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"Accounting Cliff" Looms for Public Companies with Operations in China

By Thomas M. Shoesmith

The Public Company Accounting Oversight Board (PCAOB) has been trying to exercise its oversight responsibilities with regard to registered accounting firms in China for years, but so far has been prevented from doing so by PRC authorities. If the PCAOB cannot complete its inspections of these firms by December 31, the firms may be deregistered, and U.S.-listed companies with operations in China could find themselves with a new reason to fear they will not be able to comply with their obligation to file audited financial statements with the Securities and Exchange Commission. Meanwhile the SEC's brief filed in the Deloitte case paints a gloomy picture of any possible agreement with the Chinese authorities.

There are hundreds of U.S. public companies whose principal operations are in China. All of them must file financial statements with the Securities and Exchange Commission (SEC), and certain of those financial statements must be audited by an accounting firm registered with the PCAOB. Often the accounting firm is the PRC affiliate of an international accounting firm.

The PCAOB was established under the Sarbanes-Oxley Act and its members are appointed by the SEC. As board member Lewis Ferguson recently noted, the PCAOB was created in response to the "systemic and undetected financial and accounting fraud" involved in the Enron, WorldCom, and other scandals of the early 2000s. There are now 2,380 audit firms registered with the PCAOB, including 915 firms located outside the United States. The largest number of foreign firms registered with the PCAOB are Chinese: 52 firms in Hong Kong and 48 in the People's Republic of China.

The PCAOB has cooperative agreements with 14 foreign regulators (in Australia, Canada, Dubai, the UK, Germany, Israel, Japan, the Netherlands, Norway, Korea, Singapore, Spain, Switzerland and Taiwan). There is no cooperative agreement with the China Securities Regulatory Commission (CSRC) or the PRC Ministry of Finance, the bodies with regulatory authority over accounting firms in the PRC.

The PCAOB has been trying to conduct inspections of accounting firms located in the PRC for many years. Absent a cooperative agreement with the Chinese authorities, however, the PCAOB is barred from conducting any inspections in China. Meanwhile the problems with U.S.-listed Chinese companies have mounted. More than 65 China-based issuers have had their auditors resign, and 126 issuers have either been delisted from U.S. securities exchanges or "gone dark," according to the PCAOB.

The "Accounting Cliff"

The PCAOB is facing a December 31 deadline to complete its international inspections—including inspections of Chinese accounting firms. The deadline has been extended once before, from December 31, 2009. If it is not extended again, or if the regulators don't work out a compromise, on January 1, there will be no PCAOB-registered Chinese accounting firms.

Representatives of the PCAOB and the Chinese authorities have been meeting at least since last year to find a way to avoid this "accounting cliff." In addition to Chinese concerns about sovereignty, much of what the PCAOB needs to inspect are regarded as "state secrets" in China. It is possible Beijing does not want foreign regulators inquiring into the finances of Chinese companies because of fears that further wrongdoing will be uncovered. And, it is even possible Beijing is willing to allow companies to face difficulties maintaining foreign listings as a way to make China's own exchanges more attractive.

A tentative deal between the SEC, the PCAOB, the CSRC and the Ministry of Finance was reported in the press in mid-2011, but it never materialized. Talks continued and this month, there are once again reports of a tentative deal. But again, so far it has not materialized.

All of this is in the context of the SEC's own dramatic move against five Chinese accounting firms—the PRC member affiliates of the Big Four plus BDO—when it commenced administrative proceedings to force the disclosure of work papers or ban the firms from practicing before the Commission. A separate Client Alert describing the SEC's December 4, 2012 action appears here.

What happens if there is no deal?

Unless the December 31 deadline is extended, if there is no deal, then on January 1, 2013, no Chinese accounting firm will have an active registration with the PCAOB. None of those firms therefore could sign an audit report for a U.S. reporting company. With annual reports for fiscal year-end companies due in a few months, this would be a disaster for China-based issuers.

Could issuers convince their international accounting firms to have an office outside the PRC perform their audits? Perhaps, although if more than 20% of the issuer's operations are in China, the non-PRC accounting firms are not permitted to rely on their Chinese affiliates' background work unless those affiliates are also PCAOB-registered. If we go over the cliff, they won't be.

Conceivably an international firm could detail enough personnel to China from other offices around the world to complete their work without relying on their PRC affiliates. This would require hundreds if not thousands of accountants to fly into China. Even discounting the expense to the issuers, there is some question whether Chinese immigration authorities might find it inconvenient, under the circumstances, to process such a tsunami of visa applications in time to permit annual reports to be timely filed with the SEC.

Meanwhile, Back at the SEC

The SEC has clearly signaled its position on this subject.

In addition to the December 3, 2012 initiation of regulatory proceedings against five PRC accounting firms, on the same day the SEC filed a strongly worded brief in its U.S. District Court action against Deloitte Touche Tohmatsu CPA, Ltd., the PRC affiliate of the Big Four accounting firm. The background of that case is summarized in a previous client alert.

The SEC's December 3, 2012 brief was both blunt and exhaustive. In the brief and attached declarations, the SEC laid out its decades-long history of government-to-government attempts to reach agreement on information sharing with the CSRC. That history starts in 1994 with a bilateral Memorandum of Understanding Regarding Cooperation, Consultation and the Provision of Technical Assistance, dated April 28, 1994. The bilateral MOU was "aimed at facilitating the provision of technical assistance and training," but not "cross-border enforcement cooperation," according to a declaration attached to the SEC's December 3 brief. In that sense it was different from the MOUs signed by the SEC with securities regulators in 20 other countries, which did address enforcement cooperation.

Then, in May 2002, the SEC, the CSRC and almost 90 other securities regulators signed a Multilateral Memorandum of Understanding Concerning Consultation and Cooperation and the Exchange of Information, under the auspices of the International Organization of Securities Commissions (IOSC). Among other things, the IOSC MMOU contains a "representation" from the signatories that "no domestic secrecy or blocking laws or regulations" should prevent the collection of information sought by another signatory in the course of enforcing the requesting country's laws. But again, the document contained no enforceable commitment to cooperate in cross-border enforcement actions.

Four years later, on May 2, 2006, the SEC entered into Terms for Cooperation and Collaboration with the CSRC to "establish parameters for a high-level regulatory dialogue" between the two countries. The SEC has similar "terms of reference" with other countries as well. In some ways, these are only agreements to talk, however, and do not resolve the underlying problem.

Thus the upshot of more than 12 years of government-to-government talks is that there is still no definitive agreement to cooperate in actual enforcement actions.

Meanwhile, the SEC has persisted in making requests for cooperation from the Chinese authorities. A separate declaration from Alberto Arevalo, an Assistant Director in the SEC's Office of International Affairs, filed with the SEC's December 3 brief, sets out "twenty-one (21) requests for assistance [sent to the CSRC] in connection with sixteen (16) different ongoing investigations … including three requests for audit work papers." The declaration said "the SEC has not received … meaningful assistance from the CSRC" in any of the investigations. Assistant Director Arevalo goes on to detail two additional years of consultations between the SEC and the CSRC, including a November 26, 2012 meeting in Washington, D.C. He then concludes, without mincing words, that "[n]one of the recent events, including the CSRC's recent communications and productions of documents, have changed the SEC staff's view that the CSRC is not now a viable gateway for the production of audit work papers, and there is no reason to expect it will become one in the foreseeable future."

The SEC's conclusion was unequivocal: "DTTC [Deloitte's China member firm] chose to expose itself to U.S. law by registering with the PCAOB and conducting audits of an issuer of securities registered with the SEC and traded on U.S. Securities Exchanges. DTTC financially benefitted when it helped that issuer raise hundreds of millions of dollars from U.S. investors." If doing so exposed DTTC to conflicts with regulators

in its home country, that is not the SEC's problem: "The party that should bear the consequences of that decision is the audit firm, not the SEC and not U.S. investors." DTTC itself has filed lengthy and persuasive arguments to the contrary, of course, but as an indication of the SEC's policy position, this brief could not be clearer.

As if this filing were not enough to absorb on December 3, on the same day, in a speech before the American Institute of CPAs (AICPA), SEC Commissioner Aguilar emphasized the importance to the markets of reliable information, and the role of the accounting profession in promoting that confidence. Commissioner Aguilar then came right to the point. "The PCAOB's inability to inspect the Chinese operations of registered accounting firms is a particular problem, given the number of claims in recent years regarding potential fraud or other irregularities at China-based companies traded on U.S. markets," he said. Commissioner Aguilar then said out loud what everyone has been worrying about. "If these [PRC audit] firms are unable or unwilling to comply with U.S. law, the question to ask is whether the companies they audit should be allowed to trade in the U.S. securities markets."

In short, the SEC and the PCAOB seem to have drawn a line in the sand: if an audit firm or an issuer wants the benefits of participating in the U.S. securities market, they must comply with requests for information by U.S. securities regulators—even if they are almost 7,000 miles away in China.

Bated Breath

The accounting firms and their clients can only wait to see if the SEC, the PCAOB and their Chinese counterparts will reach an agreement, perhaps on joint inspections, or perhaps to allow the PCAOB to observe the Chinese regulators observing audit firms in China. No doubt there is some brinksmanship going on. In the meantime, issuers should begin planning for what may happen if no deal is reached.

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors below.

Thomas M. Shoesmith (bio)
Silicon Valley
+1.650.233.4553
thomas.shoesmith@pillsburylaw.com