

U.S. and Chinese regulators made progress on PCAOB oversight of registered accounting firms in China

August 31, 2022 | Client Update | 6-minute read

The PCAOB signed a statement of protocol agreement with the China Securities Regulatory Commission and the Ministry of Finance of China, which could prevent China-based, U.S.-listed firms from being delisted pursuant to the HFCAA. The PCAOB is expected to start onsite work soon and will reassess in December 2022 whether it is able, to its satisfaction, to conduct inspections of PCAOB-registered accounting firms in mainland China and Hong Kong and also obtain information in its investigations.

Recap of the HFCAA and potential delisting of China-based companies

In 2020, the U.S. Congress passed the Holding Foreign Companies Accountable Act (HFCAA), under which the Securities and Exchange Commission (SEC) will prohibit the trading of securities of a non-U.S. company on U.S. stock exchanges or the over-the-counter market if the Public Company Accounting Oversight Board (PCAOB) has determined that it has been unable to inspect the company's accounting firm for three consecutive years because of a position taken by an authority in the company's jurisdiction. See [here](#) and [here](#) for our previous client updates on this subject.

In December 2021, the PCAOB made a determination that it was unable to inspect or investigate completely registered accounting firms headquartered in mainland China and Hong Kong. According to the [PCAOB's own data](#), the determination impacts 15 PCAOB-registered accounting firms located in mainland China and Hong Kong with over 160 public companies as their clients. The combined market capitalization of these public companies is approximately \$1.5 trillion. As of the end of August 2022, over 160 China-based companies had been conclusively [identified by the SEC](#) as firms that had retained an accounting firm that the PCAOB was unable to inspect or investigate completely because of a foreign government's position. These China-based companies would potentially be subject to the HFCAA trading prohibition in 2024 should they be so identified by the SEC for two more times under the HFCAA.

Announcements by the regulators

The announcement of the statement of protocol agreement signed on August 26, 2022 (Cooperation Agreement) between the PCAOB, the China Securities Regulatory Commission (CSRC) and the Ministry of Finance of China followed months of negotiations. The Cooperation Agreement was built on earlier arrangements made in the 2010s between the two sides on the same subject.

While the Cooperation Agreement has not been made publicly available, the SEC, the PCAOB and the CSRC published fact sheets and Q&As ([PCAOB fact sheet](#); [SEC fact sheet](#); [SEC Q&As](#); [CSRC's Q&As](#)) regarding key terms in the Cooperation Agreement.

The PCAOB's [press release](#) describes the Cooperation Agreement as the most detailed and prescriptive agreement it has ever reached with China, highlighting that the PCAOB has the sole discretion in selecting the subject of its inspections and investigations without input from the Chinese authorities, and that procedures are in place to allow PCAOB inspectors and investigators to review complete audit working papers of accounting firms located in mainland China and Hong Kong.

At the same time, both the PCAOB and the SEC cautioned that the Cooperation Agreement is only a first step in the process before the PCAOB will consider reversing its current view of its inability to inspect accounting firms in mainland China and Hong Kong and to obtain complete information from these firms, emphasizing the importance of full and timely access to information.

In its Q&As, the CSRC recognized the importance of the bilateral cooperation in improving audit quality, protecting investors and promoting compliance with local laws. The CSRC also clarified that assistance by the Chinese authorities also covers inspections and investigations by the PCAOB which call for information from accounting firms located in Hong Kong to the extent that those Hong Kong firms audit mainland China-based, U.S.-listed companies and maintain audit working papers for their engagements in mainland China.

Information accessible by the PCAOB

Whether the PCAOB will have access to complete records of audit work papers during its inspections and investigations has long been an important cross-border regulatory issue. The SEC Q&As state that the Cooperation Agreement “does not allow withholding or redaction of information contained in audit documentation for any reason” and permits the PCAOB to transfer information to the SEC in the normal course.

“View only” review by PCAOB inspectors and investigators is anticipated for restricted data, including data containing personally identifiable information.

In addressing the question of whether and how sensitive information in the audit documentation would be treated in accordance with Chinese laws, the CSRC's Q&As refer to the [proposed amendments](#) to the relevant Chinese regulations on confidentiality and archives administration concerning overseas securities offering and listing and highlight the primary responsibility imposed on listing applicants and listed companies to ensure information security in accordance with the relevant Chinese laws on data security and personal information. Accordingly, one might expect that decisions on how to treat state secrets and other sensitive information will also involve the company being audited making decisions about whether information provided to its auditors contains any state secrets and other sensitive information.

Both the SEC and the CSRC touched on the question of witness testimony in the PCAOB's enforcement actions. According to the SEC's Q&As, PCAOB investigators will be able to question witnesses directly in China and create their own transcripts. The CSRC's Q&As reveal that the Chinese authorities “will take part in and assist in interviews and testimonies” requested by the PCAOB.

What to expect next

The PCAOB has already issued document requests and testimony notifications and intends to send its inspectors to Hong Kong in September 2022 to start onsite inspection work on the selected firms. Information requested by the PCAOB in the form of document requests is intended to be provided to the PCAOB through the CSRC. The PCAOB's experience working with its Chinese counterparts in the coming months will inform its reassessment, by December 2022, of its ability to inspect PCAOB-registered accounting firms in this region effectively, as well as its assessment of whether it can obtain the information it needs in its investigations.

In China, the proposed amendments to local laws on confidentiality and archives administration concerning overseas securities listing and offering were published in April 2022 for public comment, but the final rules have yet to be announced. Noticeably, in the draft version, there was an emphasis of the CSRC's cooperation with foreign securities regulators in cross-border inspections and investigations, and the requirement that onsite inspections should mainly be carried out by the Chinese authorities and that foreign regulators should rely on the results of such inspections was removed. The signing of the Cooperation Agreement could accelerate the promulgation of the final rules which are expected to set out concrete requirements for listing applicants and issuers when handling sensitive information in interacting with their auditors. Similarly, the [draft rules](#) announced for public comment in December 2021 regulating overseas listing and securities offerings of Chinese companies, once finalized and released by the CSRC, are also expected to include detailed provisions regarding the eligibility requirements and domestic process for China-based companies' U.S. listings.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Michael S. Flynn

+1 212 450 4766
michael.flynn@davispolk.com

Li He

+852 2533 3306
li.he@davispolk.com

Ran Li

+86 10 8567 5013
ran.li@davispolk.com

James C. Lin

+852 2533 3368
james.lin@davispolk.com

Martin Rogers

+852 2533 3307
martin.rogers@davispolk.com

Xuelin (Steve) Wang

+852 2533 1092
xuelin.wang@davispolk.com

Kevin Zhang

+852 2533 3384
kevin.zhang@davispolk.com

Yuan Zheng

+852 2533 1007
yuan.zheng@davispolk.com

This communication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. This may be considered attorney advertising in some jurisdictions. Please refer to the firm's privacy notice for further details.