SEC and PCAOB Dispute Deloitte's Stance on China Work Papers

Auditors of U.S. Listed Companies Must Submit to Working Paper Reviews

By

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On May 9, 2012 the SEC instituted an enforcement action against Shanghai-based Deloitte Touche Tohmatsu CPA Ltd. (DT-Shanghai or the Firm) owing to the Firm's on-going failure to provide the Commission with its working papers related to the audits of an unnamed foreign private issuer that is under investigation for possible accounting fraud. Separately, the SEC filed an action against DT-Shanghai last year in connection with its refusal to provide access to the working papers supporting its opinion on Longtop Financial Technologies Limited, which is also under investigation for alleged accounting fraud. This latest maneuver by the SEC comes at a time when the Public Company Accounting Oversight Board (PCAOB) has stated that it is seeing progress towards the goal of reaching an agreement with the Chinese regulators on conducting joint audit inspections.

Auditing firms aspiring to examine financial statements of U.S. issuers must register with the PCAOB and be subjected to periodic inspections, which involve review of working papers for selected clients. Many foreign-based firms have done so, and most cooperate fully with the mandated inspection regime. However, a number of registrants' auditors, domiciled in several different nations, have raised objections, typically citing real or presumed national prohibitions against sharing confidential client-related information with official or unofficial interlocutors from foreign jurisdictions. The PCAOB maintains a listing of the rebuffs it has received (http://pcaobus.org/International/Inspections/Pages/IssuerClientsWithoutAccessList

.aspx), and although China and Hong Kong figure, by far, most prominently among this suite of non-cooperators, they are not alone in having this distinction.

In its new administrative proceedings against the Firm, the SEC charges that DT-Shanghai has violated the rules under Section 106 of the Act, as amended by Section 929J of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Under those rules, DT-Shanghai is deemed to have consented "to produce its audit workpapers for the Board or the Commission in connection with any investigation by either body with respect to that audit report" and the firm is "to be subject to the jurisdiction of the courts of the United States for purposes of enforcement of any request for production of such workpapers."

In the earlier action (September, 2011), after more than a year of fruitless efforts to gain access to the Firm's Longtop audit working papers, the SEC filed a subpoena enforcement action against the Shanghai firm. According to DT-Shanghai, its reason for not producing the responsive documents is that it believes that doing so could subject the Firm to sanctions under Chinese law. It states that, unless consents are obtained from the appropriate authorities, Chinese law prohibits it from producing documents to persons or entities outside of China. Reportedly, DT-Shanghai was unable to obtain such approvals. Presumably, if DT-Shanghai were to comply with the SEC subpoena, it could subject the Firm to potential civil and criminal sanctions in China.

Clearly DT-Shanghai finds itself on the horns of a dilemma involving two competing firm interests. On the one hand, the Firm elected to become a PCAOB-registered accounting firm that wishes to be engaged to serve as auditors to U.S.-listed Chinese companies. As such, it is bound by certain U.S. rules and regulations, including those governing foreign public accounting firms. Yet DT-Shanghai, a Chinese member of UK's Deloitte Touche Tohmatsu Limited, is an accounting firm based in the People's Republic of China, which has to abide by what it refers to as China's "States Secrets" laws.

Clearly, it is in China's interest to have Chinese companies be able to raise capital abroad to support expansion, production and employment within China, and doing this will necessitate, in some cases, compliance with securities and related regulations of other nations. It is also in China's interest to promote growth and prosperity of its professional service firms – indeed, China's recently announced mandate to have its public accounting firms majority controlled and managed by nationals who have been qualified under Chinese law corroborates this observation. For those firms to be able to serve multinational Chinese businesses, issues such as this conflict between the so-called state secrets laws and foreign capital markets' investor protection goals will have to be successfully resolved.

While the final outcome of this ongoing showdown is yet to be revealed, each side seems to have lately taken steps that have undoubtedly raised tensions. This may make the ultimate resolution of this problem more difficult to achieve.

For example, Reuters has reported that the publicized concerns over U.S.-listed Chinese companies had prompted Chinese authorities to look into tightening the rules on using the variable interest entity (VIE) structure, a structure used by many Chinese companies listed in the U.S. This might have prompted some Chinese companies to take steps toward unwinding their existing VIE arrangements. Some further suggested that this tightening was a way to coax Chinese companies overseas to return home to be listed.

Following DT-Shanghai's disclosure that it could not risk non-compliance with Chinese secrecy laws, Reuters' sources noted that the Chinese authorities had met with certain accounting firms in China, including the "Big Four" firms, to caution them to be mindful of its laws on confidentiality. This does not bode well for a speedy solution to the current problem.

On the U.S. front, on the other hand, inquiries into reporting practices and trading suspensions surrounding reverse takeover (RTO) companies prompted the SEC to tighten the standards on RTO companies before they can be listed on U.S. exchanges.

The Commission approved new rules in November, 2011, which included having companies complete a one-year "seasoning period" and maintain a requisite minimum share price over certain periods. While these new rules were not meant to target RTO companies of particular national origin, they nevertheless were perceived by some to be directed at Chinese RTO companies, since in the past few years there have been a spate of Chinese enterprises using this route as a means of becoming listed in the U.S., and some of these have led to allegations of accounting fraud.

In the authors' views, nevertheless, the most recent news pertaining to this particular saga has been positive. As noted, China will require the "Big Four" accounting firms in China to restructure into limited partnerships to be owned and led by Chinese citizens upon the expiration of terms of the joint ventures. As reported by *China Daily*, "[s]uch an arrangement will make individual partners liable for their actions in China and as a result they can be sued for their own private assets." A lead partner of a "Big Four" firm "believes that the reform will bring greater discipline to the China audit market [and] the new model will be a big discipline and put big pressure on those signing off accounts and carrying out due diligence to fulfill their responsibilities." If indeed China's latest regulatory action has been taken with improvement in quality as at least one of its goals, this could be good tidings for investors in Chinese companies, whether registered in the U.S. or not.

Those of us in the accounting profession, not just in the U.S. but in China as well, should welcome more communication and greater cooperation among regulators, especially in addressing such complex matters as cross-border listings. Only by doing so can possibly conflicting objectives and needs – national pride, protection of investors, and economic growth, among them – be dealt with to all parties' satisfaction. As one official of a professional accounting organization based in China put it quite simply, "[t]hey need to talk with each other, as well as share information." A partner of a local Chinese accounting firm, quoted in an interview conducted by *China Daily*, voiced the same sentiment, saying "[t]here should have been greater dialogue between regulators

of China and the U.S. and an acknowledgement that China has the right to supervise audit companies in China as does the U.S. in its own land."

One possible solution to this conundrum would be for Chinese authorities to impose a PCAOB-equivalent inspection regime on firms auditing publicly-traded companies, whether or not those companies are listed on Chinese exchanges. Having such oversight of reporting companies would encourage good governance by those companies. Recently, after months of arduous negotiations, it has been suggested that there could soon be an agreement between the Chinese and U.S. authorities to enable the PCAOB to observe inspections of Chinese accounting firms (somewhat analogous to auditors' obligation to "observe" clients' inventory taking procedures), which would indeed represent progress. As Dr. Paul L. Gillis, a professor at the Guanghua School of Management, Peking University, and a member of PCAOB's Standing Advisory Group, writes, "[i]f [PCAOB Chairman James R.] Doty is able to close the deal to allow PCAOB staff to observe Chinese regulators as they inspect Chinese accounting firms, he will have achieved a remarkable diplomatic breakthrough. It may set the table for an eventual agreement on joint inspections."

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