Auditing Wars

Transnational accounting regulation in China

Guest Series

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Unless US and Chinese auditing regulators can agree on some form of access to inspect Chinese auditors, all US-listed Chinese companies could be forced to delist. While relisting in Hong Kong is a possibility, similar auditing issues are being raised. The Chinese private sector will be the biggest loser from any failure to find a compromise between regulators given that gaining access to capital is already difficult and the loss of US markets would be a further blow.

Between a rock and a hard place

A slew of frauds at US-listed Chinese companies have highlighted flaws in the attempts of US regulators to provide, what they believe is, adequate investor protection. The US Securities and Exchange Commission (SEC) demands the audits of all US-listed companies meet the standards established by the US Public Company Accounting Oversight Board (PCAOB). Unfortunately, Chinese-based auditors are unable to release their audit working papers to US regulators without breaching Chinese law. As such, complying with US regulations could land Chinese auditors in Chinese jails and failure to comply could land them in US jails.

Negotiations continue

In order for overseas auditing firms to audit US-listed companies, they must submit to an inspection by the PCAOB to ensure they are following US standards. Chinese regulators have been reluctant to offer joint inspections as they believe this is a breach of national sovereignty and have pushed for the equivalent of the audit oversight systems in third countries, similar to the agreement China has struck with the EU. Unfortunately, the PCAOB has little statutory authority to offer this.

Joint inspections are the most likely solution

The China Securities Regulatory Commission (CSRC) may well cede to some form of joint inspections between Chinese and US regulators but on the condition that only they will be allowed to administer punishment to wayward Chinese auditors. However, approval from the Ministry of Finance is questionable given the issue of "face".

Consequences of failed negotiations

The most likely consequence of a failure to reach a compromise is deregistration of all accounting firms that the PCAOB is unable to inspect. This means that US-listed Chinese companies will no longer have an auditor and will have to delist. The most natural place to relist is Hong Kong but even then similar auditing issues exist. The biggest loser will be the Chinese private sector, which is already starved of capital and might have even less access to it in future unless a compromise is reached.

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The U.S. Securities and Exchange Commission recently filed charges against five Chinese accounting firms, all affiliates of global accounting networks. Share prices in U.S. listed Chinese stocks plummeted as investors fretted over the possibility that the problems of the accounting firms could lead to a mass delisting of Chinese stocks listed in the United States.

Is a mass delisting of US-listed Chinese stocks a reality?

On another front, the U.S. Public Company Accounting Oversight Board (PCAOB) has been engaged since the mid-2000s in negotiations with Chinese regulators to be able to come to China to inspect Chinese accounting firms that audit U.S. listed companies. The inspections are necessary to make certain that these auditors are following U.S. auditing standards. The PCAOB just passed a December 31, 2012 deadline to complete inspections of Chinese accounting firms, and failure to soon reach a breakthrough in negotiations with Chinese regulators could lead to the deregistration of Chinese accounting firms and a mass delisting of Chinese stocks.

PCAOB has been unable to inspect Chinese auditors to make sure they are following US standards

This situation is likely to remain highly volatile in the months ahead.

Role of auditors

These recent events have focused the attention of investors on transnational audit regulation; an essential but little understood underpinning of global financial markets. If auditing builds the bridges that connect investors with information, audit regulators are the bridge inspectors who make certain those bridges are properly constructed and maintained.

The wider market understands little about transnational audit regulation

China is a place where the bridges connecting foreign investors with companies have collapsed. In 2011, Pittsburgh Tribune-Review reporter Lou Kilzer found 105 instances of Chinese companies subject to U.S. federal enforcement or investigation, fraud lawsuits or delisting. Shareholders lost billions in value and an industry of short sellers was spawned. Obviously, the promised accuracy and transparency of financial statements was lacking, and shareholders have rightfully questioned whether the audits were up to standard.

Problems arisen owing to the large number of frauds

Auditors point out that audits are not intended to uncover frauds. Auditors are expected to perform fraud risk assessments and design audit approaches and procedures to enhance the likelihood of detecting material fraud. Nevertheless, financial statement audits are not forensic audits, and may not uncover well-constructed and concealed frauds. That is of little comfort to shareholders who are the victims of accounting frauds. Inevitably any accounting fraud will be met by a Greek chorus of shareholders chanting, “where were the auditors”? There is an expectation gap between the expectations of investors and the responsibility that the auditors accept for finding fraud.

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Longtop and Deloitte

The increasing number of accounting frauds connected with Chinese companies listed in the U.S. led the Securities Exchange Commission (SEC) to form a task force focused on the issue. In addition to pursuing companies and executives suspected of fraud, the task force also scrutinized the "gatekeepers", the investment banks, consultants, financiers, auditors and others who helped these businesses gain access to US capital markets. The FBI

Large number of Chinese frauds a big issue for the US Securities and Exchange Commission

embedded an agent in the task force that also worked with federal prosecutors. Robert Khuzami, director of enforcement at the SEC said: “Not having proper accounting and reliable audit review for publicly traded companies with operations in China is just not acceptable. We have to find a path to resolution of this issue; It is … a big issue for us.”

Citron Research popped Longtop's bubble by pointing out that margins were too high – the auditor then resigned and the stock has been delisted prompting an SEC investigation

Longtop Financial Technologies listed on the NYSE in 2007 in an IPO underwritten by Goldman Sachs and Deutsche Bank. It was audited by Deloitte Touche Tohmatsu's member firm in China. Longtop had been a darling of Wall Street; its IPO surged 85% on the first day and it consistently outperformed the technology heavy Nasdaq composite index. In 2011, Longtop came under attack by Andrew Left of short selling research firm Citron Research. Left alleged that Longtop's margins were too good to be true. Deloitte had signed off on the previous six audit reports of Longtop, but refused to sign off on the current year, citing a number of problems including evidence that the bank confirmation process had been compromised. Deloltte's resignation led the NYSE to delist the stock, and the SEC began an investigation.

Figure 1: Longtop Financial ADR Share Price: Oct 07 – Dec 12

Source: Bloomberg

The problem is that the auditor cannot hand over its working papers to the SEC as this is against Chinese law

The SEC demanded that Deloitte turn over its working papers. Deloitte refused, citing China's laws that prohibited disclosure of working papers to foreign regulators. The SEC then served Deloitte's U.S. counsel with a subpoena with the working papers, which the lawyer, perhaps unwittingly, said he would accept. The SEC then brought action in Federal District Court in Washington D.C. to enforce the subpoena. Deloitte argued that Chinese law prohibited them from turning over the working papers, and that Chinese regulators had warned them that doing so could lead to life imprisonment for the partners involved and to the firm being banned from China. The SEC argued that American law controlled the situation and that Deloitte must comply.

The SEC's request is not unusual and helps work out who lied to the auditor

The SEC's request for Deloitte to provide its working papers was not unusual. Audit working papers are useful documents for investigators. While it would be highly unusual for these working papers to contain any smoking guns that point to the root of the fraud, they document many assertions of fact by management and others associated with the company. With the benefit of

hindsight, investigators can use the working papers to figure out who lied to the auditors. Early in a fraud investigation authorities often seek to look at audit working papers to help them better focus their own efforts.

The SEC says it received no meaningful assistance from the CSRC…

The SEC engaged in discussions with Chinese regulators to obtain the working papers for Longtop and other companies. The SEC reports that it has made 21 requests in 16 different cases for documents from the China Securities Regulatory Commission (CSRC), including three requests for audit working papers. The SEC says it received no meaning assistance from the CSRC. In April 2012, the CSRC indicated that it was willing to cooperate under certain conditions. First, the CSRC would not let the SEC use the information in any legal action without written permission from the SEC. Second, the CSRC would make its own judgment on what documents to provide. Unsurprisingly, the SEC rejected those conditions.

….and has come to the conclusion that it is not a reliable gateway for audit papers

The SEC came to the view that the CSRC is not a viable gateway for the production of audit work papers and in May 2012 it charged Deloitte with violations of U.S. securities laws for failure to turn over the audit working papers in another unnamed case.

The SEC thought they could come to an agreement with the Chinese

In July 2012, SEC Chairman Mary Schapiro visited Beijing and met with high-level Chinese officials to discuss the problem of accessing documents necessary for the SEC to enforce American securities laws. Schapiro was sufficiently encouraged by the prospect for agreement that the SEC went to court after she returned and asked the judge in the Deloitte case to stay his opinion for six months while they sought a negotiated settlement with Chinese regulators.

The Chinese wanted to retain a veto and if the SEC questioned this, it would take a long time to resolve

In October 2012, the CSRC informed SEC staff that the CSRC had come to the view that audit work papers could be shared with the SEC. But they still insisted on retaining veto power over their use. If the SEC did not agree to this condition, then they said that the request might take an indeterminate amount of time as the CSRC consulted with other government bureaus.

The CSRC was invited to come to Washington in November 2012 for meetings with the PCAOB. The CSRC asked to meet with the SEC on the same trip. The SEC told the CSRC that unless they were prepared to hand over the working papers, there was not much sense in talking about them and instead said they should discuss other regulatory matters. The SEC point person on the audit working papers did not attend the meeting that was held on November 26, yet the SEC informed the CSRC at that meeting that it was going to move ahead on the issue.

Chinese regulators have signalled their willingness to deal

Chinese regulators have signalled that they would like to deal. Tong Daochi, CSRC Director General International told a conference in Hong Kong on November 26 that “We have engaged with the SEC, SFC, and PCAOB on audit working papers and we are making progress and I think we should be able to work out a way to get them out.”

SEC v. Big Four and BDO

The following Monday, December 3, 2012, the SEC filed administrative charges against the China affiliates of the Big Four accounting firms, Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers, as well as second tier accounting firm BDO. The charges were based on the failure of the firms to comply with requests to supply audit working papers to the SEC, as is required by Sarbanes Oxley.

The SEC still went ahead and charged the Big 4 for failing to supply audit working papers

An SEC administrative trial judge will decide the case against the accounting firms. Under SEC rules, the judge has 300 days to make a decision, although many experts think that the straightforward facts of the case may result in a quicker decision. The judge may impose sanctions against the accounting firms. In the past, accounting firms that have gotten into trouble with the SEC have faced a range of penalties from admonishment to a ban on practice before the SEC. A ban on practice means the firm can no longer audit public companies. In a couple of instances, Big Four firms have faced a temporary ban on accepting new SEC clients. The penalty most expected in the present cases would be to ban the firms from auditing U.S. listed Chinese companies. The ban could also include forbidding the firms from participating in the audits of any U.S. listed company. This would create huge problems for U.S. multinationals with China operations, and accordingly would seem to be an unlikely outcome.

It is most likely that the Big 4 will be banned from auditing US listed Chinese companies…the judge has 300 days to make a decision

If the audit firms were banned from auditing U.S. listed Chinese companies these companies would be without an auditor. All U.S. listed companies are required to be audited annually by an accounting firm registered with the PCOAB. Failure to have an auditor leads to the company being delisted from the stock exchanges, and the company will eventually lose its registration as a public company when it is unable to file an annual report with audited financial statements.

This ban would leave US listed Chinese companies without an auditor and they would have to delist

The SEC also recommenced the suspended case against Deloitte, advising the District Court judge that negotiations had failed. If the judge decides to uphold the subpoena, it appears likely that Deloitte would refuse to comply since they believe that to do so would break Chinese law. Refusing to turn over the working papers under court order likely leads to the judge finding Deloitte in contempt of court, and the penalties for contempt might be even more severe, precluding Deloitte's China partners from visiting the U.S. for fear of arrest.

Deloitte is unlikely to comply with any US-issued subpoena as it would involve breaking Chinese law

Under the SEC case, only the five firms that have been charged face a current threat to their practice rights before the SEC. Should these firms be banned, their clients could select one of the other PCAOB registered firms to do their audit. Although there are 41 of such firms in China, it is unlikely than any have the skills necessary to audit the larger U.S. listed Chinese companies, some of which are among the largest companies in the world.

Only five firms have been charged but they are the only ones able to do the audits

The banning of the firms from practice before the SEC and the subsequent delisting of their clients is not likely to happen anytime soon. Any harsh decision by the judge is likely to be appealed by the firms, first to the SEC, and then to the federal courts. The wheels of justice often turn slowly in America, and the SEC case is likely to be subsumed by actions of the PCAOB long before it is resolved.

A long appeal process is likely

Public Company Accounting Oversight Board

The PCAOB is an independent audit regulator. It is a non-profit organization established by the U.S. Congress to oversee the audits of public companies. The U.S. Securities and Exchange Commission (SEC) oversee the PCAOB. All auditors of U.S. listed companies must register with the PCAOB and be subject to its jurisdiction.

PCAOB is a non-profit organisation established to oversee the audits of public companies

The PCAOB sets auditing standards for public company audits, and conducts inspections of registered accounting firms to evaluate compliance with those standards.

It sets auditing standards and conducts inspections

There are 914 accounting firms outside the United States that are registered with the PCAOB as of May 2012, including 45 in China and 51 in Hong Kong. Only 9 of the China registered firms and 17 of the Hong Kong registered firms actually issue reports on U.S. listed companies. The registered firms include the foreign affiliates of the Big Four and other global accounting networks. The Big Four are not organized like typical multinational corporations. Partners in those locations, much like franchise operations, independently own them. Each member firm of accounting firm networks needs to separately register with the PCAOB.

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PCAOB Inspections

PCAOB inspections are conducted annually for the nine U.S. based firms that audit more than 100 issuers. These annually inspected firms include the U.S. affiliates of the Big Four. All other registered firms that issue reports, including all of the nine firms in China that issue reports on U.S. listed companies, are to be inspected every three years.

Inspections conducted annually for the big firms and every three years for the rest

The PCAOB has been an active regulator since its formation in 2002. Inspection reports of the PCAOB are partially released to the public and have been highly critical of auditing practices. The Big Four have received particularly harsh criticism for lacking scepticism and for failing to obtain sufficient evidence to support their audit opinions. Many credit the PCAOB for overhauling the audit profession, changing long practiced ways of doing audits and increasing the quality of audits.

PCAOB is an active regulator, has been highly critical of the Big 4 and is credited with improving the quality of audits

PCAOB began conducting international inspections in 2005, and has conducted inspections in 38 countries through June 30, 2012. A number of countries, including much of Europe and China, objected to PCAOB inspections on grounds of data privacy or national sovereignty. China also forbid the PCAOB from conducting inspections in Hong Kong to the extent that the audits to be examined included companies that have operations on the mainland.

Began international inspections in 2005 although much of Europe and China have objected on grounds of sovereignty

Under the PCAOB's rules, the initial inspections of foreign registered firms were to be completed by December 31, 2009. As that deadline approached, it became apparent that the obstacles to inspections put up by various countries meant the deadline would be missed. The PCAOB changed its rules to defer the deadline for inspections to December 31, 2012.

PCAOB has missed its own deadline on inspections of international firms

Since 2009, the PCAOB has been actively concluding negotiations to obtain access to conduct inspects. Most of these negotiations sought arrangements for joint inspections, where PCAOB inspectors work side by side with local inspectors to review audit firms. Ten agreements have been reached since

Is trying to seek agreements for joint inspections…and has concluded 10

2009, and James Doty, PCAOB chairman recently announced that a number of agreements were close to conclusion.

China believes joint inspections violate national sovereignty and is pushing for a similar reciprocal agreement to that with the EU

Negotiations with China have been underway since shortly after the PCAOB began international inspections in 2005. China's position is that foreign regulators enforcing foreign laws on Chinese soil against Chinese companies violate China's national sovereignty. In a 2009 letter commenting on the PCAOB's proposed delay in the deadline for foreign inspections, the CSRC said that any oversight of Chinese accounting firms should rely solely on the CSRC. In 2011, the European Union recognized the equivalence of the audit oversight systems in 10 third countries, including China. The third countries and EU member states can now mutually rely on each other's inspections of audits. Chinese regulators want the same treatment from the United States, but U.S. laws do not permit the PCAOB to rely on foreign regulators.

Politicians in the US are unsympathetic to the PCAOB's plight

Politicians in the U.S. began to turn the heat up on the PCAOB to address the inability to conduct inspections in China. Senator Chuck Schumer of New York wrote to James Doty of the PCAOB on November 22, 2011, chastising the PCAOB for their failure to inspect Chinese audit firms, writing "In the case of Chinese audit firms, the Board is failing to do its job". Schumer called for the PCAOB to exercise its enforcement authority against Chinese audit firms that have not submitted to independent regulatory review.

Has been some co-operation with the Chinese…

The most promising breakthrough came in August 2012, when Chinese regulators agreed to allow PCAOB inspectors to observe a portion of the Chinese inspection of Ernst & Young in China. The PCAOB was only allowed to observe the quality control portions of the inspection and was not allowed to inspect any audit working papers. PCAOB officials indicated that the observations were a trust building exercise and did not meet the requirements of inspections.

….but this failed to lead to a breakthrough and the SEC has brought charges against Chinese accounting firms

Chinese regulators came to Washington the week of November 26, 2012 to meet with the PCAOB and the SEC. The SEC meetings did not lead to a breakthrough and the SEC brought charges against the Chinese accounting firms the following Monday.

The PCAOB has offered to make joint inspections with the Chinese but likely has little statutory authority to offer more

The PCAOB presented a proposal to Chinese officials in the meetings during the week of November 26. That proposal was likely for joint inspections along the lines of the agreements that have been signed with many other countries. The PCAOB likely does not have the statutory authority to offer any better deal to the Chinese than joint inspections. PCAOB board members spoke of the meetings in public speeches in the days following the Chinese negotiations. Board member Lewis Ferguson told a journalist that the PCAOB had held wide ranging discussions with Chinese regulators on sharing audit materials, enhancing investigations and enforcement cooperation. He remained hopeful that a deal could be made, saying "we remain optimistic on final agreement, but we need to deal with current problems now".

PCAOB Chairman James Doty told auditing conference in New York "the current state is not sustainable. We are coming to a crossroads where we will have to make some important decisions about how to best protect investors."

The inspection deadline of December 31, 2012 passed without action by the PCAOB, which is now out of compliance with its own rules. PCAOB board member Lewis Ferguson told a Reuter's report "we've had periods before

where we ran over deadlines while trying to get things done”. Ferguson indicated that Chinese regulators were reviewing a PCAOB proposal they received in November and that “there is forward movement” and “the number of issues … has been narrowed significantly”.

Apparently the number of issues has narrowed significantly

The PCAOB appears to be making a final effort to reach an agreement with Chinese regulators for joint inspections. Ferguson’s comment that the number of issues has been narrowed significantly indicates that Chinese regulators have likely found a way to allow for joint inspections. The hang-up is going to be over what to do with the inspection findings. Chinese regulators are going to insist that they alone administer any punishment to wayward Chinese auditors. China insisted on this when they negotiated to open up H-share audits in Hong Kong to Chinese auditors and are unlikely to agree to more favourable terms to U.S. regulators. The idea that foreign regulators could punish Chinese accounting firms is likely a nonstarter for Chinese regulators. The PCAOB is likely to insist that it retains the right to punish firms. While the PCAOB would always have the ability to terminate the registration of a recalcitrant firm, that would probably not be an effective deterrent to bad auditing. The death penalty is so severe that firms would reasonably assume that the PCAOB would rarely use it.

Joint inspections might be approved but China will insist that only they will be allowed to administer punishment to wayward Chinese auditors

From the Chinese perspective, statements by CSRC representatives indicate a willingness to reach an agreement, yet any proposed agreement appears to have been undermined by other regulatory agencies in China. The CSRC and the Ministry of Finance jointly regulate the accounting profession. The CSRC, under the leadership of Guo Shuqing, has always seemed more globally oriented, recognizing that participation in global capital markets requires accepting global standards and close cooperation with foreign regulators. The Ministry of Finance (MOF) may be more ideological, less interested in globalization, and more protective of China’s sovereignty. Any solution from China has to work its way through this political minefield.

While the CSRC has indicated a willingness to agree, other regulatory agencies are less so such as the Ministry of Finance

The actions of the SEC in bringing action against the accounting firms may make it difficult for Chinese regulators to compromise. Any compromise at this stage might be viewed as a concession by Chinese regulators. That could result in a loss of face for Chinese regulators, which is a difficult thing to take in Chinese society. Compounding this problem is the recent change in administrations in China. China’s new leaders may be reluctant to be viewed as having lost in China’s first confrontation with the United States that takes place under their watch.

There is an issue of “face” following the SEC’s legal actions

Consequences of failed negotiations

If the present negotiations fail to reach an agreement for joint inspections, the PCAOB will be forced to act. PCAOB chairman James Doty said “the firms have gotten themselves into a pickle”. The most likely consequence of the PCAOB’s inability to inspect will be the PCAOB moving to deregister all of the accounting firms that it is unable to inspect. That deregistration does put the firms in a pickle, since unless registered with the PCAOB they cannot play a substantial role in the audits of U.S. listed companies.

The most likely consequence of the PCAOB’s inability to inspect will be the PCAOB moving to deregister all of the accounting firms that it is unable to inspect

The PCAOB action could take many forms, but the most likely option appears to be changing existing PCAOB rules to ban the registration of firms that it

cannot inspect and to terminate the registration of any registered firms that it cannot inspect. A proposed rule change must go through the PCAOB's rule making process, which includes public comment, possibly public hearings, and eventual adoption. The SEC must approve the rule before it is effective rule. The rulemaking process likely takes a minimum of six months, but it is unlikely that the PCAOB and SEC are going to be in a hurry. If they wish to minimize the disruption caused by the decision, they might set an effective date well into the future - say June 30, 2014. That would give plenty of time for diplomacy to work, and would give Chinese companies plenty of time to figure out how they might exit U.S. capital markets.

PCAOB likely to favour a diplomatic response and set a long-dated deadline, possibly by mid-2014

But it will actually be the clients of these firms that will be in a pickle. Under exchange rules, a company must have a PCAOB registered auditor as a condition of listing. When a company loses an auditor, the exchanges typically immediately delist the company unless there are credible plans to find a new one. In China, however, all of the PCAOB auditors would be deregistered, and it would be impossible for companies to find a new auditor.

It's the clients of these firms that will be in a pickle as they need a registered auditor

In theory, an overseas-based auditor could fly into China to do the audits. However, Chinese law requires these auditors obtain a temporary practice license that requires them to follow Chinese laws, including the laws on audit working papers. Any firm coming to China to audit is likely risking its PCAOB registration for the same reason the Chinese firms would lose theirs.

Can't parachute in auditors

Companies that are delisted by the exchanges would still be registered with the SEC and their shares could continue to trade on the informal over the counter markets known as the pink sheets. Eventually the companies would be unable to file their annual report with the SEC, since these reports must include financial statements audited by a PCAOB registered firm. Failure to file required reports eventually leads to the SEC striking the company from the registry of public companies. About 50 Chinese companies were struck off for this reason in the past year.

Would have to de-list… similar to the 50-odd Chinese companies that were de-listed in 2012

Implication on MNCs

The PCAOB and the SEC will need to be careful that any action against accounting firms in China does not have an unintended impact on multinational companies operating in China. Terminating the PCAOB registration of firms means the firms can no longer play a substantial role in the audit of a U.S. listed company. Many U.S. based multinationals have significant operations in China that are usually audited by the Chinese member firm of their U.S. auditor.

De-registered Chinese auditing firms could not play a major role in the audit of a US listed company

Here is the definition of substantial role from the PCAOB rules:

(p)(ii) Play a Substantial Role in the Preparation or Furnishing of an Audit Report

The phrase "play a substantial role in the preparation or furnishing of an audit report" means –

-1 to perform material services that a public accounting firm uses or relies on in issuing all or part of its audit report with respect to any issuer, or

-2 to perform the majority of the audit procedures with respect to a subsidiary or component of any issuer the assets or revenues of which constitute 20% or

more of the consolidated assets or revenues of such issuer necessary for the principal accountant to issue an audit report on the issuer.

Note 1: For purposes of paragraph (1) of this definition, the term "material services" means services, for which the engagement hours or fees constitute 20% or more of the total engagement hours or fees, respectively, provided by the principal accountant in connection with the issuance of all or part of its audit report with respect to any issuer. The term does not include non-audit services provided to non-audit clients.

Note 2: For purposes of paragraph (2) of this definition, the phrase "subsidiary or component" is meant to include any subsidiary, division, branch, office or other component of an issuer, regardless of its form of organization and/or control relationship with the issuer.

Note 3: For purposes of determining "20% or more of the consolidated assets or revenues" under paragraph (2) of this Rule, this determination should be made at the beginning of the issuer's fiscal year using prior year information and should be made only once during the issuer's fiscal year.

When these rules are applied to a typical MNC with operations in China, the first question is whether the China auditor performs more than 20% of the total engagement hours or fees. The total engagement hours and fees would include all fees and hours around the world to audit the company, including the hours and fees of the home country team. If the China firm does more than 20% of those totals, it must be registered with the PCAOB.

A "substantial" role is anything greater than 20% of total engagement hours or fees…

If the auditor is not required to be registered under the 20% of total hours and fees rule, the second question is whether the China firm is performing the majority of audit procedures with respect to a subsidiary, division, branch or component that makes up 20% or more of the consolidated assets or revenues of such issuer. Because most MNCs have many subsidiaries in China, this test may be easy to pass since, even when total China assets or revenue are over 20% of the MNC, no single subsidiary may trip the wire. The first test, whether the China accounting firm has more than 20% of the total worldwide fees or hours, is probably the key test.

…or if the audited subsidiary/associate makes up more that 20% consolidated assets or revenues

It is likely that few, if any, MNCs will have a problem with this rule should their China accounting firm be deregistered. MNC fees and hours tend to be heavily weighted to the headquarters, so even where the MNC's China assets and revenues may be higher than 20%, the hours and fees are likely to be less than 20%. Should the PCAOB propose deregistering the firms, the SEC should require companies to disclose the impact immediately so that investors are properly informed.

Most MNCs should have no problem with these rules

Implications to Chinese Companies and Investors

Chinese companies that face delisting because their auditors are deregistered will be looking for alternatives to provide liquidity to their investors. Chinese stock exchanges are not generally suitable for these companies. China severely limits the participation of foreign investors in its markets. It will take considerable time before China reforms its securities and currency controls to make it possible for these companies to list in China with their present shareholders.

US-listed Chinese companies face de-listing but cannot simply re-list in China with current shareholders

Some companies may decide to go private by making an offer for the outstanding shares of the company. Many U.S. listed Chinese companies have already gone private, encouraged to do so by the low valuations in the market. In a going private transaction, insiders typically make a tender offer to shareholders to acquire the outstanding shares at a specified price. Recent going-private transactions have involved a premium over recent trading values of about 20%. The company appoints a special committee of independent directors who evaluate the offer and obtain a fairness opinion from a financial advisor.

Some companies could go private

The China Development Bank, the bank of China's State Council, has funded approximately $1 billion of going private transactions. Some observers believe that the intent of the China Development Bank is to hold the investments until conditions are ripe to list the companies on China's stock exchanges. The China Development bank might provide funding to delisted companies seeking to follow this path.

Some believe the China Development Bank is preparing for this option

The most obvious alternative for delisted companies will be to seek a listing on the Hong Kong Stock Exchange (HKSE). Most of the large State-owned enterprises that are listed in the United States have also offered H-shares on the HKSE. These companies may face little difficulty exiting the U.S. exchanges, simply selling additional shares in Hong Kong and buying back outstanding ADS shares. Companies may also look to other exchanges such as London and Singapore.

Another alternative is to relist in Hong Kong, Singapore or London

Other U.S. listed Chinese companies would have to go through a listing process in Hong Kong. The high quality of existing U.S. filings may make this process easier, although companies will be required to present new financial statements that are prepared under IFRS instead of the U.S. GAAP that is customarily used for U.S. listings. Some companies may initially seek a secondary listing in Hong Kong, which would permit the continued use of U.S. GAAP until the company is delisted in the U.S. Estimates of the time required for moving a listing to Hong Kong range from six months to a year.

It could take six months to a year to relist in Hong Kong

There is a reason why so many Chinese companies chose to list in the U.S. instead of Hong Kong when they first did their IPO. Often, that was because U.S. markets offered higher valuations, especially for technology and internet companies. Hong Kong requires that companies have a track record of profitability before listing. The U.S. has no such requirement, and many internet companies have listed in the U.S. long before they turn profitable. Many companies that were ineligible to list in Hong Kong in their initial IPO have now established a track record of profitability. Some companies, however, have yet to turn profitable and would not be eligible to list under current listing rules in Hong Kong.

Hong Kong requires companies to have a history of profitability and this might be a problem for some….

Hong Kong has also been less receptive to the variable interest entity (VIE) structure, where China operations are controlled through contracts instead of through ownership. The HKSE has specific rules for VIEs that require expanded disclosure. There are also rigorous conditions that must be met and some companies may face difficulties complying with all of the conditions set by the HKSE.

…it is also less receptive to the VIE structure…

Hong Kong has its own problem with audit working papers. Standard Water was a Chinese company that had a failed IPO in Hong Kong. The Securities and

Futures Commission (SFC), Hong Kong's security regulator, asked auditor Ernst & Young for the audit working papers. Ernst & Young said it was unable to do so; the audit had been done by its affiliate on the mainland, which had invoked the same arguments being used against the SEC. SFC took the case to Hong Kong courts, and a decision is expected in early 2013. Because of the importance of Chinese listings to the Hong Kong market, it is viewed to be unlikely that this case would lead to the same consequences as in the United States.

…and whilst it has its own issues with auditor working papers, the consequences are likely to be different

Prospects for Agreement

Both Chinese and U.S. regulators and politicians may be willing to let this issue play out. Unlike other potential areas of confrontation, the damages from kicking Chinese companies off of U.S. exchanges can be well contained. In reality, no one may be hurt. The companies are largely unaffected. Shareholders may prosper if the company is relisted in Hong Kong and the shares trade at a higher value because of the resolution of this overhang. Investment banks, lawyers, and accountants will prosper from the relisting or going private process. While the U.S. exchanges will lose Chinese listings, and the actions may cause other foreign companies to pause before listing on U.S. markets, the exchanges can argue they have the highest standards in the world.

The damage could be well contained and it could be that no-one will get hurt

The biggest risk is to China. If Chinese entrepreneurs are unable to obtain access to capital, indigenous innovation may suffer, and China's long-term competitiveness may be affected. Chinese stock exchanges are not ready to replace U.S. markets for entrepreneurial companies. The CSRC recently announced it was liberalizing rules for Chinese companies to list overseas, motivated in part by a huge backlog of pending IPOs in China.

China will be the biggest loser in that another avenue to capital for private entrepreneurs will be closed

The only scenario that resolves the situation without kicking Chinese companies off of U.S. stock exchanges is where the United States and China reach a diplomatic solution. From the U.S. perspective, the PCAOB and the SEC have likely put their best offer on the table. Both regulators are bound to follow U.S. laws, which generally require them to regulate auditors as they have proposed. A law change seems unlikely, given it would propose a lower standard for Chinese companies than that imposed on other companies, including American companies. James Doty has pointed out that the Supreme Court case that upheld the constitutionality of the PCAOB established that the PCAOB is in a reporting line to the President, but it is unlikely, and perhaps not legally possible, for the President to settle the dispute in another fashion.

The US has put its best offer on the table and any further compromise would require a change of law

Investors should watch this situation closely. The market is likely to move significantly if the issue is either resolved or the likelihood of deregistration and delisting increases.

Watch this space….