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Q&A with Marcum BP

Drew Bernstein, co-founder/ managing partner of Marcum Bernstein & Pinchuk, a leader in SEC audit, accounting and consulting services to Chinese companies seeking access to capital markets. For 21 years, Drew has worked at the intersection of the Chinese and U.S. market.

Drew is a known thought leader regarding the importance of corporate governance, the drivers of the U.S. and China IPO market, SEC and regulations and CSRC (China Securities Regulatory Commission).

Marcum BP has become one of the top-ranked auditors for Chinese companies listed in the U.S. markets and a trusted resource for both U.S. investors considering making investments in China and for Chinese companies and individuals undertaking business expansion or acquisitions in America.

Marcum BP is dedicated to bridging the gap between China and America by providing high quality, professional independent audit services, financial due diligence, and advisory services to our clients. We have built a very deep expertise in Chinese business practices, combined with highly trained accounting professionals so as to be able to facilitate successful transactions and beneficial business relationships.

Drew Bernstein, CPA

Q&A

Q: What are the accounting issues concerning US regulators about Chinese public companies?

DB: For the past two decades many of China's most innovative private companies chose to go public on the U.S. stock markets, NASDAQ and New York Stock Exchange, rather than China's domestic stock markets. Collectively, these companies accounted for about $1.9 trillion in market value at the end of last year. Many of them have performed very well for investors and are in fact viewed by China as some of the crown jewels of their technology industry. But others have had lapses in the accuracy of their financial reporting and demonstrated poor corporate governance.

One of the drivers of this issue is that China is one of a handful of countries that does not permit local audit firms to be inspected by the Public Company Accounting Oversight Board, or PCAOB. The PCAOB was set up as part of the Sarbanes-Oxley Act of 2002, a federal law that established sweeping auditing and financial regulations for public companies. Lawmakers created the legislation to help protect shareholders, employees and the public from accounting errors and fraudulent financial practices. The PCAOB regular inspections of all auditors who audit public companies. But under Chinese law, local audit firms are not permitted to share their working papers with foreign regulators unless it is done through the Chinese government agencies. This includes the local affiliates of Big Four audit firms based in China and Hong Kong, who audit the majority of the larger Chinese companies listed here in the U.S. and also audit the China operations of many multinationals and large Chinese state-owned enterprises.

The SEC and PCAOB have become increasingly vocal about their frustration with what they view as a lack of compliance with U.S. securities laws in recent months, and both have issued public statements on the issue. The Chinese government views this as an issue of national sovereignty and is willing to provide access only under tightly controlled circumstances.

NASDAQ has also put forward some proposed new listing standards for Chinese issuers that include a minimum size for the publicly traded shares, the requirement for an officer or director with public company experience, and setting standards to ensure that auditors have the qualifications in place to reliably audit companies in China in line with PCAOB audit quality standards. These seem to be common-sense reforms that should provide clarity and consistency to market participants.

Q: Is there a risk of U.S. regulators delisting Chinese companies and if so why?

DB: In May 2020, the U.S. Senate passed the Holding Foreign Companies Accountable Act, which would require foreign companies to disclose if their auditor had been subject to PCAOB inspection and would then require the SEC to delist these stocks if they remain out of compliance for three years. The bill still needs to pass. While the sanctions are directed at the public companies, they have very little control over this issue, since it would require the U.S. and China to agree upon a workable inspection approach that both sides can accept.

Q: What accounting guidelines do Chinese public companies adhere to? What is the issue?

DB: Chinese companies that are listed in the U.S. need to adhere to the same accounting standards as from other parts of the world, either US GAAP or IFRS. They need to comply with the same guidance from the SEC when it comes to critical accounting issues. So, in theory the financial reporting should be comparable with American companies.

However, in many parts of China it is challenging to find people with a detailed knowledge of U.S. GAAP and SEC accounting issues. Also, senior management may resist making the investment in developing strong internal controls that you need as a public company. Sometimes you see management invest a lot of effort in preparing for an IPO, but then over time the disclosures become less accurate and corporate governance reverts to be more informal as time goes on.

My sense is that investors are now going to start placing more emphasis on the quality of accounting and governance before they invest, and that this will raise the bar for Chinese companies that want to list in the U.S.

Q: In general, are the Chinese accounting problems widespread or is it a question of a few bad apples?

DB: Fraud is not a new issue and can be found in any market and for hundreds of years. In China, fraud issues are being resolved with new corporate governance requirements which will support both domestic markets and boost collaboration across international markets. Overall, China and the U.S. have differing accounting standards and methods. Our focus at MarcumBP is to bridge the gap between China and U.S. accounting standards and ensure our clients comply with the U.S. SEC standards should they want a public offering in the U.S. capital markets.

Q: Our investors are generally value investors, meaning they depend on financial transparency. How do they know the financial reporting is accurate and dependable?

DB: Earning and retaining investor trust is important for all companies. On the investor side, due diligence is important just as it is with every deal. A reputable auditor can give an investor a level of assurance that financial statements are accurate. Additionally, investors can look at the company's margins and key financial ratios and evaluate the business model from that standpoint. Furthermore, the investor can scrutinize the quality and reputation of the management team and corporate governance structure. The due diligence process needs to be a combination of looking at the balance sheet and determining if the company has the key success factors to instill confidence, trust and ultimately succeed as a public company.

Q: In your opinion what should investors beware of regarding Chinese public company accounting?

DB: To be clear, I am not an investment adviser. Investors need to do their due diligence by having access to all financial statements, have a clear understanding of the company's business model ((how they make money,) and carefully evaluate corporate governance.

Q: What other issues are important for U.S. investors to know?

DB: Increasingly, U.S. investors will seek to understand the goals of the company. If the company is a viable investment option, it will have global expansion plans, have a demonstrated path to profitability and a clear purpose to raise capital in the United States. If the company has no other options to raise capital, it may be less intriguing. China's domestic stock market has been very vibrant this year, so companies have a lot of options.

Q: What advice would you give to Chinese issuers to prevent delisting?

DB: A key piece of advice that I would give Chinese issuers is to be audited by a PCAOB compliant firm like MarcumBP.

But putting aside the issue of PCAOB inspections, the most common reason that Chinese companies face delisting is due to weaknesses in their public company infrastructure.

In many cases, our firm is asked to come in when a company is in crisis mode to help untangle the mess and find out if there is a legitimate company behind the numbers. Thus far we have been successful in helping at-risk companies to preserve their listing.

Q: How can a Chinese company regain compliance and avoid delisting?

DB: In most cases, the exchanges will provide a reasonable amount of time to regain compliance as long as the company presents a clear strategy, acts decisively, and follows through on their promises. Depending on the circumstances, those actions can include completing an accounting restatement, upgrading the internal staff and systems, and even making changes to senior management. It is important that the company acknowledge any shortcomings that brought them to this place and demonstrate a real commitment to improve for investors in the future. As long as the underlying business issues can be fixed, a company has the opportunity to win back investor trust over time.

When a company is in that position, I like to tell them, "This process is going to involve some pain, but you also have the opportunity to learn a lot. Let's make sure those lessons are not wasted so you never have to repeat them!"

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Note: This article is not an attempt to provide investment advice. The content is purely the author's personal opinions and should not be considered advice of any kind. Investors are advised to conduct their own research or seek the advice of a registered investment professional.