Securities Regulation Daily Wrap Up, ACCOUNTING AND AUDITING —PCAOB chairman sounds alarm on lack of inspection, enforcement authority in China, (Jul. 9, 2020)

Securities Regulation Daily Wrap Up

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Chinese authorities have rejected the PCAOB's principles on inspections and enforcement, which leaves the Board unable to fulfill its mandate in China, the chairman said.

PCAOB Chairman William Duhnke, a speaker at a recent SEC roundtable on investing in emerging markets, touted the Board's coordination with other global accounting and auditing authorities worldwide while warning that investors face significant risks when investing in Chinese companies listed on U.S. exchanges or U.S. companies with subsidiaries in China due to the steadfast opposition of the Chinese government to allowing the PCAOB's inspections and enforcement staff access to personnel, audit work papers, and other activities crucial to fulfilling the Board's mandate.

Inspections. Duhnke spoke about the difficulties of conducting inspections in certain jurisdictions. The PCAOB has conducted inspections in over 50 different countries, he said, and currently is unable to proceed with inspections in four jurisdictions: China, Hong Kong, Belgium, and France. In France, the cooperative agreement between the two regulators recently expired, and the PCAOB is working with Belgium's new regulator on coming to an agreement, Duhnke explained, adding that the Board has an agreement in principle with Belgium that should hopefully be made official soon. The sole impediment to a new agreement with both Belgian and French authorities is receiving final approval from data protection authorities under the EU's GDPR, and the Board has no concerns about its ability to continue oversight activities in these two countries, Duhnke said.

Inspecting audits in China and Hong Kong is another matter, Duhnke remarked. The Board is blocked from performing inspections in these jurisdictions. There are currently 17 PCAOB-registered firms in Mainland China and Hong Kong that sign audit reports for U.S. issuers, covering 195 public companies with a combined market capitalization of approximately $1.7 trillion, according to Duhnke. Investors must understand these restrictions on the PCAOB's access in China, he continued, noting that the Board and the SEC have issued several public statements outlining these challenges.

While the Board has engaged in discussions with Chinese authorities about allowing PCAOB inspections, Duhnke declared that any further discussions are unlikely to be productive unless China embraces three principles of the Board: the ability to conduct inspections and investigations consistent with the Board's mandate; the ability to select audit work and potential violations to be examined; and access to firm personnel, audit work papers, and other documentation. Chinese authorities have refused to accept these principles, pointing to their refusal to allow the PCAOB to inspect the audits of state-owned enterprises, even though they have shares listed on U.S. exchanges, and redacting or refusing access to audit work papers. "Without acceptance of our principles, we simply cannot perform our mandate," Duhnke said.

Enforcement. Turning to the PCAOB's enforcement mandate, Duhnke said that the Board's enforcement program conducts its overseas investigations as it does domestically. The only real differences is that in some jurisdictions, there is a home country enforcement regulator with which the staff must cooperate. Duhnke heralded the PCAOB's "long and successful history of cooperating in enforcement matters with jurisdictions across the globe." He added that approximately 26 percent of the PCAOB's settled enforcement orders involved non-U.S. firms or their associated persons.

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However, just like with the Board's inspections program, enforcement in China and Hong Kong is difficult due to longstanding restrictions imposed by the Chinese authorities, Duhnke said. He noted that the Board thought progress had been achieved with regard to enforcement access in 2013 with the signing of a Memorandum of Understanding (MOU), which had been the result of years of negotiations with the Chinese authorities for enforcement cooperation. Unfortgunately, since the signing of the MOU, Chinese cooperation has not been sufficient for the PCAOB to obtain timely access to relevant documents and testimony.

More recently, Duhnke said, Chinese authorities have produced no documents at all, and even when documents were produced, they were so untimely or incomplete as to prevent meaningful progress on the relevant investigation. Chinese authorities have also prevented PCAOB enforcement staff from interviewing witnesses located in China. Because of these challenges, the Board no longer views the 2013 MOU as effective for enforcement cooperation, Duhnke said.

Working with firms. Duhnke said that in the absence of PCAOB access to Chinese firms, the staff engages with the largest U.S. accounting firms at the global level. For over a year, the Board has had an elevated exchange with the global firms, including coordination between the Board and the SEC in conversations with firms to encourage monitoring of their member firms' quality controls and risk management in China. Duhnke praised the firms' responsiveness in this area, but cautioned that "trust but verify" applies, and the PCAOB does not have the means to verify in China and there are no prospects of doing so on the horizon.

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