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China's Financial System, Transparency and Accountability Challenges

Mr. Chairman and members of the Commission, I thank you for the opportunity to appear before you today. My name is Paul Gillis and I am a professor at Peking University in Beijing and a member of the Standing Advisory Group of the Public Company Accounting Oversight Board (PCAOB). My comments today are my personal views and do not necessarily reflect the opinions of my university or the PCAOB.

American investors have lost billions of dollars because of accounting scandals in China. These scandals have ranged from accounting misstatements to outright theft of corporate assets by Chinese executives. American regulators have been unable to protect investors in U.S. traded Chinese securities in large part because China has blocked their access to people and records that are located in China.

U.S. listed Chinese companies

There are over 200 Chinese companies listed on the major U.S. stock exchanges, and hundreds more that are thinly traded on the over-the-counter bulletin board (OTCBB) and pink sheets. These companies can be put into three categories.

First are the large state-owned enterprises that rank among the world's largest companies. Most of these companies listed on the New York Stock Exchange about the time that China entered the World Trade Organization in 2001. Chinese bureaucrats encouraged these listings as a means to reform these companies by raising capital to modernize them ahead of increased global competition. U.S. listings of these companies also served to import U.S. corporate governance standards, forcing a level of transparency and accountability on these companies that helped them to reform. There have been few reported accounting problems with large SOEs. Most of these companies also have listings in China and Hong Kong and are subject to regulation in those markets.

The large SOEs are audited by a China member firm of the Big Four accounting firms. The Big Four are the world's four largest accounting firms and include Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCoopers. The Big Four operate through locally owned practices in most countries in the world and audit the largest corporations globally. The Big Four have been in China since 1980, and were given the right to audit in 1992. The China member firms were initially established by the global organizations of these firms, but ownership has since been transferred to local and Hong Kong partners. This past year the firms were required to restructure into limited partnerships that are 60% owned by locally qualified partners. Local ownership must increase to 80% over the next five years. The Big Four are very large in China, which each employing over 10,000 accountants.

The second type of company that listed in the U.S is privately held companies that did an initial public offering (IPO). China's stock exchanges closed with the revolution that brought the Communists to power in 1949 and reopened in 1990. Until recently, China used its own stock exchanges mainly to reform state-owned enterprises and these markets were not accessible by private enterprise. Private enterprise became legal in China early in the opening up process that began in the late 1970s, but did not become legitimate until Jiang Zemin invited businessmen to join the Communist Party in 2001. Until recently, private enterprise in China had great difficulty accessing capital and could not even obtain loans from banks. Consequently, many private enterprises looked overseas for capital. NASDAQ and the New York Stock Exchange became the preferred listing venues for private Chinese companies, although others have listed on most stock exchanges around the world. China opened an Small and Medium Sized Enterprise (SME) Board in Shenzhen in 2005 and ChiNext, China's answer to NASDAQ, in 2009. Since these boards opened more Chinese companies are seeking capital in China, and there are almost 1000 companies queued up for listing. The listing requirements in China are more rigorous than the U.S., and it is difficult for foreign investors to participate in China's markets. That has led many Chinese companies to seek listings in the U.S. Most of these U.S. listed companies are also audited by the Chinese member firms of the Big Four, although some of the smaller ones are audited by small U.S. based accounting firms.

The third category of companies includes small private Chinese companies that have gone public in the U.S. by means of a reverse merger. In a reverse merger, a Chinese company merges into a shell that is already registered as a public company in the U.S. Most reverse mergers are traded on the OTCBB although some have done secondary offerings and upgraded to the major exchanges. Companies that came to market through reverse mergers have experienced a high level of accounting irregularities, likely because these companies are not subject to the rigorous IPO process before listing. The exchanges have revised their rules for reverse mergers to require a seasoning period prior to the companies being listing on the exchanges and this appears to have effectively ended the use of reverse mergers to list Chinese companies. Small U.S. based accounting firms audit most reverse merger companies.

Accounting and auditing standards for Chinese companies

Chinese companies that list in the United States must produce financial statements following either International Financial Reporting Standards (IFRS) or U.S. Generally Accepted Accounting Principles (U.S. GAAP). All Chinese companies must also produce financial statements following Chinese Accounting Standards (CAS) for local tax and regulatory purposes. Companies that list on China's stock exchanges must report under CAS. CAS has converged with IFRS, which means its requirements are substantially consistent with IFRS, although details may be different. The U.S. Securities and Exchange Commission (SEC) does not accept financial statements prepared under CAS.

State-owned enterprises listed in the U.S. report under IFRS, while non-State owned U.S. listed Chinese enterprises typically report under U.S. GAAP.

Accounting standards that were developed in the West based on Western business practices are often difficult to apply in China. Chinese business practices rely less on the rule of law and more on personal trust between parties. Western accounting standards, particularly in the area of revenue recognition, rely heavily on contract documentation that may be missing or delinquent in China. Similarly, internal controls designed in the West that rely primarily on the separation of duties and the need for collusion to commit a fraud commonly fail in an environment where deep personal relationships may create a perceived obligation to assist a friend, even in fraud.

Auditing standards in China are based on global auditing standards. Chinese auditing standards apply to apply to companies listed in China, while auditors of companies listed in the U.S. must follow the standards set by the PCAOB.

Regulation of the accounting profession in China falls principally under the jurisdiction of the Ministry of Finance (MOF). The China Securities and Regulatory Commission (CSRC) also regulates auditors of companies listed on China’s stock exchanges.

U.S. regulation of Chinese accounting firms

All auditing firms that audit U.S. listed companies must register with the PCAOB and follow its standards when conducting audits of U.S. listed companies. 47 mainland accounting firms and 49 Hong Kong accounting firms have registered with the PCAOB, although only a small number of these firms actually issue reports on U.S. listed companies. The mainland and Hong Kong firms that are registered with the PCAOB include the local member firms of large international accounting firm networks including the Big Four.

The PCAOB sets auditing standards for audits of U.S. listed companies, and also conducts inspections of registered accounting firms to assess their compliance with these standards. These inspections are an important part of investor protection in the U.S. All registered Chinese accounting firms that audit at least one company traded in the U.S. are subject to inspection by the PCAOB at least once every three years. Accounting firms that audit more than 100 listed companies are inspected annually, but no Chinese accounting firm audits that many listings.

PCAOB inspections of accounting firms help to protect investors by assuring that audits are done in accordance with PCAOB auditing standards. There is empirical evidence that PCAOB inspections improve audit quality [1]. While I believe it is unlikely that timely PCAOB inspections would have avoided all of the accounting fraud that has occurred with U.S. listed Chinese companies, I believe that regular inspections would likely have encouraged more effective audits. More effective audits might have led to earlier detection of some frauds and have possibly prevented some fraudulent companies from listing.

Objections to PCAOB inspections

China has forbidden the PCAOB from coming to China to perform the required inspections and from having access to working papers. From the Chinese perspective, a foreign regulator enforcing foreign laws on Chinese soil against Chinese nationals violates China's national sovereignty. China has also blocked the PCAOB from conducting inspections in its Special Administrative Region of Hong Kong to the extent that the subject audit includes operations on the mainland.

National sovereignty is a particularly sensitive issue for the Chinese. The Chinese psyche is deeply etched by the humiliation brought about by the unequal treaties that concluded the Opium Wars in the 19th century and from the Japanese Occupation in the 20th century. China is particularly sensitive to any action that it perceives impinges on its national sovereignty.

A number of other countries have also raised objections to PCAOB inspections based on national sovereignty or data privacy concerns. Despite these objections, the PCAOB has successfully negotiated arrangements with many of these countries to conduct inspections jointly with their local regulators [2]. While some countries other than China, including Italy and Greece, have yet to agree to PCAOB inspections, none of these countries use U.S. capital markets as extensively as China. The PCAOB has requested permission to conduct inspections of China based firms jointly with Chinese regulators, but this request has been refused. The PCAOB had previously amended its rules to extend the deadline for foreign inspections until the end of 2012. Largely because it was unable to negotiate access to conduct inspections in China and other countries, the PCAOB failed to complete the initial round of foreign inspections that were required under its rules to be completed by the end of 2012. Because the PCAOB has been unsuccessful at obtaining access to China and certain other countries it is currently out of compliance with its own rules regarding inspections while it continues to try to negotiate bilateral agreements.

China's preference is that the PCAOB should rely on China's own robust audit regulation of accounting firms. While China regulates each of the PCAOB registered Chinese accounting firms, it does not inspect most of the audits conducted for U.S. listed Chinese companies. That is because most of these companies have incorporated outside of China, typically in the Cayman Islands, for purposes of getting themselves out from under Chinese regulation. Consequentially, these companies fall into a regulatory hole. China cannot effectively regulate them because the parent companies are not Chinese companies and the U.S. cannot effectively regulate them because China will not allow American regulators access to the people and records associated with the company. In my opinion, this regulatory hole is a significant factor in creating an environment conducive to fraud.

The SEC has faced and currently faces similar problems enforcing U.S. securities laws against those perpetrating fraud in U.S. listed Chinese companies. The SEC has attempted to obtain audit working papers on a number of alleged Chinese frauds without success. Audit working papers are useful sources for securities regulators when investigating alleged frauds. The accounting firms have refused to provide these working papers to the SEC despite the requirement to do so under U.S. laws. The firms have said that providing these working papers to the SEC would violate Chinese laws and could subject their partners to imprisonment and the firm to expulsion from China.

China's State Secrets Law prohibits the transfer of information related to China's national security and interests outside of China's borders without the approval of relevant Chinese authorities [3]. While audit working papers would rarely contain information that would be considered a state secret in a conventional sense, China has an expansive and poorly defined view of what might constitute a state secret. While most countries have laws that protect state secrets, China's definition of a state secret often includes commercial information related to transactions with state owned enterprises. China's Archives Law also has the potential to impose broad restrictions on the transfer of information outside the country's borders.

Current status of PCAOB and SEC negotiations with China

The SEC currently has two cases pending against Chinese accounting firms. The first is in the U.S. District Court in Washington and seeks to compel the China member firm of Deloitte Touche Tohmatsu to produce audit working papers on Longtop Financial Technologies, Inc, a Chinese company that was delisted from the New York Stock Exchange under allegations of fraud[4]. The second case was filed in December 2012 against the Big Four accounting firms in China as well as the local member firm of BDO [5]. The firms were charged with administrative violations related to their refusal to provide audit working papers to the SEC as required by the U.S. Sarbanes-Oxley Act. The SEC has indicated that it is seeking to ban the firms from practice in the U.S. [6].

If the PCAOB is unable to reach agreement with Chinese regulators to conduct inspections in China and have access to working papers it may be forced to deregister the accounting firms that it cannot inspect, which may be the same result that the SEC is seeking. U.S. listed companies are required to have a PCAOB registered auditor and to submit to the SEC financial statements that are audited by a PCAOB registered auditor. Consequentially, if all of the China-based accounting firms are deregistered by the PCAOB or banned from practice by the SEC all of their clients may be unable to find an auditor and may be delisted by the stock exchanges and eventually struck off the rolls of public companies in the U.S.

PCAOB negotiations with Chinese regulators have been underway for many years. This past October, PCAOB inspectors were permitted to observe Chinese regulators as they inspected the quality control processes of a major international accounting firm in China. The PCAOB inspectors were not allowed to examine any audit working papers, which is the substantive part of a PCAOB inspection. In November 2012, the PCAOB gave Chinese regulators a draft agreement providing for cross-border audit oversight of PCAOB registered Chinese accounting firms. According to Chinese press reports, the CSRC and MOF submitted a recommendation to the State Council on how to proceed on audit cooperation. No details on the recommendations have been made public and the State Council has taken no action.

Impact on multinational corporations

The problems with PCAOB inspections in China may also affect U.S. multinational corporations (MNCs) with operations in China. Under PCAOB rules, any accounting firm that plays a substantial role in the audit of an U.S. listed company must be registered with the PCAOB. Many U.S. MNCs have significant operations in China that are typically audited by the Chinese member firm of the company's U.S. auditor. If the Chinese member firm plays a substantial role in the audit, it must be registered with the PCOAB. Should the PCAOB deregister the Chinese member firm, it could create difficulties for the U.S. auditor to sign off on the financial statements of the parent company.

The PCAOB definition of substantial role makes it unlikely that MNCs will face difficulties. An auditor is playing a substantial role if it earns more than 20% of the worldwide audit fee. It is also considered to play a substantial role if the auditor audits a subsidiary with more than 20% of worldwide assets or revenues of the company. While there are U.S. MNCs with more than 20% of worldwide assets or revenues in China, most likely operate in China with multiple subsidiaries and consequentially will likely fall under the threshold.

Recently Caterpillar announced that it would write down $580 million of the $700 million it had paid to acquire a Chinese mining equipment manufacturer [7]. The write down became necessary when Caterpillar discovered accounting irregularities at its new subsidiary. The irregularities were discovered before the annual audit was completed. The company had previously been listed in Hong Kong. The situation reminds us that accounting problems in China are not limited to Chinese companies that have listed in America, but can extend to MNCs that have operations in China.

Recommendations

The PCAOB and the SEC play critical roles in protecting the interests of all investors in U.S. markets. Full compliance with U.S. laws must be a condition of accessing capital from U.S. markets. I believe that the PCAOB and SEC have made every effort to reach agreement with Chinese regulators for access to the people and records that will allow them to fulfill their statutory responsibilities. To date, these efforts have failed to reach agreement, and U.S. investors have been harmed.

China has benefited from access to U.S. capital markets. Large state owned enterprises became globally competitive in part because of access to U.S. capital and from the reforms required to comply with U.S. corporate governance principles. U.S. markets enabled China's entrepreneurs to access capital when local funding alternatives were insufficient for their needs. If access to U.S. capital markets is cut off for China's private sector, China risks retarding indigenous innovation with potentially adverse consequences to China's long term competitiveness.

China has raised legitimate concerns that regulatory cooperation could impinge upon China's national sovereignty and risk disclosure of state secrets. However, China must recognize that protection of its national sovereignty and state secrets may be incompatible with overseas listings of its companies. If China is unwilling to cooperate with foreign regulators, its companies cannot be permitted to raise capital on foreign stock exchanges.

The decision is up to China. If it is unwilling to accept U.S. regulation of its U.S. listed companies, it must withdraw these companies from the U.S. capital markets. U.S. regulators have waited too long to act.

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