BORDER CONTROL

As U.S. and Chinese officials look to break the deadlock over extra-territorial inspections of auditors, a Hong Kong firm is caught in the middle. Teresa Lee investigates

Illustrations by Tree Tree Tes

Zhonglei (HK) C.P.A. Co. Limited, a Hong Kong accounting firm, unexpectedly found itself in the spotlight after its application to become a registered auditor in the United States was rejected in June.

It became the first Greater China firm to be blocked since the Public Company Accounting Oversight Board – the U.S. watchdog that inspects auditing firms – tightened its rules last October. It was a move aimed at encouraging foreign governments, including China, to agree to allowing inspections of their audit firms by U.S. regulators.

There's nothing to suggest that the U.S. regulators found any flaws with Zhonglei's integrity or competence. Zhonglei in Hong Kong is affiliated with the Beijing-based Zhonglei, which is already registered with the PCAOB. The problem, the PCAOB told the firm, was that Chinese law prevented the board from inspecting Zhonglei's work for companies based in China.

According to the October rule change, any non-U.S. auditing firms seeking to register with the PCAOB must provide it with statements confirming whether local law or local authorities would allow the firms to be inspected by the board. Zhonglei was unable to provide such statements. "We don't even know whom to ask for the statements," says Ricky Ho, a director at Zhonglei.

In response, the board declined Zhonglei's application. "In light of the apparent obstacles to PCAOB inspections of audit work that Zhonglei may perform for issuers with operations located in the Chinese mainland, the board is unable to determine that approval of Zhonglei's registration application would be consistent with the board's responsibilities … to further the public interest in the preparation of informative, accurate and independent audit reports," the PCAOB told Zhonglei.

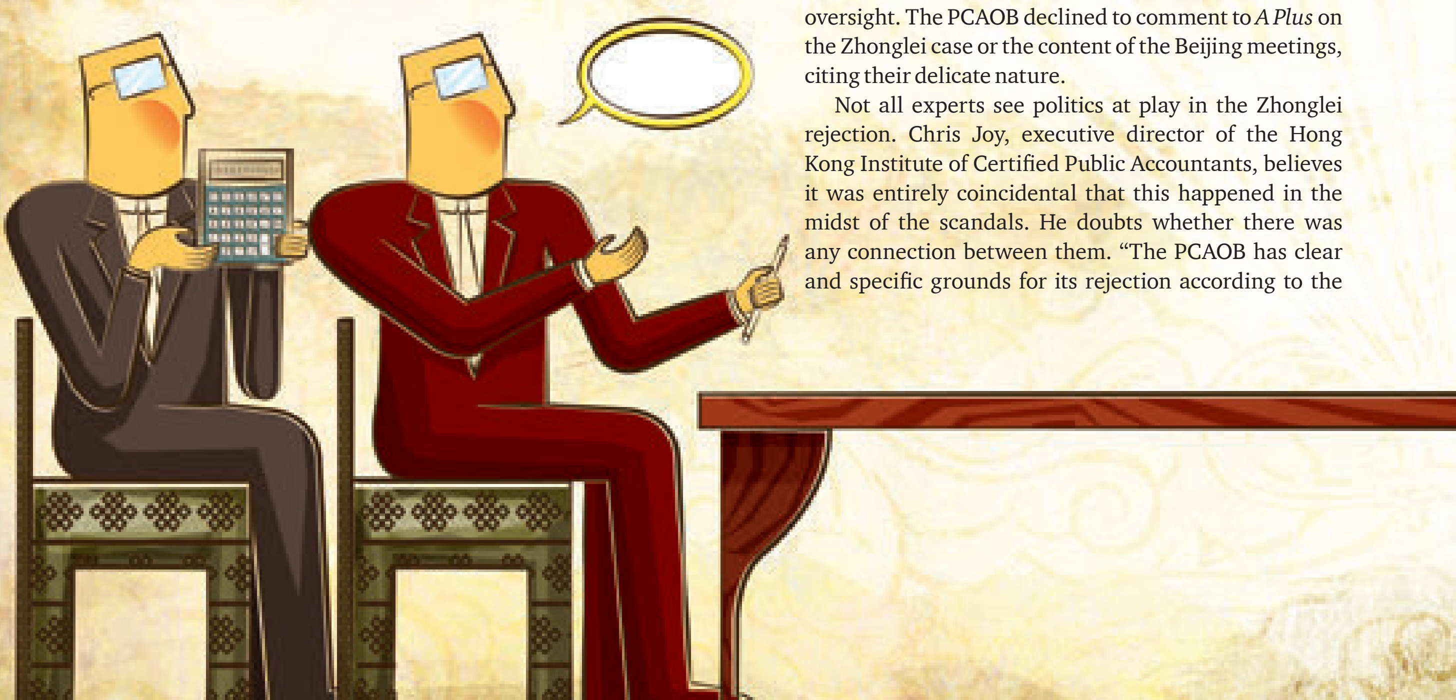
Whether it was a coincidence or not, the tighter rule took effect at a time when many Chinese companies that had listed in the U.S. by way of reverse mergers were getting in trouble. Many of them had to suspend trading or delist because of accounting irregularities and auditor resignations.

"The rule was intended to put pressure on China. Zhonglei just happened to be the first firm to challenge the rule. The PCAOB had little choice but to reject its application," says Paul Gillis, a visiting professor of accounting at Peking University's Guanghua School of Management. "Zhonglei was a victim of PCAOB frustration with Chinese authorities."

Since 2007 the PCAOB has sought the right of U.S. regulators to inspect Chinese auditing firms that have audited U.S.-listed companies. Beijing has so far resisted these advances, citing concerns about sovereignty, national security and commercial secrecy, among other reasons. But the recent spate of financial irregularities and alleged misconduct involving U.S.-listed, China-invested companies has heightened the pressure on U.S. regulators to take action.

In July, officials from the PCAOB and Securities and Exchange Commission held talks in Beijing with China's Ministry of Finance and the China Securities Regulatory Commission to discuss issues relating to auditing oversight. The PCAOB declined to comment to *A Plus* on the Zhonglei case or the content of the Beijing meetings, citing their delicate nature.

Not all experts see politics at play in the Zhonglei rejection. Chris Joy, executive director of the Hong Kong Institute of Certified Public Accountants, believes it was entirely coincidental that this happened in the midst of the scandals. He doubts whether there was any connection between them. "The PCAOB has clear and specific grounds for its rejection according to the



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statement issued in October 2010," he says. "I don't see any other reason beside that."

The PCAOB had already warned that it might take action against auditors from jurisdictions that didn't permit inspections. "Since 2004 the board has approved registration applications of non-U.S. firms with the expectation that any potential obstacles to inspections would be resolved," the PCAOB's then acting chairman, Daniel Goelzer, said in October. "The continuing obstacles to inspections in some jurisdictions have forced us to re-evaluate that approach to registration."

According to Joy, at least three Hong Kong auditing firms have approached the Institute since the rule change for help with the statements requested by PCAOB on whether an inspection by U.S. regulators would be permitted. Zhonglei was not among them. In all cases the Institute helped the firms concerned, but it is not yet known if the applicants have received PCAOB approval because at the time of this writing none had yet appeared on the PCAOB's approved list.

The Institute told the firms that, as the statutory regulator of auditors in Hong Kong, it is comfortable working with overseas regulators and is open to discussing collaboration with any overseas regulator and that there are no impediments to overseas regulators arranging inspection visits to Hong Kong audit firms. But it stopped short of providing the PCAOB with explicit inspection access into the territory.

Joy says that restrictions on access to audit working papers imposed by mainland laws and regulations also apply to working papers of Hong Kong firms that work on the mainland operations and activities of their clients. He stresses that the Institute can make no representations on behalf of the mainland authorities.

Ho says that, while he is disappointed at the decision against Zhonglei, "there is nothing we can do but to accept the reality." Asked if he feels that the firm was caught in a political storm, Ho concedes that the decision came at a particularly delicate time. "The PCAOB is doing its job to protect investors, which is good," he says. "It is doing its part to maintain the quality of the U.S. markets."

The PCAOB: now and then

Formed in 2002 by the Sarbanes-Oxley Act after the collapse of Enron, the PCAOB is a not-for-profit corporation established by the U.S. Congress to regulate and inspect the audits of public companies in order to protect investors' interests. Auditors of U.S.-listed companies must register with the board. More than 900 non-U.S. auditing firms from 87 jurisdictions have registered to date. These include 54 in China and 56 in Hong Kong.

One of the biggest challenges facing the PCAOB in the past few years has been the oversight of multinational audits. Currently, an audit report that is signed by a U.S.

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company may be based on the work of affiliated firms that are separate legal entities in other countries. Should the PCAOB find misstatements or inconsistencies in those reports, it is often hamstrung by a lack of access to data and limits to what it can do.

To remedy the situation, the PCAOB has been discussing joint inspections with other countries and has recently signed agreements with authorities in Switzerland and the United Kingdom. The PCAOB has also been paying attention to China, given the high U.S. market interest from mainland Chinese companies because of difficulties in raising domestic funds.

According to PCAOB research, more than 200 Chinese companies were listed in the U.S. between the start of 2007 and the end of the first quarter of 2011. Nearly three-quarters were brought to the market through reverse mergers, hence bypassing the great scrutiny of an initial public offering. This compares with more than 50 IPOs. Reverse mergers by Chinese businesses accounted for more than a quarter of all backdoor listings in the U.S. in that period, while the rest involved primarily U.S. companies.

Although the fact that many Chinese companies opting for backdoor listings may not be a concern in itself, recent enforcement actions against a large number of Chinese reverse-merger entities have put pressure on both the PCAOB and the U.S. Securities and Exchange Commission.

Since December 2010 more than 25 listed Chinese companies have disclosed auditor resignations or accounting problems to the SEC. At least eight registrations have been revoked, nearly all of which were the result of reverse mergers. The Bloomberg Chinese Reverse Mergers Index, which tracks 78 companies that gained a U.S. listing through the back door, plunged about 44 percent in the first seven months of this year.

The PCAOB has repeatedly raised concerns about the quality of some of the audits and has stressed how important it is for the board to conduct inspections in China. "If Chinese companies want to attract U.S. capital for the long term, and if Chinese auditors want to garner the respect of investors, they need the credibility that comes from being part of a joint inspection process that includes the U.S. and other similarly constituted regulatory regimes," said James R. Doty, chairman of the PCAOB.

Gillis says the CSRC's current proposition – that the PCAOB should rely on the Chinese regulator's work – has significant flaws because the CSRC is unable to fulfill the PCAOB role regarding Chinese and Hong Kong firms. According to Gillis, the regulatory power of the CRSC extends only to auditing firms that also possess securities licences. But none of the Chinese registrants with the PCAOB has such a licence and is therefore not subject to CSRC inspections. CSRC inspections also do not apply to overseas-listed Chinese companies.

Hong Kong auditing firms, meanwhile, are subject to regulation by the Institute through its practice review programme and disciplinary proceedings. The Financial Reporting Council initiates investigations into auditors of listed companies on the basis of complaints but does not discipline or prosecute.

Another shortcoming, Gillis says, is that most Chinese examiners are unlikely to be familiar enough with PCAOB rules or U.S. accounting standards to inspect the audits of U.S.-listed companies.

Zhonglei, meanwhile, seems content to let the storm pass by. "We thought there would be no harm in getting the registration, because more companies are hoping to be listed in the U.S.," Ho explains. "Even though we don't need it now, we thought we might need it one day." Ho says Zhonglei has given up its attempt to register with the PCAOB. Instead, the two-year-old firm, which has no business in the U.S., plans to focus on Hong Kong and the mainland. A