Why the audit fight between regulators will hurt China

The Big Four accounting firms have ignored requests to submit auditing papers to the US Securities and Exchange Commission because it violates Chinese law, but as Paul Gillis points out, China will lose out unless a compromise is found

The US Securities and Exchange Commission (SEC) shook markets for US-listed Chinese companies last December when it charged the Big Four accounting firms and BDO with violations of US securities laws for refusing to give audit working papers to the SEC. In a separate case, the SEC is suing Deloitte in federal court to get the audit working papers on Longtop Financial Technologies, a Deloitte client that collapsed under fraud allegations.

Separately, the Public Company Accounting Oversight Board (PCAOB) has been blocked from inspecting Chinese accounting firms that audit US listed companies.

China has blocked the accounting firms from turning over working papers to the SEC and has not allowed the PCAOB to come to China. China considers that allowing foreign regulators to enforce foreign law against Chinese people on Chinese soil to be a violation of its sovereignty. National secrets may also be at play. China has an expansive definition of national secrets and recent allegations of corruption have landed too close to the powerful.

China considers that allowing foreign regulators to enforce foreign law against Chinese people on Chinese soil to be a violation of its sovereignty

Paul Gillis, Peking University

Hong Kong has its own version of this problem. The Securities and Futures Commission sued Ernst & Young for audit working papers on a failed IPO. Ernst & Young demurred, pointing out that its mainland affiliate who actually did the work could not supply the papers because of Chinese restrictions.

The SEC says it seeks to censure the firms or ban them from auditing US listed companies. If the PCAOB is unable to quickly negotiate access to inspect the firms, it too may seek to prevent the accounting firms from auditing US listed companies. That could lead to a disaster for the clients of these firms, since an auditor is required for a company to keep its listing. If all the Chinese auditors are banned, all of the US listed Chinese companies may be kicked off the US stock exchanges.

Unless Chinese officials blink, delisting of Chinese companies from US exchanges is an increasingly likely outcome

US multinationals (MNCs) are also threatened by this action. In order for an auditor to play a substantial role in the audit of a US MNC, it must be registered with the PCAOB. Should the PCAOB move to deregister all Chinese accounting firms, US MNCs may have difficulty getting their China operations audited. Caterpillar's recent accounting troubles in China have shown that shareholders of MNCs face some of the same risks as investors in Chinese companies.

Both China and the US have reasonable positions. China has the right to control what goes on within its borders, free of interference from other nations. The US is right to demand that companies that seek capital on US markets play by US rules. The SEC and the PCAOB are charged with enforcing US securities laws and can hardly back down.

Some Chinese officials have indicated that overseas listed Chinese companies should come home to list. That is simply not practical. China's own stock markets reopened in 1990 principally to help restructure state-owned enterprises. Only recently have privately owned companies had meaningful access to these markets. ChiNext, the NASDAQ of China, has grown spectacularly since its launch in 2009, but with thousands of companies in the pipeline, it will likely be a decade before it is able to meet the capital needs of China's growing entrepreneurial companies.

Unless Chinese officials blink, delisting of Chinese companies from US exchanges is an increasingly likely outcome. Some companies would likely seek to move their listings to Hong Kong and others may follow the lead of other Chinese companies and go private. Others may just go dark, stopping communications with shareholders and wiping out their investments.

It is up to China to decide. If it is unwilling to compromise, China's entrepreneurial companies may lose access to needed capital, which could significantly damage indigenous innovation with long-term negative effects on China's economy.

Perhaps some of China state-owned enterprises are too sensitive to allow foreign regulators to pour over their records. China should not allow those companies to list abroad. China, however, should not interfere with the ability of its private companies in non-sensitive sectors to raise capital abroad, and should allow these companies to subject themselves to foreign regulation as a private matter.

Paul Gillis, Peking University, Beijing