TheStreet

Auditors Play Defense on China Stocks

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12/23/10 - 09:17 AM EST

NEW YORK (TheStreet) - As the president of an auditing firm closely tied to Chinese companies traded in the U.S., Hamid Kabani faces a steady attack from short sellers hell-bent on proving conspiracy theories all about cooking the books.

Short sellers thrive on bad news, selling stock they have borrowed in hopes they can buy the shares back at a lower price and pocketing the difference. In many cases, they try to drive stocks lower by digging up dirt on the companies. They can be helpful as unofficial watchdogs, but clearly have an ax to grind, and are not infallible.

Kabani says criticism of his company is unfounded and unfair.

"This is a one-sided view that paints everyone relating to China as a villain," Kabani says. "Our problem is that we are in professional services. We don't want to start a mudslinging game with [short sellers] because we won't win."

There certainly is plenty of mud flying in the other direction. The short sellers sling it on web sites, for the most part. They charge that auditors like Kabani are part of a network of investment professionals who get shaky Chinese companies listed on U.S. stock exchanges through tricks with reverse takeovers. The shorts claim that auditors, bankers, and stock promoters then cooperate to float dubious new issues of stock with misleading financial statements, bilking American investors while lining their own pockets -- and those of early investors -- with hundreds of millions in profits.

Prominent on the shorts' list of suspect U.S. auditors are Kabani & Co., Frazer Frost, Goldman Kurland Mohidin, and Sherb & Co., among others. The shorts will sometimes target a reverse takeover company, or RTO, solely on the basis of checking who audited the company's financial statements filed with the **Securities and Exchange Commission**. None of the auditor firms have faced formal charges of fraud.

Sherb & Co. recently came under fire when Kerrisdale Capital, a short-oriented firm, opined on its web site that **China Education Alliance**(CEU) -- a Sherb client -- was "mostly a hoax." Steve Sherb, managing partner with Sherb & Co., said in answer that his firm takes its responsibilities as auditor of U.S. publicly traded companies "very seriously."

"The allegations against China Education Alliance were by firms or individuals that stated explicitly that they held short positions in the stock," Sherb said.

China Education denied what it called "baseless accusations" and has announced a $10 million share repurchase program.

Goldman Kurland Mohidin partner Ahmed Mohidin, who was formerly employed at Kabani & Co., declined to speak in detail about the Chinese companies his firm audits, but commented broadly that concerns about fraud are overblown.

Frazer Frost has disintegrated. Formed a year ago as an independent firm representing a partnership between Frost, PLLC, and Moore Stephens Wurth Frazer & Torbet, LLP, Frazer Frost had counted more than 20 Chinese reverse merger companies as clients. The partnership has ceased operations. Requests for comment from the parent firms brought no response.

There is no question that auditors are key players in China deals. Properly audited financial statements are a key requirement for any new issuance of shares in the U.S. Audit firms in this country are normally given unrestricted access to a company's financial records. They are expected to check the veracity of statements in detail, verifying that customers and vendors exist, visiting facilities, cross-checking revenues and receivables, whatever it takes.

Audits of China-based companies are complicated by differences that relate to both standards and fees. Fees charged by Chinese audit firms tend to be a lot lower than those charged by U.S.-based firms, while standards at the Chinese firms are not so high, experts say.

Those factors work together to encourage RTO companies to retain Chinese audit companies for work in China. Jacob Frenkel, a former SEC attorney who specializes in small-cap fraud cases, says that U.S.-based audit firms frequently accept the China-based firms as affiliates and sign off on work done in China without investigating properly themselves.

"One of the problems," says Frenkel, now a partner at Maryland-based law firm Shulman Rogers, "is that even when it comes to Chinese accountants, there have been a good number of cases where they proved to be the facilitators of fraud, rather than fulfilling their roles as gatekeepers."

Only Monday, the SEC announced a settlement with Moore Stephens Wurth Frazer & Torbet, requiring the firm to pay $129,500 in connection with its work for a China Energy Savings Technology, a now defunct small cap that has been the focus of a series of SEC fraud cases dating back to 2006. The SEC asserted that MSWFT had good reason to exercise "heightened skepticism" with regard to China Energy, and failed to do so.

The fallout from allegations of fraud can be widespread. **RINO International**(RINO), a company that specializes in heavy environmental projects, was targeted in November by short-oriented research firm Muddy Waters. The allegation -- published on the internet -- was that Rino didn't have as many customer contracts as it had claimed. The company's CEO soon told auditors that the charge was partly true. The stock was delisted as a result.

When short sellers noted that the company used Frazer Frost as its auditor, other Frazer Frost clients, such as **Harbin Electric**(HRBN) and **China Valves Technology**(CVVT), saw immediate sharp declines in share prices, though there were no allegations of fraud relating to them, no known investigations, and no other obvious negative catalysts.

Representatives for Harbin Electric did not respond to requests for comment. China Valves CEO Jianbao Wang said his company is "committed to the highest standards of corporate governance. We are working to retain a Big Four auditor to provide internal controls assessment and improve the system."

Over-reliance on Chinese auditors has been controversial. In July, a warning came from the Public Company Accounting Oversight Board, or PCAOB. The PCAOB is a regulatory body created under the Sarbanes-Oxley Act of 2002. Essentially, its mission is to audit the auditors. An industry alert issued by the agency on July 12 called upon U.S. auditors to bear down on Chinese companies.

"Sometimes all the operations or most of the operations are in the China area and the firm in the U.S. is not taking an active role in the audit," says Greg Scates, deputy chief auditor with the PCAOB, in explaining the agency's action. "They're just taking the information from the Chinese auditor and doing little or no work, taking it at face value."

Scates acknowledges that auditors have been the security industry's principal gatekeepers since the securities acts of 1933 and 1934. He understands the ire of investors who have gotten badly burned by the collapse of China-based stocks engineered through reverse mergers.

"If a material fraud has been committed, then obviously you want to find out who were the key players, how they orchestrated this fraud, and then ask whether the auditors should have caught the fraud or why the auditors didn't catch the fraud," he says.

According to Scates, the PCAOB has been seeking access to the records of audit firms in China, but has met resistance from the Chinese.

"We're not into China yet. We're not able to inspect firms domiciled in China right now. A number of countries are blocking us right now."

The PCAOB's Fight Is Hampered

Investors hoping that the PCAOB will ride to their rescue in China may have a longer wait. Of late, the agency's role has grown more complex, and perhaps less transparent, thanks to intervention by the SEC.

On July 26 -- two weeks after the PCAOB sent out its notice to auditors -- the SEC issued a final rule concerning the oversight of PCAOB inspections. The rule granted the right of audit firms to ask the SEC to review PCAOB findings. The SEC can now override PCAOB decisions, on occasion.

The PCAOB was taken by surprise by the SEC's move.

"The Board was not consulted concerning this rule and was not aware that it would be issued yesterday," PCAOB Acting Chairman Daniel Goelzer said in July. "We are studying the Commission's release in order to understand its impact on our work."

One impact seems fairly clear: Delays.

Auditors say they often get caught up in issues that have little to do with a company's financial statements, and can be blamed for the collapse of a stock even when their role is positive.

Kabani mentions the notorious case of **Bodisen Biotech**(BBCZ.PK), a reverse merger company that hit the skids in 2006 after short sellers and journalists raised key questions. The stock traded for about $20 a share in early 2006. It finally spiraled down to 12 cents last year, before recovering slightly, to about 50 cents a share recently.

Benjamin Wey

Kabani says that, because his firm audited Bodisen, it has been unfairly blamed for the blow-up, lumped together with the chief promoter of the Bodisen deals, Benjamin Wey of New York Global Group.

While on retainer with Bodisen, Wey's firm used a pseudonym to publish glowing assessments of the company, documents filed in a shareholder lawsuit show. Investors claimed they were led to believe the assessments were independent. Days before Bodisen severed ties with Wey, New York Global earned commissions from handling the sale of more than $15 million in Bodisen stock, according to forms filed with the SEC.

At the time, Bodisen announced an intention to defend itself vigorously. Shareholder suits against Bodisen were dismissed.

In delisting Bodisen, the Amex expressed concerns both about Wey's role and about Bodisen's internal accounting. But Kabani maintains that no one has challenged the financial statements his firm prepared for the company, and that he and his company have been criticized unjustly.

The way Kabani sees it, his firm blew the whistle in the Bodisen deal, by disclosing in a footnote to a financial statement that Bodisen had hired Wey as a promoter.

Attempts to reach Bodisen Biotech for comment were unsuccessful. The company's Web site lists Joseph Visconti as the company's U.S. representative, but the Florida telephone number provided has been disconnected.

Wey defended his company's role, saying everything he does is "by the book, fully disclosed publicly.

"That's how I do things," Wey said in an interview. "Our firm's name was disclosed in Bodisen's public filings seven different times. Do I need to teach people to read from A to Z? Seven times! Seven times! One more time: Seven times! This is public information. How many more times can I tell people to read facts and not perception?"

Referring to class action lawsuits brought against Bodisen, Wey noted that he and his firm were not named as defendants. He said his firm did not earn large commissions from the $15 million in sales of Bodisen stock, calling any such suggestion "totally false."

"We had customers who were regional holders in Bodisen shares," Wey said. "When those customers wanted to sell stock, we simply handled the Form 144 sale on behalf of the existing holders of Bodisen shares. New York Global Group at the time had a broker-dealer subsidiary that fully executed trades on clients' behalf."

Wey praised Kabani as "a good auditor. He did exactly what he should've done. If I were an auditor, I would have disclosed it as well."

Wey does offer his own explanation as to why the numbers that Chinese companies report to Chinese officials often do not match those mentioned in SEC documents.

"Under U.S. GAAP, revenue is booked when products are shipped out of the company's warehouse," Wey says. "In China, however, revenue is recognized when the receiving party issues you a government-issued receipt. But there's a 17% tax incurred. There are many companies in China that do not necessarily want to pay that 17% upfront. So they delay asking for the receipts. That doesn't mean that revenue is not properly booked."

And there, Wey says, "is the one major mystery and why you have this fuss over the China reverse mergers and IPOs."

Those kinds of bookkeeping discrepencies prompted recent short-seller attacks against **China Green Agriculture**(CGA), another client of Kabani's firm.

Shorts have focused on a stark discrepancy between the 2008 revenue numbers that the firm reported to the SEC and much lower revenue numbers reported on tax filings in China. In response, China Green Agriculture issued a press release on Sept. 13 saying "a number of bloggers believed to be short sellers or affiliated with short sellers have posted incorrect and defamatory reports."

"It is well documented that reports filed with the PRC State Administration for Industry and Commerce (SAIC) often do not reflect the comprehensive income and financial condition of a company," China Green said in its Sept. 13 release. "Oftentimes, Chinese companies access SAIC filings to learn more about their competitors to gain a commercial advantage. As a result, many companies have understated their financial results in such filings."

Kabani suggests that the world needs uniform guidelines for auditors -- a solution not likely to happen, anytime soon, other experienced professionals say.

"Look, there are bad people everywhere. It's not that China is bad or here is bad. We can't characterize it that way," Kabani says. "But if you have a uniform system of reporting and a uniform system of auditing, then you can at least have some form of assurance."

- *Written by Robert Holmes in Boston*.