CHINESE RTO ISSUERS' AUDITS and US CPA FIRMS' AUDITOR LIABILITY EXPOSURE

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Chinese reverse takeover (RTO)[1] companies are increasingly subject to rumors and charges of financial reporting irregularities. Allegations of fraud, auditors' resignations, inquiries and investigations by the Securities and Exchange Commission (SEC), audit committee internal investigations, trading suspensions, delistings of stocks, and class action lawsuits against the companies, officers, directors and even auditors have been prominently featured in business news headlines in recent months. It's therefore a good time to review the basics of RTOs and of auditors' responsibilities for the financial statements of foreign subsidiaries examined by other auditors.

Although going public through a reverse takeover (or a reverse merger) transaction is not a new tactic for private companies seeking a listing without the usual registration process, its use has been the "strategy du jour" for many Chinese companies seeking access to our capital markets. It is appealing to both domestic and foreign companies because it is often perceived to be a quicker and less costly method of going public, when compared to an initial public offering. If a registered "shell" company, or a small operating entity, is available to enter into a stock-based transaction, this can be the "back door" route to a listing for the nominal acquiree (but the actual acquirer) company.

Through reverse takeovers, these formerly private Chinese companies (also referred to as issuers) become subject to SEC reporting requirements. Some Chinese RTO issuers have chosen to employ smaller accounting firms as their auditors, many have retained a "Big 4" or other major international accounting firm as their auditors, presumably to elevate their credibility in the eyes of the investing public. Regardless of the size of the auditing firms, all auditors of these issuers should dedicate adequate resources to fully comply with U.S. auditing and reporting requirements, especially given the fact that, most, if not all, of the operations of these Chinese RTO issuers are in

[1] A reverse takeover transaction involves a foreign or domestic private company nominally being acquired by a U.S. company that is either dormant or has minimal on-going operations. The merger is effected via a stock swap, the ratio of exchange being such that the former owners of the nominal acquiree become the majority owners of the combined company, which succeeds to the registration of the former shell entity. Typically, the public company then changes its name to reflect the name of the Chinese operating company.

China, far removed where the parent company auditors are based, where business practices and auditing and accounting standards may have unique characteristics.

Because of the number of Chinese RTO transactions that have been consummated over the last several years, the number of issuers that have substantially all of their operations outside of the U.S. have increased. This raises practical concerns for auditors: if the new registrants' auditors are the U.S. firm, the questions of who audits the Chinese operations (where all or most activity actually occurs), of how responsibilities are shared, if a China-based firm does the overseas work, become critical.

The Public Company Accounting Oversight Board (PCAOB) has observed, through its inspections of registered public accounting firms, that some of these firms might not have conducted the Chinese issuers' audits in accordance with PCAOB audit standards. Specifically, it noted in a staff audit practice alert published in 2010 that "…some firms may be issuing audit reports based on the work of another firm, or by using the work of assistants engaged from outside of the firm, without complying with relevant PCAOB standards."

Further, the PCAOB "…has observed some situations in which it appeared that U.S. registered public accounting firms that provided those auditing services did so by having all or most of the audit performed by another firm or by assistants engaged from outside the firm (including firms and assistants located in another country) without complying with PCAOB standards applicable to using the work and reports of another auditor and supervising assistants." "Another firm" would in this case include a member firm in an international network of firms bearing the same name as the U.S. firm, but based in another locale, such as in Hong Kong or China, as well as an unrelated audit firm located there.

The U.S.-based auditors of Chinese RTO issuers must make logistical and cost determinations in connection with the conduct of such audits. Under U.S. Generally Accepted Auditing Standards (GAAS) -- specifically AU sec. 543, *Part of Audit Performed by Other Independent Auditors*, which was carried forward as an interim standard by PCAOB and remains in effect today -- when the financial statements have been audited by an audit firm other than the U.S. firm expressing the auditors' overall opinion, the auditor (called the *principal auditor*) must make a fundamental and important decision. Either the principal auditor must assume full responsibility for the audit -- in which case it plans and conducts the entire audit, including of those remote operations -- or it arranges to rely on the work of a separate firm (called *other auditor*) to conduct the audit of the remote operations.

If the principal auditor takes full responsibility in the auditors' report, it must either conduct its own audit of the Chinese issuer or take certain steps to plan, control, and review the work of other auditor, and may not include report language to suggest that responsibility for the auditors' opinion is in any way being shared. In such circumstances, even if another accounting firm is used to assist the conduct of the audit, that firm's audit personnel are treated as staff of the principal auditor, and must be accordingly subjected to the same degree of oversight as are the auditors' own employees.

On the other hand, if the principal auditor chooses to assign partial responsibility to the other auditor, this must be made explicit in the auditors' report on the financial statements – and, even then, certain limitations apply. A failure to properly apply the relevant requirements would have serious consequences (beyond the fact of non-compliance with auditing standards), since, for example, if the principal auditor failed to make mention of the other auditor but did not actually either audit or control the conduct of the audit by the other auditor, users of the issuer's financial statements would place unwarranted reliance on financial statements which, in material part, were unaudited or could have been audited in a deficient manner. Investment decisions could therefore have been made based on the presumption that the information was properly examined, when it was not, and when the embedded financial statement information could have been materially false and misleading.

Principal auditors cannot share responsibility with other auditors unless the portion of the consolidated financial statements not subject to the principal auditors' direct attention is a relative small fraction of the total assets and revenues being reported. Clearly, the post-merger financial statements of these Chinese RTOs are virtually entirely comprised of the financial positions and operations of the foreign subsidiaries. Thus, apportioning responsibility would be unacceptable.

The PCAOB has implied that some auditors of Chinese issuers failed to properly apply AU sec. 543. In one instance, a U.S. firm engaged to audit a Chinese issuer actually retained a local firm in China to conduct the audit. In the *year preceding* the audit, although the audit partners of the U.S. firm had traveled to China to meet with the client and with the other audit firm to gain an understanding of the client's business and review with the other auditor its audit process, the U.S. firm did *not* have its own personnel in China during the audit. Moreover, the audit procedures performed by the other auditor constituted substantially all of the audit procedures on the Chinese issuer's financial statements. The Chinese firm did not issue its own report, but substantially all of the audit documentation was maintained by the firm in China.

Given these facts, PCAOB took the position that the U.S. auditor had not complied with AU sec. 543 when it issued its audit report stating that it had audited the issuer's financial statements, and expressing its unqualified opinion on those financial statements. PCAOB concluded that the U.S. firm could not serve as the opining auditor pursuant to AU sec. 543, since it had not conducted the audit.

Although there have been several lawsuits filed to date in the U.S. against the issuers' auditors for failure to comply with U.S. GAAS, the plaintiffs' specific allegations remain largely undisclosed. As more information is made public, a clearer picture will emerge, and these may well vary from case to case. However, based on the authors' own experiences with irregularities associated with audits involving foreign subsidiaries, including those in China, and with the other difficulties following reverse takeovers in general, it is suspected that some auditors may well find themselves in jeopardy because of noncompliance with this seemingly innocuous, but critical, auditing standard. Attorneys with clients who are Chinese RTO issuers, or their auditors, therefore might usefully review this standard to better understand its implications as it relates to the responsibilities of being a principal auditor.

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