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FEATURE

Who's Minding the Minders of Chinese Accounting?

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Auditors and regulators aren't doing enough to protect investors from problems at U.S.-listed Chinese companies.

INVESTORS WHO BUY THE U.S.-listed shares of small Chinese companies depend on financial auditors to offer independent and expert oversight of their corporate statements. These investors also rely on the Public Company Accounting Oversight Board (PCAOB), the quasi-government agency created by the U.S. to supervise the country's auditors after the Enron and other accounting scandals that occurred early this decade.

Yet red flags from this hot, fast-growing slice of the stock market often seem to go unmentioned by U.S. auditors and regulators.

We previously raised the issue of auditor independence in a story about American Dairy (ticker: ADY), a Chinese milk-powder company that jolted shareholders in December by saying it had dismissed its independent accounting firm, withdrawn its 2007 revenue and profit guidance, and was the subject of an informal Securities & Exchange Commission probe ("Curdled Expectations," Dec. 17, 2007). American Dairy's independent U.S. accountant, Murrell Hall McIntosh, was working with a Hong Kong auditor, Henny Wee, who, it turned out, was a principal in Belmont Capital Group, a firm that provided capital-raising and consulting services to American Dairy before its public listing. The SEC is investigating whether Wee was truly independent. After our story, the company's shares collapsed and ADY since has hired Grant Thornton as its independent auditor.

Auditors and regulators aren't doing all they should to protect investors from problems at U.S.-listed Chinese companies.

But American Dairy is just one of 170 small Chinese companies that have come public in the U.S. since 2000 via a "reverse merger." In these transactions a privately held Chinese company hooks up with a shell company that has a U.S. listing. This way the Chinese outfit avoids much of the time, expense and regulatory scrutiny that comes with a traditional initial public offering.

The same U.S. auditor, Murrell Hall, was also working with Wee when he introduced OraLabs, a shell company, to Belmont, which then introduced it to China Precision Steel (CPSL). The meetings, described in proxy filings, took place in December 2005 -- long after the date Wee told the SEC he ended his business ties with Belmont. Belmont signed a consulting agreement with China Precision, and was paid with shares ultimately representing 11% of the company.

This pattern "shares many similarities" with the relationship among American Dairy, Murrell Hall, Wee and Belmont, says Todd Fernandez, senior research analyst at proxy-research firm Glass Lewis, and "raises serious questions about auditor independence." Wee and Murrell Hall didn't respond to requests for comment. Tracy Hung Wan, CEO of Belmont, referred Barron's to proxy filings with the SEC. The SEC and China Precision wouldn't comment.

There are many reasons accounting problems seem rife in Chinese companies. Kenneth Banet, the partner overseeing Grant Thornton's China practice, explains that Chinese reporting is tax-oriented, and companies don't report sales until customers pay their bills because sales tax is due immediately on receivables. Companies frequently underreport sales and profit to avoid being on the hook for taxes they haven't received. They also often borrow from related-party companies without repaying. (These related parties are common in China because laws limit the kinds of businesses single companies may conduct.) But to list in the U.S., a company must bring its numbers into compliance with U.S. accounting principles and correct any misreporting before an independent auditor signs off on the statements.

Audits of Chinese reverse mergers are even more complicated. For one thing, the Chinese partners usually are opaque, with ownership structured through British Virgin Islands holding companies. The SEC doesn't scrutinize reverse mergers, until the new company raises funds. As a result, investors depend heavily on those in a position of oversight -- such as auditors.

The way advisers are paid in reverse mergers can pose conflicts for supposedly independent auditors. Peter Humphrey, founder of Beijing-based ChinaWhys, which helps multinationals investigate potential fraud in their Asian operations, says that consultants helping Chinese entities list through a reverse merger are often compensated with up to 15% of the stock of the new public company. "The auditors, who are paid by the lead consultants, at least indirectly become stakeholders. In some cases they may even receive actual shares," Humphrey says.

In China, U.S. auditors frequently use contractors to review corporate financials, which also can cause problems. The PCAOB periodically inspects auditors. Mark West, the board's regional associate director, says "inspection teams [have] reported several deficiencies regarding the use of other auditors, including firms reporting on the financial statements as principal auditor when their participation was not sufficient to enable them to serve in that capacity."

All of these shortcomings can lead to more restatements. Puda Coal (PUDC), for instance, said it "mistakenly" overstated 2007 revenue guidance by 34% and net income guidance by 59%, but didn't realize it for more than six months. And China BAK Battery 's shares have lost more than half their value after it restated three years of financials in 2006.

The PCAOB's database can help identify problems. One auditor of Chinese companies like China Clean Energy (CCGY) and China Kangtai Cactus Biotech (CKGT) is Michael T. Studer of Freeport, N.Y. In 2006, during an inspection, the PCAOB found "deficiencies of such significance that it appeared...the Firm (Studer) did not obtain sufficient competent evidential matter to support its opinion on the issuer's financial statements." Moreover, in 2004, the National Association of Securities Dealers expelled Studer's firm and barred him from association with any securities firm.

A spokesman for Studer said the firm "will of course comply with any directives" from the PCAOB. He added the NASD bar did not involve any accounting or auditing matters and is on appeal in federal court.

The Bottom Line:

Beware of Chinese companies coming public in the U.S. via reverse mergers. Their accounting can be murky, financial restatements are rising and conflicts of interest abound.

Sky One Medical (CSKI) and China Education Alliance (CEUA) hired auditors at Sherb & Co., in Boca Raton, Fla. PCAOB's database has a June 2007 entry reporting "deficiencies" in an inspection of Sherb. The auditor's registration file also includes a letter in which Sherb asks the PCAOB not to deny its registration based on a pending securities class-action lawsuit that accused Sherb of signing off on alleged revenue fabrication by a Boca Raton-based financial-services company.

Christopher Valleau, who runs Sherb's China practice, says the PCAOB inspection found a single audit deficiency that didn't pertain to a Chinese client, and that it "is not uncommon or unusual for any quality firm that audits public companies to have at least one comment from PCAOB staff." Sherb has made partners more responsible for any problems, he says, and improved education. The class-action suit, he adds, was settled "without any finding of fault against our firm" and never went to trial.

As for Murrell Hall's recent decision to stop auditing Chinese reverse mergers, Valleau say it's a non-event. "If Ernst & Young left, it would impact the landscape. But not Murrell Hall, and not us. There are plenty of firms out there doing what we do."