Forbes

## Showdown In Hong Kong: Key U.S. Oversight Board Declares A Win As China-Based Auditors Open Access

By Drew Bernstein

It had all the elements of high-stakes financial drama. Two hundred companies were about to be banished from U.S. markets. One trillion of market cap held by American pension funds and 401Ks was at risk of vaporizing. Angry speeches blasted the floor of the U.S. Congress. Then, last week, the storm passed.

At least for now, the delisting clock for Chinese companies has been stopped for three years, according to Gary Gensler, Commissioner for the Securities and Exchange Commission (SEC). The waters seem safe to invest in Chinese equities again.

Two decades ago, the Public Company Accounting Oversight Board (PCAOB) was formed in the wake of Enron's meltdown as the "auditors' auditor" to ensure that independent accountants performed their work with diligence and skepticism. But one group of public companies remained beyond their grasp – issuers audited by mainland China and Hong Kong-based audit firms. These auditors included the local affiliates of the "Big Four" global giants.

Over the years, the SEC and PCAOB negotiated, threatened, cajoled, and threw up their hands in despair. All to no avail. Their counterparts in China, the CSRC and the Ministry of Finance, insisted that allowing U.S. regulators to pry unsupervised into the books of Chinese companies would violate China's sovereignty. Among the most prominent companies listed on the NYSE at that time were the jewels of the state-owned enterprises (SOEs) essentially the property of the Chinese Communist Party.

In response, Congress passed the Holding Foreign Companies Accountable Act, signed into law in December 2020, and set a three-year time bomb that would delist most U.S.-listed Chinese companies if the PRC refused to yield on audit inspections.

Then, last summer, China blinked. In late August 2022, the PCAOB announced that China had agreed to permit unfettered inspections of China and Hong Kong-based auditors, including accessing all the working papers that auditors use to test the accuracy of a company's books and interview the auditors without any restrictions.

Within weeks, a team of 30 PCAOB inspectors installed themselves in Hong Kong and combed through the audit papers and interviewed auditors from the mainland. The CSRC initially advised they would "assist" in the interviews, raising concerns about whether the PCAOB staff would have a free hand. Investment bankers, institutional investors, and senior management held their breath, waiting to see if the inspections would be successful.

Last Thursday, the PCAOB stated that the team had gotten full cooperation in carrying out their inspections.“ Our teams were tough. They were thorough. They tested the PRC compliance with skepticism and rigor,” said PCAOB Chair Erica Williams.

“PCAOB inspectors and investigators were able to view complete audit work papers with no redactions, and the PCAOB was able to retain information needed to complete our work. The PCAOB had direct access to interview and take testimony from all personnel associated with the audits the PCAOB inspected or investigated.”

From a U.S. regulator's perspective, this sounds like a home run. They were able to get compliance on all the toughest issues that had held up negotiations with their Chinese counterparts for over a decade. PCAOB inspections have become extremely rigorous under the leadership of Chair Williams, who has a background as an SEC litigator early in her career. The regulators do not hesitate to hand out fines and pull the licenses of auditors who are seen to do shoddy work or fail in their role as “gatekeepers” to the capital markets.

Chair Williams made it clear that the completion of the audits should not be construed as “a clean bill of health” and that the inspections unearthed a range of deficiencies that may be disclosed in future PCAOB reports, which usually gives auditors time to remediate the issues before they are announced publicly.

At a time when the United States and China can’t seem to agree on much, there is steady progress on collaboration of shared issues. The effective resolution of this heated conflict over audit inspections sends a hopeful signal that other intractable issues may be resolved if approached with a spirit of pragmatism and mutual respect for what each side considers to be core interests. Given the interdependence of the two largest economies in the world, it is likely that common interests will prevail over incendiary rhetoric.

An “All Clear” Signal for China IPOs?

Today, hundreds of China-based companies would welcome the opportunity to go public in the United States, ranging from multi-billion dollar “unicorns” to middle-market companies determined to raise growth capital and access U.S. dollar funding sources.

Next year, we could see a massive rush of new listings from China onto the NASDAQ and the NYSE. However, investors will still need to exercise caution and be very selective if they want to play in the China new listings market.

Any IPO prospectus contains a long list of “risk factors” investors will evaluate. Following are most pertinent as it pertains to Chinese companies.

Risk factor #1 – We don't know the extent of the issues that the PCAOB uncovered and if the final reports will undermine the credibility of China-based auditors or spark investigations into the companies they audit.
Risk Factor #2: The Chinese regulators still have much work to do. Over the past year, they have crafted a brand-new framework of regulatory approvals for companies that desire to list overseas. The Cyberspace Administration of China, which is China's top cybersecurity cop and was responsible for shutting down Didi Global's app shortly after their IPO in July of 2021, has recently begun issuing approvals for overseas listings of internet companies — which removes a huge risk factor for that industry. The CSRC, China's version of the SEC, announced its own approval process for overseas listings, including companies that employ a VIE structure to get around limitations on foreign ownership in restricted sectors like media and telecom. But so far, the agency has not approved any listings, and the process remains unclear.

According to Paul Gillis, a leading expert on China audit issues and a professor at the Beijing International Studies University, "China wants to make this deal work. They don't want a complete financial decoupling with the US capital markets right now since they have enough other problems to contend with in their economy." In particular, the recent crackdown on large private enterprises has been disastrous for the unemployment of fresh college graduates. With 8.3 million students graduating college each year, China's government and stagnant SOEs cannot possibly absorb this fresh talent. So China is motivated to unleash the nation's strong entrepreneurial spirit.

Risk Factor #3: Even if the PCAOB is satisfied for now, the SEC and NASDAQ remain highly skeptical of any new stock listing coming out of the PRC and Hong Kong. Earlier this year, there were several micro-cap IPOs whose shares shot up by as much as 3,000% on listing day, only to collapse days later. NASDAQ has held up approval of smaller IPOs and reportedly put several small underwriters on a "blacklist." It is suspected that brokerages or buying groups operating out of Hong Kong artificially inflated the shares and bailed out, just as retail and momentum traders were piling into the market. So, caveat emptor for some China microcaps.

Still, we could see several higher-quality companies from China dive back into the IPO pool in 2023, just as the COVID lockdowns are being lifted across China. Right now, the virus is still impacting Beijing and other cities, with more than half of workers calling out sick at many companies last week. Once those workers recover from the virus, they will have money in their pockets and be eager to get out and travel and consume, potentially igniting a consumption boom in China's economy.

Given the massive backlog of aspiring public companies, and the potential for more reasonable valuations after the deflation of the recent tech bubble, it could be an extremely interesting year ahead for astute investors.

**Read Article Online**