The Financial Times

August 12, 2019

China probe to clean up accounting industry

Chinese regulators are accustomed to tackling fires in the auditing industry.

In recent years the financial documents of several public companies have mysteriously perished in office fires. In other cases of suspected fraud, years of audit documents have been burgled or whisked away in stolen vehicles.

But now a series of billion-dollar corporate scandals and the struggle of one of China's largest auditors has ratcheted up the pressure on the China Securities Regulatory Commission to clean up the accounting industry. The flashpoint is an investigation the CSRC began last month into Ruihua Certified Public Accountants, the country's third-biggest accounting firm, after one of its clients, Kangde Xin, was caught inflating its profits by about Rmb12bn ($1.8bn) over several years.

The clean-up exercise has extra urgency because it comes as foreign investors are ploughing money into Chinese companies. The decision by index provider MSCI to include a growing number of Chinese stocks in its widely-tracked emerging markets benchmark is expected to funnel up to $100bn into businesses on the mainland.

"China very much wants to attract foreign capital, both in debt and equity markets, and Chinese companies are starved for capital," said Drew Bernstein, co-regional managing partner at New York-based accounting firm Marcum Bernstein & Pinchuk. "I think there's a realisation on [the regulator's] part that reliable auditing is necessary to attract this capital."

The probe into Ruihua has already ricocheted out across China's capital markets, with the regulators suspending IPO approvals for at least 20 clients of its clients. Ruihua did not respond to several requests for comment.

The scandal first erupted in May when Kangde Xin, a polymer materials maker, said it was missing bank deposits of Rmb12bn. An investigation by the CSRC into Kangde Xin subsequently found that it had inflated profits by about the same amount over four years, triggering the probe into Ruihua.

Ruihua had more than 9,000 employees in 2017 and worked with more than 300 listed companies, according to its website. It claims some of the country's largest state-owned groups, such as electricity provider State Grid, as clients.

The scrutiny of China's domestic auditing industry provides a sharp contrast to China's last round of accounting scandals, which centred on the listings of Chinese groups in the US and Canada, and were linked to auditing work done by the big four auditing firms: EY, PwC, Deloitte and KPMG.

During that period, starting in 2011, more than 100 Chinese companies delisted in New York and fines were handed out to accounting firms. EY, for example, paid an $8m fine in connection with the 2011 collapse of Sino-Forest, a Chinese company listed on the Canadian stock exchange that was accused of accounting irregularities.

"The big four got a bad rap the last time around but Chinese firms haven't seen that kind of downside yet from a major domestic accounting scandal," said Violet Ho, head of greater China business intelligence and investigations at Kroll. "The people [at accounting firms] don't understand what the greater reputational risk will look like in the future."

China's corporate sector has certainly experienced bizarre, even comical, accounting incidents for more than a decade. Between 2011 and 2017, several troubled companies, including Yamada Green Resources and China Paper, suddenly lost their financial documents in freak fire accidents.

Famously, China Animal Healthcare lost five years of financial statements midway through a forensic audit in 2015 when the company said a truck carrying the documents was stolen. Crucial paperwork at China Sun BioChem suffered a similar fate in 2009.

But it is Beijing's move to open up the country's capital markets to overseas investors that has raised the stakes. The more than 200 Chinese stocks in MSCI's flagship emerging markets index has drawn new attention to how domestic listings are vetted by local companies.

Many of the largest accounting firms in China are affiliates of the big four, such as PwC Zhongtian and EY Huaming. The largest domestic firm without a global affiliate is called Pan-China.

While an initial glance at China's domestic auditing firms suggests clear regulations, investors remain concerned that auditors lack the skills and experience needed to unearth sophisticated fraud. "The hardware is there: the rules, the infrastructure and the institutions are there. But the software isn't there yet," said David Smith, head of corporate governance in Asia Pacific at Aberdeen Standard Investments.

Those investing in China are typically forced to do more due diligence work than they would in a developed market. Understanding the background of the management, for example, is often as important as understanding the company's financial results. Mr Smith added: "If you can't get comfortable with the quality of management, you're not going to get comfortable with the accounting."

Grasping a company's cash management situation can be far more complex in China, where so-called "missing cash" incidents such as the one at Kangde Xin are common.

The perils for foreign investors were highlighted by another incident in May, when drugmaker Kangmei Pharmaceutical admitted to overstating cash holdings by more than $4bn. Kangmei was one of the more than 200 Chinese companies included in MSCI's flagship index. MSCI removed Kangmei from the index in June.

For some companies based beyond the country's top-tier cities, reports from banks on a company's cash holdings can often be drawn into question.

"The bank manager's entire family might be employed by the company you're auditing," Mr Bernstein of Marcum Bernstein & Pinchuk said, noting that he often requires clients to use digital banking services so that cash positions can be confirmed without contacting bank personnel.

China's securities regulators are taking a harsher stance, several people with knowledge of the situation said. The investigation into Ruihua is likely just one of several probes that will be carried out into domestic accounting work, the people said.

Some experts say that rule breaking will continue to be difficult to weed out as long as punishment remains light for offenders. The prospect of cashing out with an IPO is a temptation for many company executives, whether they are fit for public listing or not, said Huang Rong, an associate professor of accounting at

Cheung Kong Graduate School of Business in Beijing. Without strong deterrents from regulators, China is likely to face repeated fraud cases in public markets.

Ms Huang said: “Many believe that the benefits of committing accounting fraud far exceed the costs in China, which provides strong incentives for weak firms to cook the books.”