CHANGE IS COMING TO CHINESE AUDIT FIRMS: WHEN AND WHY THIS MAY OCCUR

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China's Finance Ministry will require that the Big 4 accounting networks' Chinese member firms transition management to Chinese nationals over the next several years, according to a May 10 report by Reuters. Compliance with all the new rules, projected to occur by the end of 2017, will have the firms "localize" their operations so that they are led by Chinese citizens, and be dominated by accountants holding China's accountancy qualifications. Apart from the inevitable and regrettable human aspect, which will see the foreign nationals comprising the current leadership of the various offices being displaced, the changes are probably a natural consequence of China's growing economic might, coupled with the not atypical nationalistic sentiments that have been displayed across many industries around the world for the past hundred years, most recently in Ecuador and Argentina, where over the last few weeks foreign-owned gas and electric companies have been expropriated.

There should be little doubt that China's public accounting profession can be staffed adequately with its own citizens. Currently there are about 250,000 qualified accountants in China, with projections of 300,000 by 2017, which would almost equate to the number of CPAs in the U.S. today (albeit in a nation with three times the population, with however less GNP). The Finance Ministry (as best as can be determined) will not be requiring that all auditing jobs be reserved for Chinese nationals, but only that leadership in the firms be held primarily by natives; thus, many positions could presumably still be filled by expatriates or others. China's rapid pace of economic development, with its heavy emphasis on international trade relationships, likely presages further emphasis on professional education, making it possible that even this projection will be surpassed.

Additionally, China's accounting profession (and regulatory oversight agencies) have been upgrading over the past decade, and now prescribes a close cousin to International Financial Reporting Standards (IFRS, the system used by over 120 nations) for most reporting by public and private companies. Likewise, Chinese auditors now follow rules that closely parallel

International Standards on Auditing (ISA), which are promulgated by an instrumentality of the International Federation of Accountants (IFAC). Not coincidentally, U.S. GAAP has been converging with IFRS (and the SEC may soon permit or even require full adoption of IFRS by domestic registrants), and U.S. generally accepted auditing standards (GAAS) have just recently been rewritten to closely resemble ISA. In short, there is no need for undue concern that the just-announced "localization" mandate will have negative consequences for the quality of financial reporting by Chinese companies or Chinese subsidiaries of U.S. or other foreign companies.

The late supreme leader Deng Xioping's statement that "to be rich is glorious" has been often quoted. That sentiment is fully consistent with the expectation that there will be further progress toward the professionalization of China's accountants and other skilled service providers. It is not deemed reasonable to suppose that its longer-term interests would be well served by indulging slapdash accounting and auditing practices.

It is true that over the past few years, a number of allegations have been made about the quality of financial reporting by *some* Chinese companies, and in particular by subsidiaries or branches of U.S. registrants, some of which achieved public status via so-called reverse takeovers (RTOs), which, for example, allows a Chinese (or other foreign -- or even private U.S.) company to become a publicly-traded one by means of merger with a "shell" public company in the U.S. Although affecting only a fraction of such companies, there have been enough of these assertions – concerning financial reporting fraud, auditors' resignations, inquiries and investigations by the SEC, audit committee internal investigations, trading suspensions, de-listings of stocks, and class action lawsuits against the companies, officers, directors and even against the independent auditors – to have been acutely embarrassing to a regime and nation assiduously seeking to be granted a leadership role within the family of developed nations.

In the authors' own experience, there have clearly been examples of slipshod audits of smaller Chinese companies and subsidiaries of U.S. parent entities – but then again, there are many instances of substandard, GAAS-deviant examinations of smaller but purely domestic U.S. companies, as well. It has been widely observed that notwithstanding mandating a regime of high quality financial reporting standards (either U.S. GAAP or IFRS), and despite having a cadre of trained professional auditors and a codified set of first-rate auditing standards, unless

there is a well-functioning system of regulatory oversight (such as the SEC aspires to have), there will be, from time to time, erroneous or even fraudulent financial reporting that will adversely affect investors and others, which ultimately dampens enthusiasm for investing, raises the cost of capital, and limits economic growth. There is arguably room for improvement in oversight of the auditing profession in many, perhaps all, capital markets.

Some are speculating (as did the *Wall Street Journal* in a May 11 article) that this move was prompted by a desire to shield Chinese accounting firms from increasingly insistent PCAOB demands to inspect the work of those firms that are involved directly or indirectly in audits of U.S.-listed companies, consistent with the requirements imposed under the Sarbanes-Oxley Act. If correct, this conjecture would indeed be an ominous sign for investors in companies having audits performed, in whole or in part, by Chinese firms, even those flagged with Big 4 banners. However, there may also be an alternative, more benign reason why China is moving to assert greater local control over its accounting profession. If this perception is correct, it could bode well for investors both foreign and domestic, if not immediately then perhaps with the passage of time.

Thus, to the extent that a contributing motivator for the Finance Ministry's current initiative is the desire to compel a greater emphasis on the quality of audit performance, this will ultimately lead to heightened confidence in financial reporting by Chinese companies and affiliates of non-Chinese entities. This in turn should lubricate the international flow of capital, benefiting not only investors, but consumers as well. Coupled with several related, expected developments (such as the PCAOB's hoped-for ability to conduct reviews of the work done by Chinese auditing firms), these modifications to the staffing and structure of international CPA firms' Chinese affiliates may, when the dust settles, prove itself to have been a constructive change.

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