

## All eyes on implementation as US and China reach agreement on PCAOB audits

*By Karry Lai* August 29, 2022



**Challenges will be expected on many fronts, including whether the PCAOB can have sufficient access to sensitive information and personnel, and whether the data it receives is financially meaningful**

The US Public Company Accounting Oversight Board (PCAOB) and China Securities Regulatory Commission (CSRC) signed an audit oversight agreement on August 26, marking a first step toward opening access for the PCAOB to inspect and investigate completely registered public accounting firms in mainland China and Hong Kong SAR. Market participants told IFLR that this is a good start

but the real challenge will be in implementation and whether the US is satisfied with the information it can get and expect to receive from its audits.

The Holding Foreign Companies Accountable Act, under the PCAOB **rules**, requires the US Securities and Exchange Commission (SEC) to prohibit the trading of securities of a non-US issuer listed on US stock exchanges if the PCAOB determines it has been unable to inspect the company's accounting firm for two consecutive years. More than 200 US-listed Chinese companies face potential delisting under the rules.

The **CSRC** said that “the signing of the agreement is an important step forward by regulators in China and the US towards resolving the audit oversight issue that concern mutual interest, and lays the foundation for proactive, professional and pragmatic cooperation of the next stage”.

“While market participants likely are pleased to see the beginnings of an agreed path forward to avoid delisting of hundreds of Chinese companies, a large open question remains whether access to the business records US regulators are demanding to see will materialise going forward,” said Doug Davison, partner at Linklaters.

Under the statement of protocol between the two countries, the PCAOB will have sole discretion to select the firms, audit engagements and potential violations it inspects and investigates – without consultation with, nor input from, Chinese authorities; PCAOB inspectors and investigators can view complete audit work papers with all information included and for the PCAOB to retain information as needed; and the PCAOB can have direct access to interview and take testimony from all personnel associated with the audits it inspects or investigates.

PCAOB chair **Erica Williams** said: “On paper, the agreement signed grants the PCAOB complete access to the audit work papers, audit personnel, and other information we need to inspect and investigate any firm we choose, with no loopholes and no exceptions. But the real test will be whether the words agreed to on paper translate into complete access in practice.”

According to a statement from SEC chair **Gary Gensler**, in light of the time required to conduct inspections and investigations, inspectors must be on the ground [in China and Hong Kong SAR] by mid-September if their work has any chance to be successfully completed by the end of this year.

Covid restrictions are one implementation challenge as they could affect travel.

## **Challenges on multiple fronts**

Although the incentives for China to disclose more data are clearly now stronger, the key issue for the US is whether the data presented by Chinese firms will actually be financially meaningful. “For example, in an economy like China’s, where the state still looms large in the corporate space, it will be quite unclear whether the reporting of “losses” will be net of both explicit and implicit subsidies Beijing provides to firms,” said Harry Broadman, partner at Berkeley Research Group, where he chairs the firm’s emerging markets practice and its CFIUS practice, and a faculty member at Johns Hopkins University.

Another challenge is Congressional politics. “Some in the US Congress may not like this deal seeing it as giving China, a country they don't want to receive special treatment, special treatment,” said Jean-Marc Blanchard, executive director at thinktank Mr & Mrs S.H. Wong Center for the Study of Multinational Corporations.

Except in areas where Chinese firms operate in sensitive sectors involving personal and business data, Broadman believes that in the short-run, US authorities will likely ease up slightly on delistings, and perhaps more intensively engage Beijing in a dialogue on certain firms’ data prior to taking action but he is dubious the agreement will result in a wholesale change. “In part, it depends on the stance toward China writ large by the White House, which in turn will hinge on the disposition of the US investor and business communities with respect to China,” he said.

Another is that China might not honour the agreement. “This is not just a matter of dishonesty,” said Blanchard. “Given US-China relations and the rapidly evolving nature of the tech sector, some information that is not viewed as sensitive today may be deemed sensitive later.”

A number of US-listed Chinese companies have been voluntarily delisting due to the sensitive nature of the data they hold. Earlier this month, five Chinese state-owned enterprises announced plans to delist from the New York Stock Exchange due to the burden of complying with reporting obligations. Late last year, ride-hailing company Didi announced its plans to delist from the US less than six months after its IPO.

In terms of PCAOB authorities accessing information from accounting firms in Hong Kong SAR, Blanchard said that it is about whether Hong Kong SAR can serve as a true neutral ground. “US regulatory authorities will need to be able to do what they need to do in the manner they deem best without undue interference, with communications or people-to-people interactions, and thereby fulfil their legal and regulatory obligations,” said Blanchard.

Hong Kong SAR will no doubt be the “high ground” for access by the US to the most reliable financial data of Chinese firms, since there are stronger incentives in that market for Chinese entities looking to entice foreign investors, said Broadman.

He added: “However, it may well turn out that Hong Kong SAR will become even more of an enclave market for Chinese firms seeking global investors than it already is. That poses obvious risks for Beijing’s policymakers looking for a sea change to bring Chinese firms more front and centre as global financial players.”

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