Calling to Account

International auditors have received criticism as a result of their affiliations with US-delisted Chinese companies, but are using their expertise to embrace and serve as bearers of audit industry standards in China.

By Jade Zhu

ACCOUNTING firms in China are not without their challenges. International auditing companies, most notably the "Big 4" that includes KPMG, PricewaterhouseCoopers (PwC), Deloitte Touche Tomatsu (Deloitte) and Ernst & Young (EY), sit in the middle of ongoing deliberations between regulatory bodies in the US and China as they prepare for localisation restructuring of their Chinese entities. At the same time, they are watching formerly guaranteed earnings from State-owned enterprises (SOEs) trickle into the pockets of second-tier competitors.

Nevertheless, the reputation of the Big 4 as reliable industry leaders remains secure, as the firms' cumulative decades of expertise and best practice standards continue to bolster their status in the eyes of lawmakers in China. With increasing auditing supervision and the internationalisation of financial reporting practices in China, the demand for experienced auditors will continue to rise in the coming years.

Under Scrutiny

Chinese companies in the last decade have raced to list on stock exchanges in the US and Canada, but reporting standards on these companies' internal finances have remained far from adequate. Beginning in 2010, breakthrough media coverage revealed that a number of US- and Canada-listed Chinese firms were defrauding investors and overstating assets, among other illegal activities. The US Securities and Exchange Commission (SEC) has filed lawsuits against a number of Chinese companies, including Longtop Financial Technologies in 2011 and, very recently, China Sky One Medical in September 2012.

>> The Big 4 still fall behind their US counterparts in terms of partner-staff ratios <<

Many investors, after first selling off stocks in Western-listed Chinese companies, have come to distrust even the most prestigious auditing bodies responsible for sharing accurate financial reports with the public. Carson Block, founder of Muddy Waters, a due diligence research firm focussing on Chinese companies, says, "Investors now seem to regard small auditors of China listings with suspicion, and many investors now accept that the Big 4 offer far from adequate protection against fraud as well."

The reputation of the Big 4 has taken public hits. Joy Shaw, a reporter for PaRR, a web-based intelligence and data provider, says, "The SEC investigations have definitely had an impact on the Big 4, which have become more picky about the companies they choose to audit and stricter in their compliance."

Trust Issues

Auditing the auditor has also emerged as part of the regulatory debate, as the Public Company Accounting Oversight Board (PCAOB), the audit governance arm of the SEC, has stated that it will not register firms that it cannot audit. Chances of reaching an agreement to allow PCAOB inspections of Chinese auditing firms by the deadline of 31 December 2012 are slim. Paul Gillis, professor of practice at Peking University's Guanghua School of Management in Beijing and founder of chinaaccountingblog.com, writes that he allows a 10 per cent chance that the PCAOB would deregister the Big 4 firms from practicing, but also ventures a 70 per cent chance that the PCAOB will simply have to once again push back reaching an agreement with Chinese regulators (the original deadline was in 2009).

Some experts say that the Big 4, especially Deloitte (as it has been served with not one, but two SEC lawsuits), are simply caught in a tug of war between Chinese and US government bodies. Regardless, proposals both in the US and by the International Auditing and Assurance Standards Board have pushed for disclosures of the names of engagement partners on audits to increase partner accountability. Joachim Schindler, KPMG's global head of audits, has expressed his support for this policy in a public statement, and Gillis has backed it as well, noting that transparency and accountability are always necessary in auditing processes.

>> Companies know that the prestige of a Big 4 name on an audit will build investor trust <<

Despite investors' suspicions, Chinese enterprises will remain an integral part of world economic growth, thus creating continued demand for auditors. Raymund Chao, assurance leader for Asia Pacific at PwC, says "[China] still presents many opportunities for PwC to grow. In auditing, we will see steady growth, and in other assurance services there will be significant opportunities to support Chinese enterprises in areas such as corporate governance, the systems of internal controls, data security, and so on."

Standardising Moves

Chinese regulators are aware of lax accounting standards and dubious financial reporting issues among Chinese companies. Wang Ou, vice head of research at the China Securities Regulatory Commission, told Reuters in June 2011 that China had to "admit that some of our companies may have flaws," and that "current measures to tackle risk in China may be inadequate."

The Ministry of Finance (MOF) and its subsidiary, the Chinese Institute of Certified Public Accountants (CICPA), an organisation that enforces professional CPA standards in China, have regularly updated accounting laws to increase consistency in information and bring industry practices more in line with International Financial Reporting Standards (IFRS), a standardised set of accounting guidelines recognised in many countries. Previously known as the PRC General Accepted Accounting Standards (GAAP), the new set of Chinese Accounting Standards (CAS) was introduced in 2006, with the most recent changes in 2010.

According to a PwC report released in May 2011, the new CAS "differs significantly from . . . the old PRC GAAP . . . but is in many respects converged to IFRS as issued by the International Accounting Standards Board." Chao notes that this is a positive step for comparative information, and will create more consistency in financial information, ideally increasing transparency on audits.

The further localisation of the Big 4 could also nurture an increase in the number of domestic CPAs. While this process will leave the companies structurally changed, for the moment it remains more a shift of form rather than content. Under localisation regulations, the Big 4 are required to cap the ratio of foreign partners to 40 per cent when their respective JVs expire, and are given an additional five years to decrease this ratio to 20 per cent.

Oliver Rui, a professor of accounting at the China Europe International Business School (CEIBS), says that Big 4 influence on the MOF is very strong, and that each firm has likely been granted a "grace period" by the MOF to truly restructure in content. "They are probably buying time for both sides," he explains.

Best Intentions

In keeping with talent shortage issues experienced in many sectors across China, the need for qualified accountants continues to outpace available supply. "The accounting profession is growing so fast that the number of experienced auditors available to carry out audits is just not there," says Ben Wootliff, director of corporate inquiries for Greater China and North Asia at Control Risks, a global risks consultancy. Wootliff notes that these problems are industry issues, and not limited to the Big 4. More importantly, given that the Big 4 only entered China in the 1980s, experts also question whether domestic talent is sufficiently qualified and experienced to be exercising the discretion needed to produce corporate audits.

As of 31 October 2010, the CICPA had counted about 300,000 professionals in China that provided services for over 3.5 million enterprises. Of these, the Big 4 remain the largest in China, with KPMG employing around 9,000, EY over 10,000, Deloitte around 13,500 and PwC with over 16,000 employees (including mainland China, Hong Kong, Singapore and Taiwan).

But despite possessing manpower in the thousands, the Big 4 offices in China still fall behind their US counterparts in terms of partner-staff ratios. Gillis notes on his website that 2008 ▸▸▸

The Big 4 auditing firms face rising competition in the China market, but continue to maintain an advantage over domestic auditing firms.

Source: Wikimedia

data showed an average partner-staff ratio of 27:1 for the Big 4 firms in China, compared to roughly 9:1 in the US in 2010. "Partners will typically have ten years of experience before taking on lead responsibilities. It will be around 25 years after leaving college before a partner will become an engagement partner for a leading SOE. But note that many accounting firms have only been in China for a little over 20 years, so the number of local partners is still low," he says.

New Players

China has been intent on developing domestic CPAs and international-standard accounting firms. Gillis notes that China had previously favoured the Big 4 by granting only those firms licences to audit, back in 1992. However, this favouritism has evaporated, as second-tier accountancies including Grant Thornton, BDO, RSM and Crowe Horwath have been allowed to enter the mainland market through franchising. Unlike the Big 4, which were operating as joint ventures in China, these second-tier international firms entered the mainland market as franchise operations and are essentially classified as domestic accounting firms.

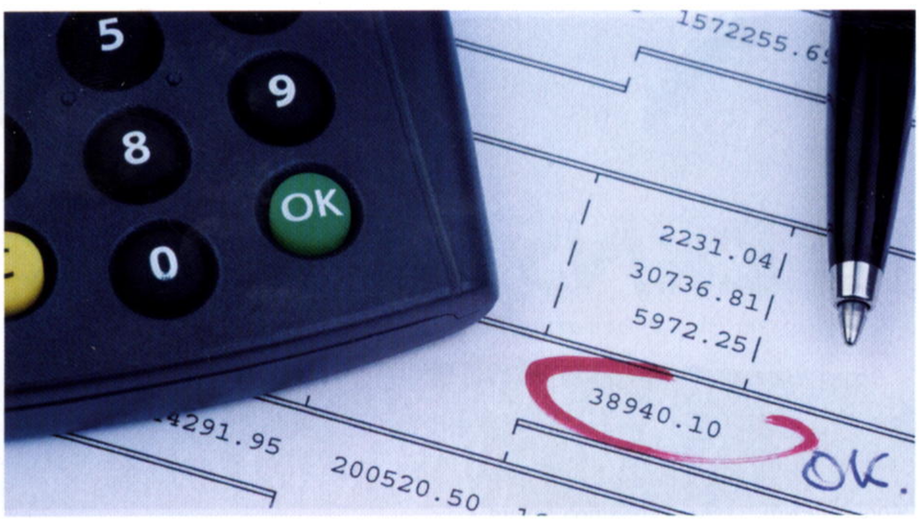
Government regulations have also shifted to encourage the growth of domestic talent. In 2009, the MOF announced a strategy to endorse CPAs in A Number of Opinions on Accelerating the Development of Certified Public Accountants, referred to as "Document 56" by accountants. These guidelines set five-year goals and comprise development strategies for large, medium-sized and small firms.

In addition, the MOF has required mandatory auditor rotation for SOEs, implying that billings previously taken for granted by the Big 4 will be spread more widely throughout the market.

These policies are clearly levelling a playing field that was already much more competitive than Western markets. Compared to the US, where the Government Accountability Office noted that the Big 4 held 98 per cent of market share in 2008, the four firms' combined operating earnings of USD1.5bn in China accounted for only 25 per cent of the industry's revenue in 2010.

Oliver Rui states that MOF policies present a "good opportunity for local auditing firms to grow." Rui explains that information security is a strong reason for China to encourage Chinese-grown audit firms. "Lots of SOEs hold sensitive information, which the government does not want disclosed to foreign firms with foreign ties," he says.

However, these factors alone may not drive firms to choose second-tier auditors. "The Big 4 are still leaders in best practice in the industry, and companies know that the prestige of a Big 4 name on an audit will build investor trust," says Rebecca Wen at dealReporter, an online provider of deals and trade intelligence. Although the Big 4 face the problem of a talent-short market, they still maintain the relative advantages of reputation and experience.



Auditors have come under fire as a number of US-listed Chinese companies are facing allegations of fraud.

Source: *Flickr, Philippe Put*

Buoyed by Best Practices

Such qualities enable the Big 4 to continue to command respect from lawmaking bodies as well as a substantial portion of the Chinese market. Chambers Yang, a Shanghai-based investment lawyer, says that even if the Big 4 are no longer directly favoured through China's policies, their reputation and strength in auditing practices and quality is much greater than competitors', and thus "market share should not be affected." Ultimately, the firms play a critical role in the market and hence in the shaping and implementation of new regulations.

>> The demand for experienced auditors will continue to rise in the coming years <<

Nonetheless, the issue of how quickly human talent can catch up with audit demand persists. "The reality is that large international companies need accounting firms with bench strength to do global audits. The drop from the Big 4 to the second tier [firms] is pretty big in terms of services and experience offered as well as global footprint," says Scott Moritz, managing director of the New York office of Navigant Consulting, a firm specialising in risk management.

Foreign expertise remains in demand in order to nurture and train local talent. The Chinese government recognises the role of internationally-respected auditors in creating transparency and trust in domestic firms as well as in developing strong domestic auditing services. Until the number of experienced partners throughout the Chinese industry rises to levels that meet demand, the Big 4 will adapt to their localisation mandates in order to continue to dominate the market for best practice audits. SBR