Multinational Firms Research Paper

Chinese Firms and the United States Equity Markets

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Introduction

Today there are many Chinese multinational companies listed on the US stock exchanges and in some cases their financial statements are riddled with fraud. United States law requires that the "Public Company Accounting Oversight Board (PCAOB) inspect the audits of U.S.-listed Chinese companies performed by China-based auditors," and thus far Chinese regulators are refusing to let that happen.[1] Specifically, this is required in "Sarbanes-Oxley," which created the PCAOB.[2] The problem with this is that the fraud can be hard to trace to "the accounting firms, the audited companies, or both."[3] This article addresses this issue on many different levels. The first is on an accounting level, because of the difference between US GAAP and IFRS, which is used in China. In addition, having possibly fraudulent audits in China jeopardizes the integrity of the financial information given to US investors and other interested parties.

The second is on a strategic level, both domestically and internationally. Domestically, it raises the question of how the SEC and PCAOB should deal with these Chinese companies if their regulatory authorities continue to resist the PCAOB's investigation efforts. For example, should the US authorities ban Chinese firms from the US stock exchanges or take less extreme measures, and what impact would any action have on market access and future technology? On the Chinese side, how would they deal with this issue internally and what could their logic be for stonewalling the negotiations so far? Internationally, how would the Chinese companies react to the situation and any penalties imposed on them such as being removed from the stock exchange? They could either go private, which would have an impact on the markets, or they could simply leave the US markets, it depends on the firm. These two strategies are functionally different in that going private would indicate that they are delisting from the equity markets and removing their public company status, while leaving the US equity markets would indicate that they are likely to list publically on the Asian markets, such as China for example. On the US side, how would they be perceived around the world if they did ban Chinese companies from the stock exchange? How would we be perceived if we kept trying to negotiate with China to come to a peaceful resolution? What effect would it have on the markets? These questions are evaluated here.

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[1] Lubman, Stanley. "What U.S.-China Auditing Dispute Means for Chinese Business Culture." *The Wall Street Journal*, January 15, 2013. Accessed January 28, 2013. http://blogs.wsj.com/chinarealtime/2013/01/15/what-u-s-china-auditing-dispute-means-for-chinese-business-culture/?KEYWORDS=china+and+the+pcaob.

[2] Chovanec, Patrick. "Foreign Policy: Clash of the Balance Sheets." An American Perspective From China. December 12, 2012. Accessed February 21, 2013. http://chovanec.wordpress.com/2012/12/12/foreign-policy-clash-of-the-balance-sheets/.

[3] Lubman, Stanley. "What U.S.-China Auditing Dispute Means for Chinese Business Culture." *The Wall Street Journal*, January 15, 2013. Accessed January 28, 2013. http://blogs.wsj.com/chinarealtime/2013/01/15/what-u-s-china-auditing-dispute-means-for-chinese-business-culture/?KEYWORDS=china+and+the+pcaob.

The third is on a big picture level and that is how the US regulatory forces and Chinese regulatory forces could use this situation to achieve their respective goals. Moreover, how would this impact the US-China negotiations going forward and would it trickle down to the firm-level? In addition, how will this dispute affect other multinational corporations listed on the US stock exchanges, aside from the Chinese companies?

The fourth is on an economic level, specifically in terms of the bond ratings for these Chinese firms as commented on by Fitch. Related to this, how will any plan of action impact all foreign companies interested in listing on the US stock exchanges going forward? In addition, the impact of the Chinese name on a firm's performance has interesting implications if any of the multinational firms were to leave, which can be illustrated in a study done in *Financial Management* by Kee-Hong Bae and Wei Wang.[4]

Finally, this paper addresses the question: why do Chinese multinational firms list on the US stock exchanges? Furthermore, how could Chinese firms and the Chinese regulators use this logic to frame the debate?

IPO and Reverse Merger Information

This paper begins by providing a broad framework for research and analysis: why do Chinese multinational firms want to list on the US stock exchanges? This can be done two ways, Initial Public Offering (IPO) or Reverse Merger. An IPO, is "the first sale of stock by a private company to the public," and can be done by a few different types of companies, including "large privately owned companies looking to become publically traded."[5] According to an article in *Business Insider* by Simon Fong, there are four key reasons Chinese multinational firms choose to list on the US stock exchanges via an IPO.[6] The first is that "if a 'Chinese' company takes foreign investment using a VIE [Variable Interest Entity] structure, it can only list abroad."[7] This arrangement starts with "a Caymen Islands company," which can also be a "100%-owned Hong Kong subsidiary" in some cases, which "then owns a wholly-owned foreign enterprise (WFOE) in China," and then "via a series of agreements controls a local Chinese company that holds the licenses necessary to operate the business in China."[8] Essentially, this circumvents "Chinese laws barring foreign ownership," and has "been called into question by Chinese

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[4] Bae, Kee-Hong, and Wei Wang. "What's in a 'China' Name? A Test of Investor Attention Hypothesis." *Financial Management* 41, no. 1 (Summer 2012): 429-55. Accessed January 23, 2013. http://web.ebscohost.com/bsi/detail?sid=a90000c4-de0c-4ef9-b609-accc78c8980c%40sessionmgr110&vid=1&hid=106&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=76371883.

[5] "Definition of 'Initial Public Offering-IPO'." Initial Public Offering-IPO. 2013. Accessed February 18, 2013. http://www.investopedia.com/terms/i/ipo.asp#axzz2LYcq7OPo.

[6] "4 Reasons Chinese Companies IPO in America." Business Insider: Money Game *Contributors*. July 21, 2011. Accessed February 17, 2013. http://articles.businessinsider.com/2011-07-21/markets/30041746_1_foreign-investment-tencent-sina.

[7] Ibid

[8] Ibid

regulators."[9] The basic premise behind this reason is that these Chinese multinational firms are not "at all eligible to [be] listed on the Chinese A-Share Market, which [restricts] the overseas-funded enterprises severely."[10] Hence, this is one of the key reasons why some Chinese multinationals do choose to IPO in the United States.

The second reason is that a lot of "companies don't meet the strict financial standards for a Chinese listing," because the IPO minimum requirements are far less rigorous financially in the US compared to China.[11] This speaks to the higher levels of deregulation in the US equity markets, albeit not as high as they were before the 2008 recession. The third reason is that "China's listing process is lengthy and opaque, a torturous examination compared with America's speedy registration."[12] We do have some bureaucracy with the SEC and other government agencies, but it is nowhere near the level of China.

The fourth and final reason is that "China's regulatory agencies perpetually overregulate, rather than letting the market decide," in that they are "concerned about investors losing money in the secondary markets," and set up regulations accordingly.[13] This speaks to the difference in mentality between the United States and China: we are more of a free-market economy whereas China is more state-owned and more restrictive with their equity markets. In a *Financial Management* study done by Kee-Hong Bae and Wei Wang, which looked at Chinese-name IPO's in particular, they hypothesized that "the first-day IPO return of China-name stocks is twice as large as that of non-China-name stocks," but "we should also expect stronger price reactions from the China-name stocks than non-China-name stocks to the events of China-name IPO listings," which is not the case for IPOs of stocks without China in the name.[14] These findings were supported by authors study, in terms of the "stronger stock price reaction."[15] In addition, the authors cite research by Hsu, Reed, and Rocholl done in 2010 that suggests "that issuing firms have competitive advantages over their publically traded industry peers."[16]

A Reverse Merger, by comparison, is when "a private company joins the public market by buying a listed company, rather than going through the heavily regulated process of an initial public offering."[17] According to an article in *Financial Management*, this is a common way for

[9] Ibid
[10] Ibid
[11] Ibid
[12] Ibid
[13] Ibid
[14] Bae, Kee-Hong, and Wei Wang. "What's in a 'China' Name? A Test of Investor Attention Hypothesis." *Financial Management* 41, no. 1 (Summer 2012): 429-55. Accessed January 23, 2013. http://web.ebscohost.com/bsi/detail?sid=a90000c4-de0c-4ef9-b609-accc78c8980c%40sessionmgr110&vid=1&hid=106&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=76371883.

[15] Ibid
[16] Ibid
[17] "US Examines Chinese Reverse Mergers." *Financial Management*, May 1, 2011, 13. Accessed January 23, 2013. http://web.ebscohost.com/bsi/detail?sid=508fe052-1048-482f-9908-

Chinese companies to gain access to US markets, and "PCAOB research revealed that 159 companies from China had accessed US capital markets through a reverse merger between January 2007 and March 2010, representing about 26 percent of all deals of this kind."[18] Digging deeper in the numbers, these 159 Chinese companies "had a combined market capitalization of $12.8 [billion] at the end of March 2010."[19] However, according to an article by Reese Darragh in *Compliance Week,* "the New York Stock Exchange and Nasdaq recently added new rules that require companies wanting to go public via a reverse merger to file an annual report with the Securities and Exchange Commission, list for at least one year on an over-the-counter or a regulated foreign exchange, and keep a minimum share price."[20]

In addition, the SEC launched "enforcement inquiries into more than 24 Chinese reverse merger companies that have disclosed auditors' resignations, accounting problems, or both."[21] Mr. Darragh also claims that "dozens of Chinese companies that used reverse mergers to go public have experienced accounting frauds or been forced to fire their auditors, restate earnings, or worse," and cites "China Media Express and Duoyuan Global Water" as examples of the resulting "stock plunges."[22] He also cites a quote from Siva Yam, the "president of the U.S.-China Chamber of Commerce," who said that the new regulations could act to protect Chinese owners who want to invest in US markets, because they "do not understand how reverse mergers in the United States work, and some of them were involved in reverse mergers in the past have informed me of losses they incurred in such deals."[23] The phenomenon of reverse mergers has interesting and important implications that will be discussed later in the analysis section of this paper.

Accounting Information

The first issue to look at is the accounting side, including the difference between US GAAP and IFRS and how the US stock exchange listing rules can make it complicated for Chinese companies interested in listing on it. As a starting point, the basic difference between the two accounting systems is that US GAAP is more rules-based, built around a key set of principles such as conservatism and consistency. IFRS, on the other hand, is based more on a framework that does not emphasize rules so much as general principles. PricewaterhouseCoopers, PwC, did a paper about these differences in much more detail, and it is a good illustration as to how

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10867b596c2a%40sessionmgr104&vid=1&hid=106&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=61050456.

[18] Ibid

[19] Ibid

[20] Darragh, Reese. "Regulators Eye Chinese Wall for Reverse Mergers." *Compliance Week* 8, no. 94 (November 2011): 59-65. Accessed February 22, 2013. http://web.ebscohost.com/bsi/detail?vid=5&sid=278f0029-2dac-4661-b4e9-ff43e233337e%40sessionmgr113&hid=113&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=73797107.

[21] Ibid

[22] Ibid

[23] Ibid

diverse really are. For example, with revenue recognition, the US GAAP "guidance tends to be highly detailed and is often industry-specific," because it "is based on fixed or determinable pricing criterion, which results in contingent amounts not being recorded as revenue until the contingency is resolved."[24] IFRS, on the other hand, "contains minimal industry-specific guidance" and "the broad principles-based approach of IFRS is to be applied across all entities and industries," in that it looks at "the probability of economic benefits associated with the transactions associated with the entity and the ability to reliably measure the revenue in question, including any contingent revenue."[25] There are many more differences like this, and that in turn makes it more difficult for foreign companies to list on the stock exchange, Chinese multinational firms included.

Each of the US stock exchanges, namely the New York Stock Exchange and the Nasdaq Stock Market, has its own listing requirements, which can make it even more difficult for these Chinese firms.[26] On the New York Stock Exchange for example, a non-U.S. firm must have a minimum number of shares/shareholders, a minimum amount of pre-tax income over the past three years, and a minimum amount of revenue over the most recent fiscal period, among other things, just to be listed.[27] More generally speaking, if a non-US firm is interested in listing on our stock exchanges, and their "annual audited" reports are done using "local GAAP or non-IASB IFRS," the "consolidated financial statements (both annual and interim) must include a reconciliation to US GAAP."[28] China, which used to have "Chinese Accounting Standards (CAS)," has since mostly transitioned to IFRS, in that their standards are close to it but some differences between the two systems still exist, such as accounting for certain impairment losses, financial statement presentation pieces, and classifying borrowing costs, among others.[29] As a result, the reconciliation to US GAAP is still necessary as of this time, because it is not truly IASB IFRS.

The final aspect of the accounting side is the issue of audit procedures and how that impacts the viewers of the financial statements. For example, according to an article in *The Wall Street Journal Asia,* auditors have run into issues with bank confirmations, or "the process by which an

[24] "IFRS and US GAAP: Similarities and Differences." IFRS Readiness Series October 2012. October 2012. Accessed February 15, 2013. http://www.pwc.com/en_US/us/issues/ifrs-reporting/publications/assets/ifrs-and-us-gaap-similarities-and-differences-2012.pdf.

[25] Ibid

[26] "Listing and Delisting Requirements." U.S. Securities and Exchange Commission. October 15 2012. Accessed February 16, 2013. http://www.sec.gov/answers/listing.htm.

[27] "Non-U.S. Standards." U.S. Equities. Accessed February 16, 2013. http://usequities.nyx.com/regulation/listed-companies-compliance/listings-standards/non-us.

[28] "Financial Statement Requirements in US Securities Offerings: What Non-US Issuers Need to Know." 2011 Edition. 2011. Accessed February 17, 2013. http://www.lw.com/upload/pubcontent/_pdf/pub4371_1.pdf.

[29] "China Accounting Standards." ChinaOrbit.com. Accessed February 17, 2013. http://www.chinaorbit.com/china-economy/chinese-accounting-standards.html.

auditor checks with the company's bank to verify its balances."[30] Examples cited in the article include China-Biotics Inc., where "BDO announced it was dropping the account" because of a "suspected fake," and Longtop Financial Technologies Ltd., where Deloitte Touche Tohmatsu "received confirmations from bank staff' which "were said to be false," or showed differences "in deposit balances and company borrowings compared with previous confirmations."[31] In addition to bank confirmations, McGladrey and Pullen LLP espoused "extra diligence" in "auditing accounts receivable, because fraud often shows up there first, because it is hidden in exaggerated cash balances."[32] All of these auditing issues raise a serious question about the financial reliability of these companies, and according to an article in *The Asian Wall Street Journal* by Peter Stein, PCAOB chairman James Doty called the inability to perform inspections in China "a gaping hole in investor protection," which is a very powerful statement.[33] The impact of these deficiencies is very important in terms of investor security, which is a key to the efficiency and success of our equity markets.

Strategy Information

The second topic to examine is the domestic and international strategy associated with this issue, beginning with the domestic side. Specifically, how should the PCAOB and SEC deal with these Chinese companies if their regulatory authorities continue to resist the PCAOB's investigation efforts? A good example of one possible course of action is Longtop Financial Technologies, mentioned previously, in that it "was delisted from the New York Stock Exchange [in 2011] after short sellers released a report alleging the company was committing fraud."[34] In addition, according to an article by Neil Gough in the *New York Times,* "the Securities and Exchange Commission has deregistered the securities of nearly 50 China-based companies and has filed

[30] Rapoport, Michael. "Auditors Sharpen Queries In China --- Verifying Basic Points, Such as Amounts of Cash on Hand, Can Be a Problem; a 'Suspected Fake' Website." *The Wall Street Journal Asia* (Hong Kong), June 30, 2011. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/874160957/13BC320D7B22B5F71DA/4?accountid=14731.

[31] Ibid

[32] Ibid

[33] Stein, Peter. "The View from Hong Kong: Chinese Firms Need to Open Up." Editorial. *The Wall Street Journal Asia* (Hong Kong), June 20, 2011. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/872405643/13BC3FAC0F85AA325DC/8?accountid=14731.

[34] Block, Carson C. "China's Auditing Train Wreck." *The Wall Street Journal Asia* (Hong Kong), May 4, 2012. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/1010816391/13BC320D7B22B5F71DA/2?accountid=14731.

about 40 related fraud cases."[35] Not only that, but in December 2012, "the S.E.C. charged the Chinese affiliates of the world's biggest accounting companies with violating securities laws for failing to turn over documents related to their auditing work on businesses in China."[36] One solution that Mr. Block advocates to alleviate problems like this is "for the Chinese government to allow U.S. regulators, including the PCAOB and the SEC, to inspect companies that have their primary listing on U.S. markets."[37] This idea however, is being hampered by the inability of the US and Chinese regulatory forces to find "common ground" on the issue.[38]

On a more in depth level, Mr. Block proposes increasing "the regulatory costs associated with poor auditing practices," in terms of "subjecting Chinese units of global accounting firms to U.S. regulatory scrutiny when those firms are auditing U.S. listed companies."[39] Another solution that Mr. Block supports is "if Deloitte's refusal to comply with the subpoena [for their audit records] stands, the PCAOB should deregister China-domiciled auditing firms," which means Chinese companies would have "to switch auditors or be forced to delist."[40] On the Chinese side, the question would be their possible logic for stonewalling the negotiations so far, and that is also answered in this article. Mr. Block says that the "CRSC [Chinese Securities Regulatory Commission] has as much interest" in audit "information-sharing as the SEC does, because if audits of U.S.-listed Chinese companies are suspect, audits of China-listed Chinese companies" most likely are as well.[41] However, the main issue is that "China isn't coming to the table because it [does not] want to give up sovereignty to regulators."[42] In addition, as Tammy Whitehouse points out in *Compliance Week,* "China forbids work papers from being released to outside regulators for fear of revealing state secrets."[43] Complicating the issue is that "in May [2012], Beijing took steps to tighten control of local affiliates of major accounting firms by

[35] Gough, Neil. "Chinese Companies Head for the Exit." DealBook. December 20, 2012. Accessed January 23, 2013. http://dealbook.nytimes.com/2012/12/20/chinese-companies-head-for-the-exit/.
[36] Ibid
[37] Block, Carson C. "China's Auditing Train Wreck." *The Wall Street Journal Asia* (Hong Kong), May 4, 2012. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/1010816391/13BC320D7B22B5F71DA/2?accountid=14731.
[38] Ibid
[39] Ibid
[40] Idid
[41] Ibid
[42] Ibid
[43] Whitehouse, Tammy. "PCAOB Gets Glimpse at China Audits, More Talks Planned." *Compliance Week* 9, no. 107 (December 2012): 7-8. Accessed January 23, 2013. http://web.ebscohost.com/bsi/detail?sid=ba6ce5c8-066d-47ac-a092-0087ed72e522%40sessionmgr111&vid=1&hid=106&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=84321084.

issuing a requirement for Chinese citizens to head those offices."[44] This would certainly have an impact on future market access and future technology, which I will analyze later in this paper.

Looking at the international side of the strategy, specifically how would the Chinese companies react to any allegations of risky accounting practices and any penalties imposed on them such as being removed from the stock exchange? An article in *Yahoo! Finance* by Joe Mcdonald explains these reactions very well, both in terms of substance and reasoning. One of the examples Mr. Mcdonald uses is Focus Media Holding Ltd., which announced its plan to "buy back its U.S.-traded shares and take the Shanghai-based advertising company private."[45] The company's logic was that it "has been seriously undervalued on the U.S. stock market," and going private will help promote its "long-term development," and the company said "the possibility" of listing on the markets in China "has not been excluded."[46] It is not only large companies, "smaller companies also are withdrawing from U.S. exchanges," and interestingly enough, "a Chinese business magazine," called Caixin, "said a state bank provided $1 billion in loans to help companies with listings abroad move them to domestic exchanges."[47] Expanding on this idea, Fushi Copperweld, China TransInfo Technology Corp., and Harbin Pacific Electric Co, all withdrew from the US stock exchanges with the help of "loans from the China Development Bank," or the CDB for short.[48] The implications of that information will be discussed later in this paper. These Chinese companies who are choosing to withdraw from the US stock exchanges also reason that "a low share price fails to reflect the strength of their business," like Focus Media, and that it "eliminates the cost of complying with American financial reporting rules."[49] Mr. Mcdonald also says that initially, "Chinese regulators" encouraged moving to the US stock exchanges "as a way for entrepreneurs to raise money and speed the development of China's economy," but recently, "Beijing has encouraged private companies to issue shares in China to help develop its markets and give Chinese households better investment options."[50] These reactions are very interesting, and they will be analyzed in more detail later in this paper. In addition, this paper examines how the US would be perceived around the world if they did ban Chinese companies from the stock exchange, if they kept trying to negotiate with China to come to a peaceful resolution, and the possible effect it would have on the markets.

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[44] Mcdonald, Joe. "Chinese Companies Pull out of US Stock Markets." Yahoo! Finance. August 14, 2012. Accessed February 20, 2013. http://finance.yahoo.com/news/chinese-companies-pull-us-stock-095649722.html.

[45] Mcdonald, Joe. "Chinese Companies Pull out of US Stock Markets." Yahoo! Finance. August 14, 2012. Accessed February 20, 2013. http://finance.yahoo.com/news/chinese-companies-pull-us-stock-095649722.html.

[46] Ibid
[47] Ibid
[48] Ibid
[49] Ibid
[50] Ibid

Big Picture Information

The third issue to examine is the big picture level, how the US regulatory forces and Chinese regulatory forces could use this situation to achieve their respective goals, how this would impact the US-China negotiations going forward, and how it would trickle down to the firm-level. This can be best illustrated by The United States Chamber of Commerce, which as quoted by Neil Gough in the *New York Times,* said in December 2012 that "failure to reach an agreement will create regulatory dead zones that harm investors and businesses," and that "the threat of retaliatory actions by regulators, on both sides of the Pacific, may create a regulatory protectionism that will harm both economies.''[51] In addition, as espoused by Michael Rapoport in *The Wall Street Journal Asia,* the SEC filed "an administrative proceeding" in December 2012 against the five big accounting firms operating in China, and the case will be heard by an "SEC administrative law judge."[52] The SEC law judge "could censure the firm or temporarily suspend them from seeking new audit clients," or more seriously, deregister the firms by taking away their "right to practice before the SEC and conduct audits of U.S.-traded companies."[53] This is a key issue because combined, "the five Chinese affiliates currently audit 126 U.S.-traded companies, according to data from the Public Company Accounting Oversight Board," for example Baidu Inc. and Apple use Ernst and Young, Sanmina uses KPMG, Qualcomm uses PricewaterhouseCoopers, and Kimberly-Clark uses Deloitte.[54]

Despite the fact that companies like Apple, Qualcomm and Kimberly-Clark are American companies, they still have Chinese affiliates, and therefore if any serious punishment were imposed on the Chinese affiliates of these accounting firms, it would have a direct impact on the multinational corporations listed on the US stock exchange because they would potentially be forced to find new auditors.[55] Mr. Rapoport also addresses the possible impact on the negotiations between the US and Chinese regulators, citing Peter Bresnan from Simpson Thatcher & Bartlett LLP, "and a former SEC deputy enforcement director:" "It's possible that the threat of disqualification will bring the Chinese regulators back to the bargaining table."[56]

[51] Gough, Neil. "Chinese Companies Head for the Exit." DealBook. December 20, 2012. Accessed January 23, 2013. http://dealbook.nytimes.com/2012/12/20/chinese-companies-head-for-the-exit/.

[52] Rapoport, Michael. "U.S.-China Audit Spat May Spill Over." *The Wall Street Journal Asia* (Hong Kong), December 31, 2012. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/1265712668/13BC320D7B22B5F71DA/9?accountid=14731.

[53] Ibid
[54] Ibid
[55] Ibid
[56] Rapoport, Michael. "U.S.-China Audit Spat May Spill Over." *The Wall Street Journal Asia* (Hong Kong), December 31, 2012. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/1265712668/13BC320D7B22B5F71DA/9?accountid=14731.

This is significant in that it can have a key impact on these negotiations, and consequently alter the goals of each side during the process.

Another key question is how this dispute will affect other multinational corporations listed on the US stock exchanges, aside from the Chinese companies. In Patrick Chovanec's blog, he does a good job of highlighting this impact, using specific companies and background information on the laws. Mr. Chovanec said that there are "plenty of multinationals listed on U.S. markets, many of them headquartered in the United States," that "have substantial parts of their business in China."[57] For example, he cites Yum Brands, which "takes in 44 percent of its revenues from KFC and Pizza Hut outlets it has in China," and General Motors, because "car sales in China account for 34 percent" of their profits.[58] This is important because in order "to sign off on their SEC filings, their lead auditors in the United States need a PCAOB-registered Chinese auditor to vouch for them," and if these auditors do not exist, "these companies have a problem."[59] As Mr. Chovanec points out, this is not an easy fix because it is "costly and cumbersome" to divide the work up between multiple auditors to ensure that "none of them is vouching for a "substantial" part of the business," and it is not clear "if easy loopholes can be created for multinationals with substantial China operations without tearing a big hole in the fabric of U.S. securities regulation."[60] In addition, as mentioned by Michael Rapoport in *The Asian Wall Street Journal,* US multinational companies like Apple, Qualcomm, and Kimberly-Clark could be impacted as well because they all "have major Chinese operations."[61] This is certainly a very important point of discussion, because of the wide-ranging implications it could have on the markets.

Economic Information

The fourth issue to examine is the economic perspective, specifically how the bond ratings of these US-listed Chinese multinational companies have and will be impacted by the accounting issues. According to the article by Mr. Stein cited earlier, Standard and Poor's, one of the main bond rating agencies in the US, "withdrew its ratings for the long-term corporate debt of a major Chinese packaging manufacturer, Nine Dragons Paper (Holdings) Ltd., after its analyst complained of being unable to get senior management to answer questions about the company's business."[62] This action caused the "stock to plunge more than 17%" initially, but after "Nine

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[57] Chovanec, Patrick. "Foreign Policy: Clash of the Balance Sheets." An American Perspective From China. December 12, 2012. Accessed February 21, 2013. http://chovanec.wordpress.com/2012/12/12/foreign-policy-clash-of-the-balance-sheets/.
[58] Ibid
[59] Ibid
[60] Ibid
[61] Rapoport, Michael. "U.S.-China Audit Spat May Spill Over." *The Wall Street Journal Asia* (Hong Kong), December 31, 2012. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/1265712668/13BC320D7B22B5F71DA/9?accountid=14731.
[62] Stein, Peter. "The View from Hong Kong: Chinese Firms Need to Open Up." Editorial. *The Wall Street Journal Asia* (Hong Kong), June 20, 2011. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/872405643/13BC3FAC0F85AA325DC/8?accountid=14731.

Dragons said it was willing to cooperate with S&P and respond to requests for information, most of that loss was recovered.[63] Fitch, according to an article by Daniel Flatt in *Asiamoney*, has said "mainland corporate faces a sizeable risk of begin targeted for more fraud allegations," due to "the combination of the country's high levels of growth and low level of international standards in the country."[64] Therefore, "good Chinese corporates looking to raise money in international capital markets will be tarred by the same fraud brush [as] a number of questionable companies that have come out of the woodwork," which could result in "a lack of trust from international investors."[65]

Ultimately, Fitch and all the other rating agencies believe that the management of these Chinese companies can and should "adopt higher standards," as opposed to relying on "opaque structures and profits."[66] Mr. Flatt did, however, put some blame on Fitch and other ratings agencies in the case of "Chinese forestry company Sino-Forest," in that they admit they "failed to realize the risks of the firm's opaque operating structure," and subsequently "withdrew the rating it held on Sino-Forest," due to "lack of transparency."[67] This issue in credit and bond ratings is a key economic issue and is linked to the idea of investor confidence, as well as the question of how it will impact foreign companies, Chinese or otherwise, listing on the US Stock exchanges going forward.

In addition, the impact of the Chinese name on a firm's performance does have some interesting implications if any of these Chinese multinational firms were to leave the stock market, which can be inferred in a study done in *Financial Management* by Kee-Hong Bae and Wei Wang.[68] They examined two periods: one ranging "from September 2006 to October 2008," called the "boom" period, and one ranging "from November 2007 to October 2008," called the "bust" period.[69] They identified "99 firms" total, with 28 "that went through IPOs during the boom period," and 16 "that went through theirs during the bust period."[70] The authors' key argument "is that the China-effect name" documented "during the boom period is driven by investor attention," and "price pressure caused by this investor attention drives the outperformance of the

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[63] Ibid

[64] Flatt, Daniel. "Chinese Firms Will Face More Fraud Stigma, Says Fitch." *Asiamoney*, July 2011. Accessed January 23, 2013. http://search.proquest.com/asianbusiness/docview/880986241/13BC3FAC0F85AA325DC/35?accountid=14731.

[65] Ibid

[66] Ibid

[67] Ibid

[68] Bae, Kee-Hong, and Wei Wang. "What's in a 'China' Name? A Test of Investor Attention Hypothesis." *Financial Management* 41, no. 1 (Summer 2012): 429-55. Accessed January 23, 2013. http://web.ebscohost.com/bsi/detail?sid=a90000c4-de0c-4ef9-b609-accc78c8980c%40sessionmgr110&vid=1&hid=106&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=76371883.

[69] Ibid

[70] Ibid

Chine-name stocks."[71] More interesting, however, is that "among the stocks that increase more during the boom period, China-name stocks drop more than non-China-name stocks during the bust period, which "is consistent with the existence of a price reversal for China-name stocks."[72] This finding in particular has relevant extensions if the Chinese-named firm in question is experiencing scrutiny by investors for possibly having a faulty audit.

IPO and Reverse Merger Implications

The first point of analysis is to examine the broad topic of IPOs and Reverse Mergers, and specifically, why and how Chinese multinational firms list of the US equity markets. For any person who is reasonably informed on the US equity markets, it should make sense intuitively that listing with an IPO it is a great opportunity for any company, multinational corporation or otherwise. The study by Kee-Hong Bae and Wei Wang cited earlier shows how popular these Chinese multinational companies really were during their IPO's.[73] Assuming this study holds true, it stands to reason that all the accounting uncertainties associates with these companies has an even larger impact on their stock price and reputation when it comes to the equity markets, possibly double compared to US-based public companies. Investors need reliable financial information from publically listed companies so they can make the best possible investment decisions, and it appears the accounting irregularities impact investor confidence much more so when it comes to Chinese multinational firms. From this perspective, I can absolutely understand the concerns of the US regulatory forces and I think they should put more pressure on the Chinese regulatory authorities to allow the PCAOB to come in and inspect the audits of these Chinese multinational companies, as required by Sarbanes Oxley. This would have to be done tactfully but forcefully, and you would have to make sure the Chinese understand why we are pushing the issue and why we will not take no for an answer. Investor security is paramount in the US equity markets, and the SEC and PCAOB should do whatever it takes to maintain that in the face of accounting uncertainty in these Chinese multinational firms.

For Reverse Mergers, it is really a double-barreled issue that deals with two key areas: legality and the reliability of financials information given to investors of these Reverse Merger Chinese multinational firms. Legally, it seems to me like this is an attempt, albeit a successful one, to skirt the laws of the US equity markets and actions by the SEC mentioned earlier, in conjunction with both the New York Stock Exchange and Nasdaq in terms of independent legal action, indicate they feel the same way.[74] I think these new regulations and legal actions enacted by the

[71] Ibid

[72] Ibid

[73] Bae, Kee-Hong, and Wei Wang. "What's in a 'China' Name? A Test of Investor Attention Hypothesis." *Financial Management* 41, no. 1 (Summer 2012): 429-55. Accessed January 23, 2013. http://web.ebscohost.com/bsi/detail?sid=a90000c4-de0c-4ef9-b609-accc78c8980c%40sessionmgr110&vid=1&hid=106&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=76371883.

[74] Darragh, Reese. "Regulators Eye Chinese Wall for Reverse Mergers." *Compliance Week* 8, no. 94 (November 2011): 59-65. Accessed February 22, 2013. http://web.ebscohost.com/bsi/detail?vid=5&sid=278f0029-2dac-4661-b4e9-

SEC are a great starting point for stunting the growth of these reverse mergers, which can only help investor security and financial reliability. Accounting fraud is really bad in these Chinese multinational reverse merger companies, such as China Media Express and Duoyuan Global Water.[75] Investor security and the reliability of financial security is a paramount concern in the United States equity markets, and therefore more action should be taken against these Chinese multinational firms if this accounting fraud continues. This could include restriction on the trading of their stock, a ban from the equity markets for a certain period of time, or even delisting and deregistering these firms, which has already been enacted.

Accounting Implications

In addressing the accounting side of this issue, it is worth mentioning that it adds key context to the problem. The accounting systems, in terms of US GAAP and IFRS, are an issue that has been ongoing since 2002 with the Norwalk Agreement, and today there is still not a full convergence in the United States. This does have an impact on publically traded companies because of the uncertainty associated with the issue, and that uncertainty extends to the equity markets as well. Further complicating the issue is the requirement in Sarbanes Oxley mentioned earlier in that there is a difference between the two systems and the Chinese regulatory authorities are resisting the PCAOB quality inspections of their multinational companies that are listed on the US equity markets. From the Chinese side it makes sense that they are trying to protect their companies from accounting scrutiny because they are looking out for their own, but it also makes sense from the United States side because they want their investors to have accurate accounting and financial information to preserve the reputation of the equity markets. This is particularly important given the specific auditing procedure issues mentioned in the research section of the paper, specifically related to auditing accounts receivable and obtaining bank confirmations.[76] Speaking from experience this summer during my internship, these are essential procedures to a proper audit, and if these are not done properly then all the related financial information is jeopardized. The PCAOB and SEC should do all they can to make sure these Chinese multinational companies know the severity of this issue, and keep putting pressure on their regulatory authorities to cooperate with us as much as possible. The quote by PCAOB chairman James Doty highlighted in the research section is particularly strong and illustrates how significant this issue really is to the US regulatory authorities.[77]

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ff43e233337e%40sessionmgr113&hid=113&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=73797107.

[75] Ibid

[76] Rapoport, Michael. "Auditors Sharpen Queries In China --- Verifying Basic Points, Such as Amounts of Cash on Hand, Can Be a Problem; a 'Suspected Fake' Website." *The Wall Street Journal Asia* (Hong Kong), June 30, 2011. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/874160957/13BC320D7B22B5F71DA/4?accountid=14731.

[77] Stein, Peter. "The View from Hong Kong: Chinese Firms Need to Open Up." Editorial. *The Wall Street Journal Asia* (Hong Kong), June 20, 2011. Accessed January 28, 2013.

Strategy Implications

The next point of analysis is the international and domestic strategy of this issue, which is particularly important because it has practical decision-making applications going forward. In terms of the domestic strategy, as alluded to earlier in this section, the SEC could and has taken many actions against these Chinese multinational firms, including delisting or deregistering these companies as well as suing them in court. They have also gone as far as to take legal action against the Chinese Big Four affiliates, as mentioned in the research section of the paper.[78] This strategy by the SEC attacks the issue from two sides: the company and the Chinese accountants who, partially at least, allowed the fraud to happen. Two additional measures the SEC could enact against these Chinese multinationals can be proposed: restricting the trading of their stock and banning them from the US equity markets not permanently, but for a specified period of time.

Both of these measures would be less extreme then those already implemented by the SEC, but they do come with an added benefit that is not obvious at first. That benefit is that it would put a large dent in the investor confidence in these publically traded Chinese multinational firms, which might give them added encouragement to leave the US equity markets without being explicitly forced out. Out of these two options, restricting the trading of their stock would send a stronger message in that regard because it would be a daily occurrence and more of a hit to the stockholders equity section of their balance sheet. The idea is that these Chinese multinational companies would get the hint that the refusal to allow the PCAOB to inspect the audits and the poor accounting problems will not be tolerated. This way, they could leave on their own terms and avoid further punishment by our regulatory authorities.

In addition, Mr. Block's suggestion to sanction or deregister the Chinese arms of these accounting firms, would send a strong message that the United States does not mess around with investor security and protection. The example he gave of Deloitte and Longtop, which was delisted from the US equity markets as mentioned previously, is very good in that it illustrates the relative inequity of the punishment situation.[79] The SEC has charged these accounting firms with securities law violations for the failure to turn over audit documents, as Mr. Gough pointed

http://search.proquest.com/asianbusiness/docview/872405643/13BC3FAC0F85AA325DC/8?accountid=14731.

[78] Gough, Neil. "Chinese Companies Head for the Exit." DealBook. December 20, 2012. Accessed January 23, 2013. http://dealbook.nytimes.com/2012/12/20/chinese-companies-head-for-the-exit/.

[79] Block, Carson C. "China's Auditing Train Wreck." *The Wall Street Journal Asia* (Hong Kong), May 4, 2012. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/1010816391/13BC320D7B22B5F71DA/2?accountid=14731.

out, but that is a more a long-term issue that will be settled in the courts.[80] Longtop was subsequently delisted from the US equity markets, but the Chinese affiliate of Deloitte received no immediate punishment, and that is simply unacceptable.[81] It depends on the severity of the situation of course, but if something like this happens again the SEC should sanction these accounting firms, in a few different ways. One option is to put a 6-month holding period in place, where the Chinese affiliates of the accounting firms could not take on or audit a publically traded Chinese multinational firm during that time frame. This would not completely cripple their ability to run a normal business operation, but it would be a strong enough message that they would strongly consider tightening their audit procedures and controls.

Another option is to limit the number of new public Chinese multinational companies the firms could take on as clients for a year or more. As with the previous sanction, it would not significantly harm their business but it would send them a harsh warning to strengthen their audits. Both of these sanctions are good strategies from the US regulatory perspective, in that they would be effective in getting the investor protection message across to the Chinese regulatory authorities and their multinational firms. There are two key things to keep in mind with these sanctions, however. One, this would only affect the Chinese affiliates of the big accounting firms, not the United States affiliates. Two, as Ms. Whitehouse mentioned, the Chinese regulatory authorities do keep a tight leash on the accounting firms there in that they restrict who can view the work papers and as Mr. McDonald pointed out, they have the citizenship requirement for firm leadership positions in the country.[82][83] In other words, it is not completely the fault of the Chinese accounting firms that the accounting has been fraudulent at times, but the sanctions would still be necessary because they have ultimately failed to do their job as auditors. Whether it is partially their fault or not, they still have to take responsibility for the accounting issues along with the multinational companies they audit. In addition, these firms have some responsibility in getting the Chinese regulators to change their strict work paper secrecy requirements.

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[80] Gough, Neil. "Chinese Companies Head for the Exit." DealBook. December 20, 2012. Accessed January 23, 2013. http://dealbook.nytimes.com/2012/12/20/chinese-companies-head-for-the-exit/.

[81] Block, Carson C. "China's Auditing Train Wreck." *The Wall Street Journal Asia* (Hong Kong), May 4, 2012. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/1010816391/13BC320D7B22B5F71DA/2?accountid=14731.

[82] Mcdonald, Joe. "Chinese Companies Pull out of US Stock Markets." Yahoo! Finance. August 14, 2012. Accessed February 20, 2013. http://finance.yahoo.com/news/chinese-companies-pull-us-stock-095649722.html.

[83] Whitehouse, Tammy. "PCAOB Gets Glimpse at China Audits, More Talks Planned." *Compliance Week* 9, no. 107 (December 2012): 7-8. Accessed January 23, 2013. http://web.ebscohost.com/bsi/detail?sid=ba6ce5c8-066d-47ac-a092-0087ed72e522%40sessionmgr111&vid=1&hid=106&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=84321084.

The international strategy from a Chinese multinational company and regulatory perspective is also interesting to look at, because it differs significantly from our domestic strategy in the United States. Instead of focusing on investor protection and security, the Chinese mainly focus on protecting their own companies first and investors second. The Focus Media example mentioned earlier is a good example of this point, in that the internal logic for taking the company private was that the stock was undervalued on the US equity markets and long-term the company would be better served elsewhere.[84] The Chinese are simply standing up for their own multinational companies and on the surface, looking out for their best interests. However, there are clear underlying factors that suggest otherwise. Based on research, there is strong evidence to suggest that the accounting fraud in many of the multinational corporations and SEC allegations against the Chinese affiliates of the accounting firms has generally had a negative impact on the reputation of these companies on the US equity markets. Subsequently, one would think that if the reputation of these Chinese multinational firms generally takes a hit, then logically the stock price would as well. It is essentially a trickle-down effect that explains the Chinese reasoning, but the problem is that as illustrated here it is much more complex and causational then they would like to lead on.

One of the surprising elements of doing research for the international strategy of this paper was the information mentioned on the Chinese state-owned banks funding, partially at least, the exit of their multinational firms from the US equity markets. For example, companies like Fushi Copperweld, China TransInfo Technology Corp., and Harbin Pacific Electric Co. have all withdrawn from the US equity markets with the help of the CDB.[85] You would never see US banks do something like this, mainly because our banking system is not predicated on state-owned entities with the exception of the Federal Reserve, and it shows a high level of concern on the part of the Chinese regulatory authorities. They are doing this because of the same trickle down logic as above, and it seems like they are trying to do this under the radar intentionally to hide the severity of the issues affecting their multinational corporations. Like before, this makes sense from a Chinese perspective in that they are trying to protect their own, but this seems like a backdoor and underhanded way to go about it, so it is worth investigating by the SEC.

The final part of the international strategy to be analyzed is the reason all these Chinese multinational firms wanted to enter the US equity markets in the first place, and ultimately why some are choosing to exit the markets now. Their initial logic for entering the US equity markets, as Mr. McDonald pointed out, was basically that it would help entrepreneurs and jump start China's developing economy.[86] This makes logical sense because although China is a very large and powerful country, their economy is not anywhere near the level of the United States, and at the time it was probably a smart move on their part. Now, however, the Chinese

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[84] Mcdonald, Joe. "Chinese Companies Pull out of US Stock Markets." Yahoo! Finance. August 14, 2012. Accessed February 20, 2013. http://finance.yahoo.com/news/chinese-companies-pull-us-stock-095649722.html.

[85] Ibid

[86] Mcdonald, Joe. "Chinese Companies Pull out of US Stock Markets." Yahoo! Finance. August 14, 2012. Accessed February 20, 2013. http://finance.yahoo.com/news/chinese-companies-pull-us-stock-095649722.html.

regulatory authorities are doing a complete reversal, and encouraging their private companies to publically list on their markets, as Mr. McDonald also pointed out.[87] Publically, their reasoning is probably that regulations in the US equity markets are too stringent and therefore their companies are better off staying at home. It may be that the accounting fraud and the resulting hit on their companies reputation has a lot to do with that change in course. In other words, listing now on the US equity markets might not yield as many benefits to their multinational corporations as it did before the accounting issues became more pronounced.

If the Chinese regulatory authorities do choose to pursue this strategy going forward, then it might reduce the burden on the SEC to prevent their multinational firms from entering the US equity markets. Of course the SEC would still have to look at pursuing action against the Chinese multinationals currently in the markets, but they would not have to focus as much on incoming companies via IPOs or reverse mergers. Assuming the Chinese keep using this new strategy with their private companies, it actually benefits the US equity markets because it allows more domestic companies, including those involving start-ups and young entrepreneurs, to list publically and provide some innovation to the markets and the economy. If the SEC and PCAOB continue to try to negotiate with the Chinese regulatory forces, however, it might cause some uncertainty in the markets, which would not be ideal given the fragile economic situation right now.

Big Picture Implications

This section of the paper focuses on the big picture level, and how it will really impact both international and US-based businesses, as well as the overall economy. An important opening point, as Mr. Gough pointed out, is that the longer this issue goes on, the more regulatory protectionism will occur which will hurt the economies and businesses in both China and the United States.[88] China might levy some regulatory action against US businesses with subsidiaries in their country, and vice versa for the United States, which would certainly have a negative impact for everybody involved and for both economies as a whole. The uncertainty associated with the SEC legal action against the big five Chinese-affiliated accounting firms also extends to the Chinese multinational and US businesses, and could impact them negatively as well. Being forced to find a new auditor would have a significant impact on both types of businesses in that it is a costly endeavor because of the bidding process and the fact that the new auditor would have to get familiar with the firm's accounting system and culture. In terms of the effect on the overall economy, it all depends on the severity of the SEC punishments, how many US and Chinese multinational businesses would be affected, and how that would translate to the individual stock prices and the equity markets overall.

In addition, the quote by Peter Bresnan cited earlier in the research section is particularly relevant in this discussion because he said that the threat of delisting Chinese multinational companies from the US equity markets could bring their regulatory authorities back to the

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[87] Ibid

[88] Gough, Neil. "Chinese Companies Head for the Exit." DealBook. December 20, 2012. Accessed January 23, 2013. http://dealbook.nytimes.com/2012/12/20/chinese-companies-head-for-the-exit/.

negotiation table. Although the underlying reason for this conclusion is not immediately clear, it may have something to do with the potential impact on China on both a business and larger economic level. On a business level, these multinational firms could go back to China and list on their domestic equity markets, but the cost of delistment by the SEC would be great in terms of both their reputation and any associated financial penalties. On a larger economic level, if their multinational companies get delisted it would give them more equity and capital at home, but having that kind of reputation as a country would harm their chances for significant foreign investment. This is especially true given the documented cases of accounting fraud I noted in the research section.

The big picture analysis is also interesting in that it deals with US-based companies with significant Chinese subsidiary operations. This includes large corporations like Apple, Qualcomm, Kimberly-Clark, Yum Brands and General Motors, and this is a significant issue for these companies because of the SEC and PCAOB requirements detailed in the research section of the paper.[89] To put it simply, they currently have to use a Chinese-based auditing firm to certify this part of their financials, and therefore if the SEC were to punish these firms it would have a huge impact on those particular subsidiaries. If the SEC were to deregister the Chinese affiliates of the large accounting firms, then the cost to US-based corporations with Chinese subsidiaries would inevitably skyrocket. This higher cost would trickle down to the overall business operations in the United States and subsequently be reflected in the consolidated financial statements. If the impact of this cost was material enough it could affect the company's hiring and capital infusion, which could in turn have a negative effect on at least a small portion of the economy as a whole.

From an accounting perspective, this also brings up a serious issue with the financial statements of these companies because of all the accounting fraud and the threat of deregistration of the Chinese-affiliated accounting firms. In order for a US-based company with subsidiaries, foreign or domestic, to properly present financial information in their annual report, they must include consolidated financial statements that contain information from all their subsidiaries. If they do have foreign subsidiaries, they must translate those financial statements into US dollars before the consolidation process can begin. Before they can translate the foreign subsidiary's financial statements, they must convert the figures from whatever accounting rules the subsidiary is using to US GAAP, typically IFRS. Herein lays the problem with the Chinese-affiliated accounting firms, because if they are not doing proper audits of these foreign subsidiaries then it makes it a longer and more expensive process to convert the financial figures to US GAAP. The tougher consolidation process and increased costs would not only impact the main US operations, but it would also jeopardize the quality of the financial information presented to investors. This would impact everything from the markets to the overall economy, and although it is a problem that most people would not normally think of, it is still something that needs to be considered when taking action against these Chinese-affiliated accounting firms.

Economic Implications

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[89] Chovanec, Patrick. "Foreign Policy: Clash of the Balance Sheets." An American Perspective From China. December 12, 2012. Accessed February 21, 2013. http://chovanec.wordpress.com/2012/12/12/foreign-policy-clash-of-the-balance-sheets/.

Taking an economic perspective, the paper examines the credit and bond ratings of these Chinese multinational firms in terms of investor confidence and equity market reaction. The Nine Dragons example that Peter Stein cited is very relevant because although they did recover most of their stock price, the initial reaction to the rating withdraw shows how sharply the stock market can react in cases such as this.[90] Daniel Flatt also made a good point in that a combination of the reputation for accounting fraud and the Chinese business atmosphere can almost certainly result in a loss of confidence from international investors.[91] Ultimately, the two points just mentioned are the two sides to this portion of the issue: the stock market implications and the international reactions. However, it seems the international reaction is the more important part of it because of the global market, economic, and investor confidence implications associated with it.

If accounting fraud did expand to companies from other countries, the decreased international investor confidence related to Chinese multinational firms could be extend and have a much larger impact. Finally, the *Financial Management* study cited earlier has some very interesting implications in terms of the severity of the negative reactions from the accounting fraud and the possible effect on credit ratings for these Chinese multinational companies.[92] Based on the conclusions of the study, it is reasonable to assume that the impact of the documented cases of accounting fraud within these companies is more severe than it would be for US-based companies. It may not be fair and it may be a generalization at times for these Chinese multinationals. However, that should only put a larger emphasis on paying closer attention to their accounting practices so it can be avoided as much as possible. It is also reasonable to assume that the impact on credit and bond ratings for these Chinese multinational firms as a result of accounting fraud could be more severe as well. The logic is that the rating agencies might look at the accounting issues more seriously because of the name and reputation associated with the firm, and hence the decrease in credit might be steeper than it would have been otherwise.

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[90] Stein, Peter. "The View from Hong Kong: Chinese Firms Need to Open Up." Editorial. *The Wall Street Journal Asia* (Hong Kong), June 20, 2011. Accessed January 28, 2013. http://search.proquest.com/asianbusiness/docview/872405643/13BC3FAC0F85AA325DC/8?accountid=14731.

[91] Flatt, Daniel. "Chinese Firms Will Face More Fraud Stigma, Says Fitch." *Asiamoney*, July 2011. Accessed January 23, 2013. http://search.proquest.com/asianbusiness/docview/880986241/13BC3FAC0F85AA325DC/35?accountid=14731.

[92] Bae, Kee-Hong, and Wei Wang. "What's in a 'China' Name? A Test of Investor Attention Hypothesis." *Financial Management* 41, no. 1 (Summer 2012): 429-55. Accessed January 23, 2013. http://web.ebscohost.com/bsi/detail?sid=a90000c4-de0c-4ef9-b609-accc78c8980c%40sessionmgr110&vid=1&hid=106&bdata=JnNpdGU9YnNpLWxpdmU%3d#db=bth&AN=76371883.

Conclusion

This paper examined five key areas with regards to the accounting fraud issues with Chinese multinational firms publically listed on the US equity markets: the accounting side, domestic and international strategy, the big picture level in terms of the goals of the two regulatory forces and the company impact, and the economic perspective. Within each of these areas, facts were presented, a detailed analysis, and some possible solutions to the problem were presented. For example, with the international and domestic strategy, it is proposed that the SEC restrict the stock trading of these Chinese multinational firms because it would be more of a hit to their balance sheet and would put more pressure on them to fix their accounting issues quickly.

Ultimately though, one thing all these solutions have in common is that investor security and investor protection is a central part of the United States equity markets, and we should do whatever it takes to preserve that, no matter how harsh the punishment. In fact, it could be argued that this is the most important decision criterion in terms of the consequences, positive and negative, of any potential action against these Chinese multinational firms or their auditors. For example, if the SEC did deregister the Chinese affiliates of the big accounting firms, how would that impact investor security? It would be good and bad: good in that it shows investors that the SEC and PCAOB are serious about the importance of reliable financial information, but bad in that it would create uncertainty in the minds of investors about what will happen with the financials going forward with regards to who the new auditor will be. Another example would be if the SEC chose to delist the Chinese multinational firms from the US equity markets altogether. Generally, this would be good for investor security because it would directly attack the accounting fraud issue and immediately remove the root of the problem. However, it could be bad depending on how much investors would lose from the delistment and how much of that loss is reimbursed by the proper sources.

The accounting material is not the central theme of the paper certainly, but it is important in that is underlines this investor-first mentality, especially given how the information presented in annual reports is certified. A proper audit is really about doing right by your clients and the stakeholders they serve, and paramount among them is their investors. It is not always positive naturally, and if you as an auditor spot obvious issues with one or more accounts that could be fraud-related, you have an obligation to follow through on that with the client. Obviously there is no right answer to this Chinese multinational firm problem, but whatever action the SEC and PCAOB decides to make, it must be strong enough to make a point to the Chinese regulatory forces while at the same time protecting investors as much as possible. Similarly, how the SEC and PCAOB handle the negotiations going forward ultimately depends on these actions and how the Chinese choose to respond or retaliate, as the case may be. It is really like a chess match, and whichever side plays their pieces the smartest will prevail. In other words, whichever side has the most leverage will most likely come out the victor in this tenuous and ongoing debate.

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