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**Testimony before the
U.S.-China Economic and Security Review Commission on
*China's Financial Conditions and Their Impacts on U.S. Interests***

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Commissioners Cleveland and Goodwin, and other members of the Commission, thank you for giving me the opportunity to participate in today's hearing. My name is Cindy Fornelli, and I am Executive Director of the Center for Audit Quality (CAQ).

Based in Washington, D.C., the Center for Audit Quality is an autonomous public policy organization created to serve investors, public company auditors and the capital markets. The Center's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the audit profession's core values of integrity, objectivity, honesty and trust. Our Governing Board consists of leaders from the public company audit profession, the American Institute of Certified Public Accountants (AICPA), as well as individuals representing the issuer, investor and academic communities. Our primary members are U.S.-based accounting firms that are registered with the Public Company Accounting Oversight Board (PCAOB). My testimony represents the views of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

My testimony today will focus on an unresolved issue between the United States and China regarding the sharing of audit working papers that is playing out in two separate contexts. The first involves the production by China-based audit firms to the U.S. Securities and Exchange Commission (SEC) of working papers relating to audits of China-based companies the securities of which are traded in the United States. The second involves the ability of the PCAOB to inspect PCAOB-registered accounting firms located in China. The CAQ believes that it is critically important that the United States and China reach agreement to settle this unresolved issue because of the potential harm to U.S.-listed companies and their investors.

The CAQ's views on this matter are rooted in our belief that the independent public company audit is a key information and quality component of the U.S. capital market system. The independent audit provides "reasonable assurance," based on management's own assertions that the financial statements are fairly presented in all material respects and, accordingly, capital market participants often consider audited financial statements in connection with investment activity. As such, the audit is part of the foundation for confidence in the U.S. capital markets. Another core piece of this foundation is the strength and maturity of the U.S. regulatory system, including the SEC and the PCAOB.

Today I will discuss a brief overview of the audit requirements for U.S.-listed companies. Then I will discuss the U.S. oversight system for audit firms, because these are critical to understanding

the matters at the heart of the unresolved issue between the United States and China. I will also briefly explain how multinational audits are conducted and the role that firms affiliated with a global network may play in the audits of multinational companies.

Role of the SEC

The securities laws and SEC rules and regulations require that all companies that have securities registered with the SEC have their annual financial statements audited by an independent auditor. Without current audited financial statements, companies cannot file annual reports with the SEC and cannot bring new securities offerings to market in the United States. The requirement for audited financial statements applies equally to U.S.-based and non-U.S. companies that list their securities on an exchange in the United States.

The SEC has enforcement authority over auditors that prepare or furnish audit reports on companies registered with the SEC, including the ability to conduct investigations and to bring enforcement actions related to those audits. Broadly speaking, the SEC has the authority under U.S. law to request documents (including audit working papers) from a foreign public accounting firm that prepares or furnishes an audit report on a U.S.-listed company, and otherwise issues an audit report, conducts interim reviews or performs audit work.

Role of the PCAOB

Since its creation in the Sarbanes-Oxley Act, the PCAOB, under the oversight of the SEC, has been the regulator of the public company audit profession. The PCAOB's role includes setting auditing standards for audits of U.S. public companies, registering public company auditors, inspecting¹ audit firms registered with it, and enforcing compliance with its rules and regulations. U.S. law requires audit firms that prepare or furnish audit reports for U.S.-listed companies to register with the PCAOB. This is true regardless of where the auditor is located, and thus firms that audit non-U.S.-based companies listed in the United States generally are subject to oversight by the PCAOB, in addition to being subject to their home-country law and regulation. The PCAOB also requires that an audit firm outside the United States register with it if that firm plays a "substantial role"² in the audit of a U.S. issuer, even if it is not the signing firm. The PCAOB also has authority to request access to audit working papers of registered accounting firms.

Multinational Audits

Companies generally are audited by an audit firm in their home country. Auditors of multinational companies also need to use audit firms located and licensed in other countries to

¹ The PCAOB "inspects registered public accounting firms to assess compliance with the Sarbanes-Oxley Act, the rules of the Board, the rules of the Securities and Exchange Commission, and professional standards, in connection with the firm's performance of audits, issuance of audit reports, and related matters involving U.S. companies, other issuers, brokers, and dealers." See <http://pcaobus.org/Inspections/Pages/default.aspx>.

² A firm performs a "substantial role" if it is: (i) Performing material services that another firm uses or relies on in issuing an audit report with respect to any issuer, or (ii) Performing the majority of the audit procedures with respect to 20% or more of the consolidated assets or revenues of such issuer. PCAOB Rule 1001(p)(ii).

perform work on the companies' foreign operations, so that the signing auditor can provide opinions on the company's consolidated financial statements. Some larger CAQ members participate in global networks composed of legally separate, independent member firms providing audit services in the jurisdictions in which they are organized and licensed. The individual member firms in these global networks agree to adhere to common policies regarding professional standards, audit methodologies, and systems for quality control and risk management. These network firms typically practice under a common brand. For example, a U.S. multinational corporation³ with China operations often would have as its signing auditor a PCAOB registered U.S. audit firm that would use the audit work performed by a PCAOB registered China firm that participates in the same global network.

The Critical Need to Resolve the Issue

The global economic and regulatory events of the past several years have underscored the interrelationship among securities markets around the world and brought a corresponding focus on the need for coordination among regulators across borders, including cooperation regarding audit firms that are subject to regulation and oversight in multiple jurisdictions. The current issue between the United States and China is one that is rooted in a conflict of law that prohibits the China firms from producing audit working papers directly to any foreign regulator and that requires those foreign regulators to seek such documents through the China regulator. Unless a satisfactory resolution can be reached between United States and China regulators for access to audit working papers, the China audit firms cannot comply with the laws of both countries.

As you likely know, there are two pending legal proceedings between the SEC and China-based audit firms based on those firms' inability to produce directly to the SEC audit working papers relating to their audits of China-based companies whose securities are publicly traded in the United States. One is an SEC administrative proceeding against five such firms, and the other is against one firm in Federal District Court. Although I am aware of these proceedings, the parties to these proceedings are China audit firms; neither the CAQ nor any of its U.S. audit firm members are parties to these proceedings. Accordingly, my testimony does not cover the specifics of either of these proceedings.

As has been publicly reported, these China audit firms are unable to produce any documents directly to the SEC, the PCAOB, or any other regulator outside of China without violating the specific directive of the China Securities Regulatory Commission (CSRC) not to produce documents directly to foreign regulators. Instead, the CSRC specified that foreign regulators must seek documents directly from the CSRC. I am not a China law expert, but I know from published reports that, if the firms were to defy this directive, they would risk severe sanctions that could affect the ability of the firms to continue operating, as well as other consequences to individual partners in those firms, including potential imprisonment.

³See, e.g., Michael Rappaport, *U.S.-China Audit Spat May Spill Over*, WSJ (Dec. 27, 2012) (noting that if the issue between the SEC is not resolved it "also could affect U.S. multi-nationals like Apple Inc., Qualcomm Inc. and Kimberly-Clark Corp. that have major Chinese operations.")

In addition, the PCAOB has authority to inspect audit firms registered with it (including non-U.S. firms) and to request access to audit working papers in accordance with Sarbanes-Oxley. As has been publicly noted, the PCAOB continues to negotiate with the China authorities on the PCAOB's ability to inspect China-firms, which would include access to working papers. In this context, it is worth noting that at the time many China firms registered with the PCAOB, they disclosed on their respective PCAOB registration forms the conflict between China laws and U.S. laws regarding access to working papers. I do not point this out to question the PCAOB or SEC's authority to request the working papers, but to make clear that this conflict has been known for some time. And because it is a conflict of laws, it is not an issue that the firms can resolve.

The SEC's public filings in the proceedings against the China firms indicate that the SEC and the CSRC have thus far been unable to resolve the issue of working paper access for purposes of investigations. Recent public statements by PCAOB Board members including Chairman Doty indicate that they hope to continue to make progress with China in negotiations on the inspection front, although they acknowledge that significant work remains to be done.⁴ Both the SEC and PCAOB have successfully negotiated agreements with other securities and audit regulators providing for cooperation in a range of circumstances, including inspections and investigations.⁵ The CAQ believes it is important that relevant authorities in the United States and in China reach an agreement here as well.

Effect on U.S.-Listed Companies and Their Investors

Because of the roles of China-based audit firms in auditing the China operations of U.S. listed multinational companies as well as China-based companies that are listed in the United States, we are concerned about the potential broad effect on investors and the capital markets if the issue is not resolved through a government-to-government agreement. More specifically, if the United States and China do not reach an agreement on this matter, actions taken by the United States or by China could deny China-based companies the ability to obtain the audit work needed to continue to access the U.S. capital markets, and thus negatively affect the interests of U.S. investors in such companies.

⁴ See, e.g., February 12, 2013 Wharton School interview with Chairman Doty (<http://knowledgetoday.wharton.upenn.edu/2013/02/reverse-mergers-cross-border-regulation-or-cold-war-with-china/>): "We have believed for a long time that our counterparts are trying to achieve a solution and are proceeding in good faith on these negotiations."; February 8, 2013 Speech by Jeanette Franzel at Baruch College (<http://www.accountingtoday.com/news/PCAOB-Franzel-Sees-Progress-China-Audit-Inspections-65657-1.html>): "We're currently in the process of negotiating an MoU, a memorandum of understanding, with the Chinese government. We've been doing this for quite some time, but we're hopeful that we're making progress because the alternatives are not good for the investors who are currently invested in companies over there, and if we think long term about the interaction of our markets with China, we really hope to see a breakthrough soon."; and February 26, 2013 Speech by Jeanette Franzel at Wayne State University (http://pcaobus.org/News/Speech/Pages/02262013_WayneState.aspx): "We have been somewhat encouraged by some incremental progress in our negotiations with the Chinese authorities, including an agreement last year on guidelines that enabled us to send an inspection team to observe part of an inspection carried out by the Chinese audit regulator."

⁵ To date, the PCAOB has entered into 16 cooperation agreements, and 12 of these agreements were concluded over the last two years. The most recent are with the French Haut Conseil du Commissariat aux Comptes (Jan. 31, 2013) and the Auditing Board of the Central Chamber of Commerce of Finland (Feb. 1, 2013).

Further, our concern also extends to investors in multinational companies that are listed in the United States but have operations in China. This is because, depending upon the severity of any action by the United States or China against the China-based audit firms if the two countries do not reach an agreement, the company's signing auditor may be precluded from using the China firms' work.

In both cases – U.S.-listed China companies and multinational companies with large China operations – the loss of access to the services of China audit firms could impair audit quality, reduce the competitiveness of U.S. capital markets, and harm the interests of investors in the U.S. markets.

Finally, it is important to understand that all China audit firms, not just those that are parties to the SEC proceedings, currently face the same conflict of laws. Thus, even if there were firms in China, other than those subject to the current SEC proceedings, qualified and willing to perform audit work on China-based companies and the China operations of multinational companies, those firms would face similar obstacles to complying with any future SEC or PCAOB requests for documents.

This is a government-to-government, sovereign-to-sovereign matter that can only be resolved through the agreement of relevant authorities in the United States and in China. Thus, we are hopeful—indeed we believe it is critical—that China and U.S. regulators continue their dialogue and work to resolve this issue as quickly as possible. As noted earlier, there is precedent where the SEC and the PCAOB, as well as the CSRC, have successfully negotiated agreements with regulators in other jurisdictions that take into account applicable laws and permit the sharing of relevant information. Given the potential risks, we urge relevant regulators and, as appropriate, other governmental authorities, to continue to work to that same end here.

Thank you for bringing attention to the need for the relevant U.S. and China authorities to resolve this issue and for the opportunity to be here today. I am happy to answer any questions.