

PCAOB Raises Concerns with Audits of Chinese Reverse Merger Companies

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On March 14, 2011, the Public Company Accounting Oversight Board (the "PCAOB") issued a Research Note providing new data on reverse merger transactions involving companies from the People's Republic of China (the "PRC"), Hong Kong Special Administrative Region (the "SAR") and Taiwan (together with the PRC and the SAR, the "China Region"). The Research Note, entitled, "Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region (January 1, 2007 through March 31, 2010)," provides further context to a July 2010 Staff Audit Practice Alert No. 6, which discussed that some U.S. registered public accounting firms were not conducting audits of companies with operations outside of the U.S. in accordance with PCAOB standards. Taken together, the Research Note and the Practice Alert demonstrate the PCAOB's concern regarding audit practices relating to reverse mergers, concentrates the focus on audits of companies from the China Region and demonstrates its willingness to investigate and impose sanctions against accounting firms not meeting applicable standards.

The Research Note contains certain statistics supporting the concern over audits of Chinese reverse merger companies ("CRMs"). During the period of January 1, 2007 to March 31, 2010, the PCAOB's Office of Research and Analysis identified 159 CRMs that accessed the U.S. capital markets, almost triple the number of initial public offerings ("IPOs") conducted in the U.S. by PRC companies during that same period. In addition, CRMs tend to have lower levels of market capitalization than PRC companies that completed IPOs during that same period. The PCAOB also identified that CRMs have relatively lower levels of revenue and assets and that the auditors of most CRMs are "triennial firms," or firms inspected by the PCAOB once every three years, as opposed to annually, because such firms audit fewer than 100 public companies.

The Research Note and Practice Alert identify certain factors which may negatively impact audits of CRMs performed by U.S. accounting firms. The factors include language differences, use of third parties to perform audit work, added travel time and expense and understanding local business conditions. The Research Note and Practice Alert highlight the second factor as the PCAOB's greatest concern. It appears that, in certain situations, U.S. accounting firms provided audit services by having most or all of the audit performed by another firm or by assistants engaged from outside the firm without complying with PCAOB standards applicable to using the work and reports of another auditor or supervising assistant.

The Research Note highlights one example in which a U.S. registered public accounting firm retained an accounting firm in the China Region, and the audit procedures performed by the other firm constituted substantially all of the audit procedures on the issuer's financial statements. The U.S. firm's personnel did not travel to the China Region during the audit, and substantially all of the audit documentation was maintained by the auditing firm in the China Region. The PCAOB's inspection staff has also observed situations in which U.S. registered firms have engaged assistants from

outside the firm for audit work on companies with substantially all of their operations in another country. For example, in order to perform audit procedures for an issuer operating in the China Region, a U.S. firm engaged a consulting firm whose personnel could speak and read the language of the area in which the issuer's operations were located. The PCAOB's inspection staff concluded that the U.S. accounting firm's involvement in the audit work performed by the consultants was insufficient for the firm to assert that the audit provided a reasonable basis for the firm's opinion on the financial statements.

U.S. accounting firms that audit U.S. public companies must comply with PCAOB standards, including the AICPA's Statement of Auditing Standards No. 1, Section 543, "Part of Audit Performed by Other Independent Auditors" ("[AU 543](#)"). AU 543 applies when an independent auditor uses the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements.

Reverse merger companies, specifically those from the China Region, and their principal U.S. independent public accounting firms should ensure that prior and future audits comply with AU 543. When part of the audit work is performed by firms other than the principal accounting firm, AU 543 requires the principal accounting firm to decide whether their participation in an audit is sufficient to justify serving as the principal auditor and author of the report on the financial statements. Moreover, when principal accounting firms engage assistants outside of the firm to perform part of the audit work, the principal auditing firm should consider whether the auditor has adequate information about the knowledge, skill and ability of assistants engaged, whether the auditor is able to plan and supervise the work of the assistants engaged, whether the auditing procedures performed by assistants from outside the firm in combination with the auditor's own work provides sufficient competent evidential matter for an audit opinion, whether the assistants engaged have appropriate language skills and whether the auditor would have the ability to comply with the PCAOB's documentation requirements. When planning future audits or assessing prior audits, reverse merger companies and their independent auditors should also involve legal counsel with relevant knowledge and experience.