



September 13, 2022

U.S.-China Auditing Agreement and Issues for Congress

On August 26, 2022, securities exchange officials from the United States and the People’s Republic of China (PRC or China) announced an agreement on a preliminary auditing framework. This “Statement of Protocol” between the U.S. Public Company Accounting Oversight Board (PCAOB) and the PRC’s China Securities Regulatory Commission (CSRC) and Ministry of Finance (MOF) governs cross-border inspections and investigations. It is to allow PCAOB officials to review the work of PRC-based accounting firms that audit PRC-based firms listed on U.S. stock exchanges.

The agreement comes after nearly 20 years of efforts by the U.S. government to gain auditing access in China. Some experts have said the deal could be a breakthrough but depends on implementation. Others say that China could still hinder PCAOB access, citing the sensitivity of corporate data to the PRC government, and past PRC approaches toward similar agreements. Securities and Exchange Commission (SEC) Chair Gary Gensler said the deal is “a step in the process” and will be assessed on PCAOB’s ability to “inspect and investigate completely audit firms in China.” Some Members have pressed the SEC to implement U.S. requirements stringently. Other Members have called for passing the Accelerating Holding Foreign Companies Accountable Act (H.R. 6285 and S. 2184—passed in the Senate), which would accelerate by one year the delisting of non-compliant PRC firms to 2023.

Background

Reliable audited financial statements and other disclosures communicate firms’ performance to investors, creditors, regulators, and the public. They are critical to sustaining trust in U.S. capital markets and promote more efficient allocation of capital between investors and firms. Federal securities laws require companies listed in the United States, both domestic and foreign, to share critical information about their performance on an ongoing basis. They also require a qualified external auditor to provide independent assurance to investors and other stakeholders that the annual reports and financial statements are free of material misstatements, whether caused by error or fraud, by giving an unbiased professional opinion on whether disclosures are fairly stated in all material respects. For example, domestic firms are required to submit to the SEC annual audited reports on Form 10-K, which provides a comprehensive overview of their performance, including audited financial statements. Foreign firms that participate in U.S. capital markets must file a different, but comparable, set of financial reports, using form 20-F.

Congress created the PCAOB (P.L. 107-204) in 2002 to provide oversight of the accounting firms that audit public

companies. Since 2002, most countries and U.S. regulators have reached agreements over how and when foreign accounting firms would be audited. China has remained an outlier, and PRC firms listed on U.S. stock exchanges have not been in compliance with SEC auditing requirements. In 2009, the CSRC issued rules that limited U.S. regulators’ access to PRC firms’ audit documents, citing national security concerns, further constraining access. PCAOB and MOF signed a memorandum of understanding in 2013 and began a pilot inspection program in 2016. Early in the pilot, PCAOB assessed China was not allowing sufficient access, resulting in an impasse.

Holding Foreign Companies Accountable Act

In response to China’s refusal to allow PCAOB audit inspections and in an effort to protect U.S. investors, Congress passed the Holding Foreign Companies Accountable Act in 2020 (HFCAA, P.L. 116-222). HFCAA requires the SEC to delist from U.S. exchanges PRC firms that do not meet U.S. audit inspection requirements, starting in 2024. It includes provisions to:

- Require the SEC to identify each issuer that retains a registered public accounting firm with a branch in a foreign jurisdiction if PCAOB is unable to inspect the work papers of the auditor in the foreign jurisdiction.
- Require, during non-audit years, for the issuer to submit to the SEC the percentage of their shares owned by governmental entities and to state whether governmental entities have a controlling financial interest.
- Require covered issuers to disclose government ownership and board of director members affiliated with the Communist Party of China (CPC) and organizing documents that include a CPC charter.
- Require the SEC to prohibit trading of securities of the issuer if PCAOB is unable to inspect the work papers of the audit firm for three consecutive years.

The enactment of HFCAA likely prompted the PRC government to reach an agreement with the PCAOB to avoid the delisting of PRC firms from U.S. exchanges as the deadline set by Congress approaches. While China is steering PRC firms to list onshore, U.S. capital markets remain important to China as a platform for PRC firms to raise capital and invest overseas. U.S. capital markets are the largest and, many argue, the most efficient and liquid in the world. U.S. equity market cap in 2022 was \$52.2 trillion, 2.6 times larger than China’s and Hong Kong’s combined markets. Many U.S. investors seek exposure to PRC firms and China as a growth market. An estimated 200 PRC firms valued at about \$1.3 trillion are traded on U.S.

stock exchanges, constituting about 2.5% of the U.S. market. These firms are audited by over 30 PRC-based auditors which are registered with the PCAOB and subject to inspection.

Preliminary Auditing Framework

The SEC has not publicly disclosed the agreement text, reportedly at the request of the PRC government. The SEC and PCAOB have at times not disclosed the details of their agreements with other countries. The U.S. and PRC governments have shared their understanding of the deal in separate statements which appear to diverge in some ways that could affect implementation (see **Table 1**). Areas to watch include:

- China’s expectations of its role in “mutual” and “reciprocal” cross-border audit oversight—including planning inspections and investigations—may allow it to influence the selection of firms, prevent the audit of sensitive state firms, and delay investigations. Central government-managed state-owned firms are not among the first batch of firms that PCAOB has selected for audit. China’s delay in reaching a deal is also creating time pressures on PCAOB to inspect firms by the end of 2022, according to statements by PCAOB officials.
- CSRC’s emphasis on selecting a sample of firms for audit indicate it may resist the audit of certain firms. Its emphasis that the audit is of the auditors and not the listed firms may indicate China could try to limit access to certain information about listed firms.
- CSRC statements that access to all documents, auditors, and personnel will be controlled by PRC regulators highlight how this arrangement may allow the PRC to slow or influence the process or information available.
- PRC discretion to determine what information is sensitive or a state secret may allow it to restrict access to such information. PRC data laws and regulations and the “view only” provision could further limit transfers to the PCAOB and SEC.
- Requirements to operate out of Hong Kong keep PCAOB officials at arms-length and arguably allows China to control information and interactions. China’s Data Security Law limits cross-border data transfers, including to Hong Kong and among firms’ operations in mainland China and Hong Kong.
- Branches of international auditors based in China—PWC Zhong Tian, Deloitte Hua Yong, and KPMG Hua Zhen—are administratively separate from their parent and the Hong Kong branches of these firms. The China-based firms audit most of the PRC firms listed on U.S. exchanges. China may confine PCAOB’s work to the Hong Kong branches of these audit firms, while limiting what mainland China branches can send to them.
- A key provision of the HFCAA not addressed by the preliminary framework, and to be handled through SEC regulations, is the requirement for PRC firms listed on U.S. exchanges to disclose members of the CPC in senior executive and board positions and details of CPC Party Committees established within a U.S.-listed firm.

Table 1. U.S. and PRC Statements on the Framework

| PCAOB and SEC | CSRC |
|--|--|
| Independent discretion for PCAOB to select any issuer audits for inspection or investigation. | PRC role in “mutual” and “reciprocal” cross-border audit oversight cooperation and “thorough communications” to plan inspections and investigations. Audit firms, not listed firms, subject to oversight. A portion of firms and selected engagements inspected annually. |
| Direct PCAOB access to interview all personnel of selected audit firms. | PRC will require PCAOB to operate from Hong Kong. PRC authorities will obtain and transfer all materials and take part in interviews. |
| Unfettered ability to transfer information to PCAOB. | China’s Data Security Law, Personal Information Protection Law, provisions on overseas listings, and other laws and regulations to govern access and transfer of information. |
| Ability to review all audit paperwork without redactions through “view only” procedures for sensitive information. | PRC and U.S. regulators must reach agreement on the use and protection of certain types of sensitive data (e.g., personally identifiable information). |

Sources: CSRC, PCAOB and SEC official statements.

Issues for Congress

Congress, not the SEC or the PCAOB, arguably has been the driving force in requiring that PRC firms comply with U.S. listing requirements. Congress could defer to the SEC and PCAOB to implement the deal. Alternatively, Congress may continue to play an active role in overseeing SEC and PCAOB implementation of the agreement to ensure it meets congressional expectations as outlined in HFCAA, and that its provisions are enacted on time. Congress might consider whether to require the PCAOB and SEC to:

- Share or make public the full text of the deal to allow Congress to assess the quality of its terms and whether it meets U.S. requirements. The lack of public visibility on China’s commitments could impede oversight.
- Create requisite disclosure and enforcement mechanisms, such as the process for de-listing PRC firms, in the event implementation is insufficient.
- Outline the process by which PRC firms will disclose CPC affiliations of senior executives and board members, and Party cells and operations in companies.
- Report to Congress on whether requirements to operate in Hong Kong differ from U.S. agreements with other countries or impede U.S. authorities and requirements.

Karen M. Sutter, Specialist in Asian Trade and Finance
Michael D. Sutherland, Analyst in International Trade and Finance
Raj Gnanarajah, Analyst in Financial Economics

Disclaimer

This document was prepared by the Congressional Research Service (CRS). CRS serves as nonpartisan shared staff to congressional committees and Members of Congress. It operates solely at the behest of and under the direction of Congress. Information in a CRS Report should not be relied upon for purposes other than public understanding of information that has been provided by CRS to Members of Congress in connection with CRS's institutional role. CRS Reports, as a work of the United States Government, are not subject to copyright protection in the United States. Any CRS Report may be reproduced and distributed in its entirety without permission from CRS. However, as a CRS Report may include copyrighted images or material from a third party, you may need to obtain the permission of the copyright holder if you wish to copy or otherwise use copyrighted material.