

Is a Proper Audit Possible of China Operations?

The Public Company Accounting Oversight Board published a proposed rule designed to create a framework for determinations to be made under the Holding Foreign Companies Accountable Act passed last year (HFCAA). That Act amends the Sarbanes-Oxley Act of 2002 or SOX which mandates that the PCAOB conduct inspections of registered accounting firms that audit companies whose shares are traded in the United States.

While the Board has conducted the required inspections for years, there is an exception – China. The PRC government and the China Securities Regulatory Commission or CSRC have steadfastly declined to permit the required inspections with few exceptions.

The HFCAA was designed to try and address the impasse. The statute requires that firms publicly traded in the U.S. disclose information to the SEC on foreign jurisdictions that prevent the PCAOB from conducting inspections. The Board's proposed rule-making is designed to create a framework to guide decision making when a report of non-compliance with the inspection requirement is made to the SEC.

While the Board's proposed rule-making appears to faithfully follow the dictates of Congress as reflected in HFCAA, the real question is to what end? The process here is being written on a slate tinged with decades of failure. In 2011 and 2012, for example, the SEC brought enforcement actions against foreign affiliates of the major accounting firms centered on this issue. Those actions, brought as Commission administrative proceedings, ultimately ended with an agreement between the PCAOB and CSRC under which the parties pledged the "fullest assistance permissible to secure compliance with the respective Laws and Regulations of the Authorities." The MOU went on to detail procedures to facilitate the arrangement. Yet little in the way of tangible results can be found despite the fact that ultimately under SOX firms that are not in compliance can be delisted.

HFCAA may have passed Congress with rare bipartisan support. The Board's new procedures may create a process for evaluating difficulties with or refusals to comply with

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the inspection process. There is nothing, however, to suggest that CSRC and the PRC are about to join the international community and help ensure that the Board can properly conduct the required inspections to safeguard public investment and trading markets which benefit everyone.

If there is no reason to expect that the new approach of Congress and the Board will yield positive results, then perhaps it is time to search for alternatives. One is to simply delist any issuer that refuses a SOX inspection, an approach nobody seems willing to pursue. A second may be to urge investors as the SEC Chair did last year to carefully evaluate the situation before investing in firms that have substantial operations in China or any other country that adopts its approach – that is, accept the risk of fraud or don't invest, an equally unattractive approach.

An alternative may offer a solution. Consider fashioning auditing standards for use in recalcitrant jurisdictions like China in such a manner that sufficient information is available to the company outside of that country so that inspectors can assure themselves that the work has been done properly. While this is not the same as sending the inspectors into China to look at the work papers as envisioned by SOX, it may result in processes that achieve the desired result: reasonable assurance of a proper audit.