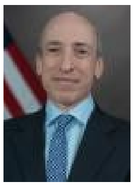
Statement

Statement on PCAOB's Determinations Regarding Public Accounting Firms in China



Chair Gary Gensler

Dec. 15, 2022

Today, the Public Company Accounting Oversight Board (PCAOB) announced that it was able, in 2022, to inspect and investigate completely issuer audit engagements of PCAOB-registered public accounting firms headquartered in China and Hong Kong. This marks the first time that Chinese authorities allowed access for complete inspections and investigations meeting U.S. standards, as required under the Sarbanes-Oxley Act.

That being said, a lot of work remains to protect investors and ensure ongoing compliance. First, the PCAOB must have continued access for complete inspections and investigations in 2023 and beyond. Second, registered public accounting firms headquartered in China and Hong Kong must work to strengthen audit quality. Third, Chinese-based issuers that access U.S. capital markets must provide specific and prominent disclosures about the heightened operational and legal risks that they face.

This fall's inspections and investigations followed the signing of the Statement of Protocol in August 2022 by the PCAOB, the China Securities Regulatory Commission (CSRC), and China's Ministry of Finance. At the time, I said the proof would be in the pudding. Today, we know that the proof was indeed in the pudding, at least in 2022.

Chinese authorities complied with the four key pillars laid out in the Statement of Protocol: The PCAOB staff was able to select any issuer audits for inspection or investigation; was able to interview or take testimony from all related personnel of the audit firms; was able to see complete audit work papers without any redactions; and can transfer information to the SEC.

Nevertheless, the SEC and PCAOB remain vigilant to critical issues regarding ongoing access for inspections and investigations, audit quality, and disclosures by Chinese-based issuers.

First, Chinese authorities will need to ensure that the PCAOB continues to have full access for inspections and investigations in 2023 and beyond. Each year, the PCAOB will determine whether it can inspect and investigate completely audit firms in China and Hong Kong, among other jurisdictions.

If the Chinese authorities do not allow the PCAOB complete access for inspections and investigations for three consecutive years, the SEC would prohibit trading in the securities of issuers engaging those audit firms, as required under the Holding Foreign Companies Accountable Act of 2020 (HFCAA). The PCAOB's 2022 determination resets the three-year clock for compliance.

Second, I would note that this determination addresses only the PCAOB's ability to access audit firms for inspections and investigations, not the quality of the audits.

PCAOB inspectors identified numerous deficiencies at audit firms in China and Hong Kong, as has been the case in other jurisdictions in the first year of PCAOB inspection.[1] The PCAOB is instructing audit firms to improve their quality control processes, as well as remedy other issues. The PCAOB intends to release inspection reports in the first half of next year detailing findings from their inspections of these audit firms.

Third, Chinese-based companies that access U.S. capital markets must provide specific and prominent disclosures about the heightened operational and legal risks that they face.

Under the HFCAA, Chinese-based issuers must disclose relevant details about the extent of governmental ownership in their company and any Chinese Communist Party (CCP) participation on their boards of directors in their annual reports filed with the SEC.[2]

Separate from the disclosures specified under the HFCAA, the SEC continues to emphasize to Chinese-based issuers their obligations to provide other material disclosures to U.S. investors. In 2021,[3] in light of regulatory developments in China and the overall risks with the China-based variable interest entity (VIE) structure, I directed SEC staff to seek enhanced disclosures from Chinese-based issuers related to their corporate structures. This includes, for example, whether the China-based entity is a VIE and whether it distributes cash to the offshore issuer that could be available to investors.

Lastly, Chinese government or party involvement in issuers' governance and operations may be material to investors and thus would need to be disclosed.

Though much work remains to be done, I thank Congress for the passage of the HFCAA and for their ongoing attention to these important matters. I also would like to thank our counterparts at the CSRC and China's Ministry of Finance for the productive dialogue over the last 16 months, including entering into the Statement of Protocol and ensuring inspections and investigations were fully compliant in 2022. I also would like to thank PCAOB Chair Erica Williams, the other Board Members, and the dedicated PCAOB staff for their diligent work.

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[1] Improving audit quality takes time, and one of the PCAOB's accomplishments of the past two decades is strengthening audit quality in jurisdictions around the world. See, e.g., Phillip T. Lamoreaux, "Does PCAOB inspection access improve audit quality? An examination of foreign firms listed in the United States," 61 J. ACCT. ECON. 313 (2016), available at https://reader.elsevier.com/reader/sd/pii/S0165410116000161?token=CDE756302B19F26FA11DB98DD24F6F6E1D3068762AD8EB3ED9DE9C954CDE6F011D1DF9761860E0711F3B5A329C5 ("The positive effect of PCAOB inspection access on audit quality is observed in jurisdictions with, and without, a local audit regulator. Overall, the results are consistent with PCAOB inspection access being positively associated with audit quality.")

[2] See the HFCAA, available at https://www.congress.gov/bill/116th-congress/senate-bill/945/text. See also Exchange Act Release No. 34-93701, Holding Foreign Companies Accountable Act Disclosure (Adopting Release), available at https://www.sec.gov/rules/final/2021/34-93701.pdf.

[3] See Gary Gensler, "Statement on Investor Protection Related to Recent Developments in China (July 30, 2021), available at https://www.sec.gov/news/public-statement/gensler-2021-07-30.