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The Pros And Cons Of US-China Auditing Oversight Deal

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(September 21, 2022, 5:45 PM EDT)

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Due to a recent agreement between the Public Company Accounting Oversight Board and Chinese securities regulators, many U.S. exchange-listed companies audited by accounting firms based in mainland China and Hong Kong may be able to continue trading on U.S. exchanges, preserving liquidity for investors and ongoing access to U.S. capital markets.

However, this agreement could lead to an increased enforcement risk through more regulatory inquiries.

In recent years, securities regulators, Congress and the public have expressed concern about ensuring that certain public companies — those that trade on U.S. exchanges while being domiciled outside the U.S. — abide by the rigorous regulatory requirements intended to protect American investors.

Recent attention has been directed at public companies and accounting firms based in the People's Republic of China and Hong Kong, where the PCAOB has historically been limited in its ability to ensure that audits of companies listed on U.S. exchanges are being conducted in accordance with PCAOB standards and other applicable regulatory requirements.

This is not a small subset of companies; today, 249 China-based companies' securities trade on U.S. exchanges, with a total market cap of approximately $915 billion.[1]

Partially as a result, and against the backdrop of an increasingly fraught U.S.-PRC relationship, Congress enacted the Holding Foreign Companies Accountable Act in 2020 to restrict access to the U.S. capital markets by foreign public companies whose financial statements are audited by accounting firms that the PCAOB is unable to fully inspect due to interference by a foreign government.

A growing number of PRC- and Hong Kong-based public companies appear wary of continued listing on U.S. exchanges or have transitioned their primary listings to the Hong Kong Stock Exchange.[2] Other such companies with a primary listing on a U.S. exchange have tried to avoid delisting pursuant to the HFCAA by switching to

U.S.-based auditors.[3]

On Aug. 26, the PCAOB announced a statement of protocol agreement, or SOP, with the China Securities Regulatory Commission and China's Ministry of Finance regarding cooperation in the oversight of PCAOB-registered public accounting firms in the PRC and Hong Kong, which could prove to be a monumental step forward in the cooperation between the PCAOB and PRC regulators.

U.S. Securities and Exchange Commission Chair Gary Gensler said the agreement "marks the first time we have received such detailed and specific commitments from China that they would allow PCAOB inspections and investigations meeting U.S. standards."[4]

If the SOP is fully implemented and adhered to by PRC authorities, then many public companies audited by PRC- and Hong Kong-based accounting firms may be able to avoid the trading prohibition on U.S. exchanges that the HFCAA would otherwise impose and preserve liquidity for their investors and ongoing access to America's deep capital markets.

PCAOB Newly Empowered to Ensure Audit Quality in PRC and Hong Kong

Congress established the PCAOB through the Sarbanes-Oxley Act in 2002 to provide oversight of the audits of public companies listed on U.S. exchanges. Its authority includes the registration, inspection and investigation of audit firms, including firms located in foreign jurisdictions that are engaged to conduct audits of foreign companies listed on U.S. exchanges.

With respect to accounting firms headquartered in foreign jurisdictions, the PCAOB typically enters into cooperative arrangements with foreign regulators, and it works with foreign regulators to address any concerns regarding data protection, state secrecy or other sensitive substantive concerns.

For jurisdictions other than the PRC and Hong Kong, the PCAOB has been able to address foreign regulators' concerns in a way that is compatible with its core mission. In the PRC and Hong Kong, however, the road to the SOP has been a long one. In 2013, the PCAOB entered into a memorandum of understanding with PRC authorities that was intended to establish a framework for future cooperation.

Despite the memorandum, the PCAOB has repeatedly stated that it has received insufficient cooperation to conduct full inspections and investigations of audit firms in the PRC and Hong Kong.

The new SOP seeks to establish a method for the PCAOB to conduct inspections of PCAOB-registered public accounting firms in the PRC and Hong Kong, as contemplated by SOX. Specifically, the SOP includes assurances from PRC authorities on issues that have historically hindered the PCAOB's ability to conduct its inspections and investigations:

- The PCAOB has sole discretion to select the firms, audit engagements and potential violations it inspects and investigates with neither consultation with, nor input from, PRC authorities.

- PCAOB inspectors and investigators can view complete audit working papers without redaction, and the PCAOB can retain information as needed.

- The PCAOB has direct access to interview and take testimony from all personnel associated with the audits that the PCAOB inspects or investigates.

- The PCAOB can transfer information to the SEC, and the SEC can use the information for all SEC purposes, including administrative or civil enforcement actions.[5]

PCAOB inspectors were slated to begin their on-site inspections in mid-September, which would include access to all necessary audit working papers. By the end of 2022, the PCAOB must determine whether it can complete inspections and investigations of public accounting firms headquartered in the PRC and Hong Kong as required by SOX and, thus, reassess whether such public accounting firms continue to present the concerns that the HFCAA was intended to address.

Increased Regulatory Investigations and Enforcement Actions Are Likely

The SOP is a significant sign of potential cross-border cooperation. As part of the PCAOB's work to ensure that investors in public companies can rely on quality audits, it will investigate the competency and conduct of accounting firms and professionals in the PRC and Hong Kong. The PCAOB has settled disciplinary orders with accountants and accounting firms around the world based on information learned during inspections.[6]

PCAOB inspectors and investigators may also determine that there is reason for the SEC or the U.S. Department of Justice to investigate not only the accounting firms over which the PCAOB has jurisdiction, but also the public companies whose audits the PCAOB will now be able to thoroughly inspect. If the PCAOB inspections uncover material compliance issues, enforcement actions by the SEC and DOJ could result from PCAOB referrals.[7]

Auditor working papers, and an auditor's record of the accounting judgments made by the public company that could be memorialized in those working papers, may also reveal possible accounting irregularities in a public company's financial statements and result in additional regulatory scrutiny or action.

Over the last 15 years, multiple PRC companies have been subjected to enforcement actions and investigations by regulators relating to accounting issues.[8] These past issues may fuel ongoing skepticism from U.S. regulators toward PRC- and Hong Kong-based public companies.

Thus, an increasing number of investigations is likely, especially given the emphasis on enforcement at both the DOJ and the SEC — indeed, enforcement is an essential part of the mission statement of both organizations. There will also be a greater number of PRC- and Hong Kong-based public companies whose accounting firms' audits will now be subject to scrutiny.

Such investigations can lead not only to enforcement actions, but often are followed by securities class action and shareholder derivative lawsuits. If a public company's auditor is subject to PCAOB sanctions or the company is made aware of significant concerns about its auditor's quality control standards, then the public company may want to consider conducting thorough internal investigations to address possible compliance shortfalls, while regulators assess remediation in their enforcement decisions.

Even if these investigations do not lead to enforcement actions, PRC- and Hong Kong-based U.S. public companies and their executives should be prepared for the time, expense and scrutiny of a potential US regulatory inquiry.

Key Takeaways and Suggestions

The SOP is a breakthrough in cooperation between the two nations, and should allow PRC- and Hong Kong-based U.S. public companies to avoid delisting pursuant to the HFCAA. Despite the extremely positive nature of this aspect of the SOP for these companies, the level of PCAOB access that the SOP entails warrants preparation by PRC- and Hong Kong-based auditors and public companies for increased scrutiny and possible enforcement risk.

Auditor Considerations

From the auditor's perspective, if actions by PRC authorities match their commitment under the SOP — PCAOB Chair Erica Y. Williams has noted that the agreement, at present, is merely "on paper"[9] — the PCAOB's improved access may require additional preparation and planning.

If an issuer chooses to engage a U.S.-based accounting firm, that newly engaged firm will be expected to obtain prior-year working papers and "should still also make inquiries of the predecessor accounting firm about certain matters," including, among other things, integrity, management disagreements, audit committee communications, unusual or significant transactions, and the reason for the change in auditors.[10]

On the other hand, issuers who maintain accounting firms not based in the U.S. should recognize that the firm's audit staff likely has not previously been subject to full PCAOB inspections and investigations.

Thus, preparation for an inspection is advisable, and could include coordination with U.S. affiliates or secondments by U.S. audit partners familiar with the PCAOB's process to select and perform its inspections, such as the level of engagement necessary from audit partners with inspectors and the types of informational requests made to audit personnel.

Among other things, these firms must ensure that their personnel cooperate with PCAOB inspectors and make all requested working papers available to them because the PCAOB requires and takes into consideration cooperation during its inspections and investigations.

In addition, the PCAOB has signaled that it may seek to conduct inspections of prior years' audits given the restrictions that it faced prior to the new SOP. As such, PRC- and Hong Kong-based accounting firms should be prepared for inspections of prior-year audits and requests for accompanying working papers by the PCAOB.

Public Company Considerations

From a public company's perspective, PCAOB inspections under the SOP may result in regulatory or disciplinary actions against an accounting firm that the public company engaged and could result in heightened scrutiny of its financial statements and other public disclosures. Public companies should pay particular attention to three areas that remain a focus of SEC and DOJ enforcement:

1. Ensure a robust set of internal controls and regularly confirm compliance with them.

2. Maintain a culture of compliance, which includes, among many other things, open, honest, and fulsome communication and coordination with external auditors.

3. Maintain and regularly ensure the maintenance of books and records that accurately and completely

reflect the company's financial information.

Finally, PRC- and Hong Kong-based companies should also be aware that the SEC and DOJ — like the PCAOB — expect and take into consideration cooperation.

If PRC- and Hong Kong-based auditors and U.S. exchange-listed public companies proactively take steps to address the potential issues discussed, they may be able to significantly limit the discomfort associated with a U.S. regulatory inquiry.

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[1] Stock Market MBA, List of Chinese Companies that trade on U.S. stock exchanges. https://stockmarketmba.com/chinesecompaniesthattradeonusexchanges.php.

[2] Al Barbarino, 5 State-Owned Chinese Cos. To Delist From NYSE, Law360 (Aug. 12, 2022). https://www.law360.com/articles/1520603/5-state-owned-chinese-cos-to-delist-from-nyse.

[3] Brian Yang, Chinese Firms' Delisting Uncertainty Lifted For Now But Clock Ticking, Scrip (Aug. 29, 2022). https://scrip.pharmaintelligence.informa.com/SC146962/Chinese-Firms-Delisting-Uncertainty-Lifted-For-Now-But-Clock-Ticking.

[4] Chair Gary Gensler, US Sec. & Exch. Comm'n, Statement on Agreement Governing Inspections and Investigations of Audit Firms Based in China and Hong Kong (Aug. 26, 2022). https://www.sec.gov/news/statement/gensler-audit-firms-china-hong-kong-20220826.

[5] Pub. Co. Accounting Oversight Bd., Fact Sheet: China Agreement (Aug. 26, 2022); US Sec. & Exch. Comm'n, Fact Sheet: PCAOB Agreement with China on Audit Inspections and Investigations. https://pcaobus.org/news-events/news-releases/news-release-detail/fact-sheet-china-agreement, https://www.sec.gov/files/china-sop-fact-sheet.pdf.

[6] Pub. Co. Accounting Oversight Bd., Enforcement Actions. https://pcaobus.org/oversight/enforcement/enforcement-actions?enforcementordertypes=Settled%20Disciplinary%20Order.

[7] Rule 5112 allows the PCAOB to refer any investigation to the SEC and, at the direction of the SEC, to DOJ.

[8] For example, in March 2014 the SEC charged PRC-based AgFeed Industries, Inc. and its senior executives with accounting fraud, alleging that the company maintained two sets of financial information and that the "real set" reflected revenues that were hundreds of millions of dollars lower than the amounts reported by the company. See US Sec. & Exch. Comm'n, SEC Charges Animal Feed

Company and Top Executives in China and U.S. With Accounting Fraud (Mar. 11, 2014). More recently, in December 2020, PRC-based Luckin Coffee Inc. agreed to pay a $180 million penalty to resolve charges brought by the SEC, which alleged that, from at least April 2019 through January 2020, Luckin fabricated more than $300 million in retail sales by using related parties to create false sales transactions. US Sec. & Exch. Comm'n, Luckin Coffee Agrees to Pay $180 Million Penalty to Settle Accounting Fraud Charges (Dec. 16, 2020). The accounting issues for both of these companies highlight the importance of quality audits.

[9] Pub. Co. Accounting Oversight Bd., PCAOB Chair Williams Statement Regarding Agreement with Chinese Authorities, YouTube (Aug. 26, 2022). https://www.youtube.com/watch?v=SWTn2J_yb3s&feature=youtu.be.

[10] US Sec. & Exch. Comm'n, Statement of Paul Munter, Audit Quality and Investor Protection under the Holding Foreign Companies Accountable Act (Sept. 6, 2022).