened by other departments. This can lead to audit results being influenced by subjective factors, thereby failing to accurately reflect the company's operational status and potential risks. This is a universal problem that needs to be addressed and resolved in various enterprises. By paying special attention to these issues in the process of internal auditing, it can help enterprises promptly avoid potential risks and maintain stable operation.

It is our view that the independence, authenticity and impartiality of internal audit are related to the degree of concentration of corporate power. We propose that the independence, authenticity and impartiality of internal audit are negatively related to the degree of corporate centralization, which needs further research support.

We are of the opinion that a robust internal audit organizational structure comprises an independent internal audit department, an audit committee evaluating audit levels, and a board of supervisors overseeing the board, management, and company. Together, they form a comprehensive, mutually restraining structure. In terms of specific implementation, while this robust internal audit organizational structure requires detailed adjustments based on the actual situations of enterprises in different industries, sizes, and regions, its principles and direction are universally applicable. It can help enterprises improve the efficiency and quality of auditing, better fulfill the role of internal auditing in corporate governance, and thereby ensure the stable operation of the enterprise.

In the context of the promulgation of the new Securities Law, the approval system for accounting firms engaging in securities audit services has been transformed into a registration system, with an increase in online supervision of the audit

process and simplification of procedures. This change favors more accounting firms that were previously unqualified to engage in securities audit services. However, accounting firms and accountants will also be jointly liable for any punishments imposed on audited enterprises due to audit violations. This further safeguards the independence of audits and places higher demands on accounting firms and accountants. In the new era with new requirements, regardless of any changes, auditors must firmly adhere to the principle of independence to remain invincible.

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