THE Asset

Impending US-China Clash on Accounting Rules

The list of problems in the financial world seems extremely long at the moment. The most obvious issue is the European debt crisis, but we can safely add a slowing global economy, the pending US “fiscal cliff”, and a host of other items to this ever-expanding directory of struggles. Naturally, it never rains but it pours, so we should also consider another issue from the world of accounting. Currently set on simmer, this nuisance, if left unchecked, could quickly rise to a boil.

Some readers may recall that Chinese stocks listed in the US have taken a substantial thrashing over the last year or so due to issues surrounding the accuracy of their financial statements. Not helping the cause of these Chinese firms was the fact that many of them gained listing in the US through reverse mergers with existing publicly-traded firms, thus enabling them to sidestep the typical rigours of the traditional initial public offering (IPO) process.

The Securities and Exchange Commission launched a probe into the allegations, but the Chinese have been very reluctant to open up the ledger for the SEC. In truth, the Chinese Securities Regulatory Commission (CSRC) has not only been slow moving, but has actively blocked many of the efforts of the SEC, claiming that such information would be classified as state secrets and, as such, could not be divulged.

The plot thickened a couple of months ago when the SEC handed Deloitte China a subpoena concerning the financials of a firm called Longtop Financial. Deloitte China refused to divulge the audit records, allegedly because the CSRC threatened jail time and business failure for the firm and its executives. The SEC then utilized Sarbanes-Oxley legislation to move forward with punishing Deloitte China, punishments which could include excluding the firm from performing audits on US-listed firms.

Here is where it gets interesting: firms that wish to handle audit work of US-listed organizations must be registered with Public Company Accounting Oversight Board (PCAOB), another Sarbanes-Oxley creation, and the PCAOB must perform inspections of those firms. The SEC movements against Deloitte China, and by all accounts the rest of the Big 4 audit firms with a Chinese branch, will likely make this an area with little wiggle room and an uncertain outcome. Since China will not let the PCAOB to perform their inspections, the PCAOB may have to deregister the firms and the SEC would have to prevent them from practicing before them. This would leave these Chinese firms without an auditor, which is a requirement for a publicly-traded organization in the US. The exchanges would have little choice from there: these firms would have to be delisted from the stock exchanges on which they are currently traded, since they would have no auditor and be unable to file financial statements with the SEC.

Though this may seem like a far-fetched outcome, one could see the basis for such an event occurring. From the Chinese viewpoint, allowing US regulators to enter their country to perform their reviews, especially after they have been repeatedly told no, would be a public embarrassment. This says nothing about what any such reviews may find; the practices of the audit firms in China as well as the companies that have contracted these auditors would be placed under a microscope. If there is any fraud or wrongdoing, the fallout could be immense.

The opposite perspective from the American side is equally compelling. If they allow the Chinese to get away with this flagrant disregard of US securities laws, it would fly directly in the face of what the US has spent the decade since Enron trying to stamp out: corporate fraud and manipulation of the system. Moreover, if the SEC, PCAOB, and stock exchanges allowed these firms to continue operating, and cases of fraud came forward after the regulators caved in to the Chinese demands, the regulators could be financially on the hook for not performing their necessary oversight. Quite clearly, this is a minefield of notable proportions. The far-reaching implications go well beyond the nuances of this particular case, and really the securities industry in general. Future foreign investments by each country could be impacted: the Chinese may wish to avoid US capital markets due to what they perceive as regulatory restrictions, while Americans may choose to avoid Chinese markets due to a fear of fraudulent activity and their perception of a backwards bureaucracy.

In addition, Chinese-US relations of a broader, political nature could be hampered or damaged by such a standoff, a dangerous possibility at such a critical juncture for the global economy and international relations. In times such as these, distrust between the world's two largest economies can only serve to destabilize the current balance, as precarious as it is.

The sincere hope, of course, is that a compromise is worked out over the coming months. One would imagine the Chinese will allow some sort of oversight or review by the American regulators, as it is unlikely they would want their firms shut out of the world's largest marketplace for securities. A concession from the American side would also be possible, notably in what sort of information they have access to in their reviews and their future role in overseeing Chinese securities. It is roughly estimated that China owns around 8%-10% of total US debt, so it would be doubtful that the US would want to rock this boat too much, especially given a debt ceiling debate is on the horizon.

Though not being given much attention by the popular press, or even the less popular press for that matter, this issue has substantial implications. It may come down to a battle of wills between two economic superpowers and the outcomes could prove to be profound. The aforementioned PCAOB has set a deadline for the end of the year for the issue to be resolved; let us hope a solution does not take that long, though with so many other pressing issues before the global financial markets, a last-minute outcome would come as no surprise.