The Metropolitan Corporate Counsel®
Special Section
Emerging Markets
National Edition www.metrocorpcounsel.com
Volume 22, No.12 December 2014

China Presents Unique Challenges for Auditors

*The Editor interviews **Drew Bernstein,** Managing Member, Marcum Bernstein & Pinchuk LLP (MarcumBP).*

Editor: Please give us a brief description of MarcumBP's work in China.

Bernstein: Our business principally consists of auditing Chinese companies that are publicly traded on U.S. exchanges and U.S. companies with operations in China. But we also perform due diligence for investors and companies looking to invest in China. And we have recently begun assisting more Chinese investors to make investments here in the U.S., for instance, with immigration matters relating to the EB-5 program. This is a trend that is growing very fast.

Editor: What challenges do auditing firms face in China?

Bernstein: Auditing in China is completely unique, certainly unlike auditing in Western developed economies and probably different from any of its counterparts across the world. The most immediate and obvious challenges for auditors are time, distance, language, and culture. Auditors working from the U.S. are functioning within a 12- to 13-hour time difference and managing a physical distance of 7,500 miles from either U.S. coast, a monumental hurdle when you consider the requisite travel time and expenses. While obvious on its face, the language barrier takes on greater significance in light of the burgeoning numbers of highly educated people who speak Chinese as their first language. For example, I have noticed during many speaking engagements at universities that a very small percentage of non-asian students speak Chinese, despite its being the most-used language in the world. When I was in college, if you wanted to learn a second language, it was likely Spanish or French. No question today that the most valuable second language to acquire is Mandarin, although it's far from easy to learn.


Drew Bernstein

Finally, China's culture involves a very different value system and business environment, which I will expand on as we continue this discussion. Suffice it to say that for any professional firm aiming to participate in the future number-one global economy, these challenges apply in full, and success depends on making an actual commitment to working in China, not viewing it as a side business. For Marcum, the clear choice was to put boots on the ground across China and establish primary operations that conform to the firm's rigorous standards for quality and integrity.

Editor: What specific issues underlie the challenges that auditing firms face in China?

Bernstein: Speaking broadly, while some problems are unique to China, many apply to emerging markets more generally, including in countries like India. Years ago, the world was ruled by Western countries whose economies ran on the principle of supply and demand. In contrast, China's economy operates on the dictates of its government, and among the six top global economies, it is the only one that is not market-driven. The Chinese government controls the money supply; it owns all the banks, and many of China's largest companies are SOEs (state-owned enterprises). Western investors simply are not accustomed to understanding the risks of investing in companies that operate within government-run economies.

Take as a prominent example the fact that there is a lack of or arbitrary enforcement of laws in China. The courts are not part of a truly independent judicial system, but rather one in which the political party dominates the decision making. Similarly, the government owns and controls China's banking system, which is generally immature, with a politicized credit allocation system and a weak infrastructure for IT, internal controls, and verification – all of which work against an auditor's efforts to access financial records.

Further, Chinese banks give enormous latitude to provincial and local branches, and capital allocation often is tied to party relationships and priorities. Prominent local businesspeople can be very influential, and branch employees are often family members. As a result, traditional verification practices for cash balances, accounts receivable, and capital equipment may be completely unreliable due to the frequent willingness of local banks and business partners to manufacture documents. Contrasting sharply, U.S. auditors take for granted how easy it is to obtain good evidential matter for an audit in America. A confirmation request to Chase Manhattan Bank and the completed confirmation sent directly back to the auditor is reliable evidential matter.

We saw another common dynamic in China's banking sector with Alibaba and its online investment company Yu'E Bao. Essentially, the government, at its will, determines interest rates, which might be as low as 2 percent for a smaller investment of $500,000 worth of Renminbi (RMB). But

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the government also understands that investors with $50 million worth of RMB have many other options. In this case, banks will bid to pay the market rate.

With this in mind, Alibaba's founder, Jack Ma, created Yu'E Bao as a type of cooperative bank intended to collect assets from individual investors and bid for market rates based on the aggregate amount. At the beginning, he deposited funds into smaller banks that didn't have access to capital, so naturally the banks started bidding competitively for these assets. Eventually, the government objected to a system that sidestepped its regulatory authority in distributing individuals' pooled savings and limited this activity to one branch from each bank.

Finally, it bears mentioning that China's accounting, valuation, and advisory professions, as a whole, are at the early stages of development. There is an enormous shortage of U.S. CPAs and other professionals residing in China to meet the demand for services resulting from the emerging need for raising public capital. Further, the industry is working with a complex system in which, for instance, the chairperson of one company might own multiple business assets with frequent interlocking ownership, related party transactions, and poorly documented deals, not to mention that ownership rights are subject to government revocation with little due process.

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Editor: Are there any official guidelines?

Bernstein: There are no specific guidelines on how to audit a company in an emerging market. As auditors, we know that if traditional sources of information are not reliable, then we have be innovative in finding another way. In China, for example, a creative approach in many of our large audits involves the use of analysts, essentially proven third parties with the ability to understand the market and gather information accurately, efficiently, and with discretion. A good audit should satisfy the requirements of the auditor's firm and provide investors with reliable information. We use analysts for this aspect of quality control.

Specifically, analysts have deep knowledge of what's going on locally. They are able to assist us in confirming information that is both critical to our audit and otherwise not available on a reliable basis. As I mentioned, the auditing process is very different in emerging markets, where you also have to work from the outside in, versus in the U.S., where you can get reliable information directly from the company and work from the inside out.

Let me give an example to bring this discussion to life. I've seen incredibly sophisticated situations where analysts set up cameras outside a factory and monitor every truck that comes and goes. They know which trucks belong to suppliers and which belong to customers, and they use computers to extrapolate the weight of the truck by marking the tires and then measuring the deflation of the tires. Based on all of that, they can gauge if the truck is empty, full, or somewhere in between, and then make assumptions that are reliable enough to verify financial statement information.

Editor: Has MarcumBP assimilated any unique capabilities into its China operation?

Bernstein: Most auditing firms in China do not assimilate areas like bankruptcy into their China operations. We know that Chinese companies often represent a significant proportion of creditors when a U.S. company files for bankruptcy, yet only about 5 percent of these creditors ever participate in the U.S. bankruptcy process. Because of our already deep involvement on the ground in China, Marcum saw an opportunity to reach out to Chinese creditors and assist them with collecting their receivables. This is one of our new initiatives.

In one case, a commercial hog-producing company with assets in the U.S. and China filed a voluntary petition for reorganization under Chapter 11 and announced that it would begin (Section 363) sale processes for all its assets in the U.S. and in China. We not only secured a 100 percent recovery for creditors, but there was so much money left over, the judge formed an equity committee. I was the chairman of the creditors committee in this case and worked with BDA (Business Development Asia) to sell the assets to Ningbo Tech-Bank for approximately $30 million more than anticipated. We think that by connecting our expertise in China with our relationships and experience in the U.S. bankruptcy system, which are frankly both two pretty abstruse worlds, we can generate a lot of value for Chinese creditors and perhaps even for U.S. equity holders.

Editor: I understand you have served on the board of directors for a number of Chinese companies. What are some interesting dynamics for Chinese boards?

Bernstein: Most people who are familiar with Chinese companies understand that the chairman makes all the decisions. In many cases, the board's role is perfunctory, certainly by comparison to a U.S. board, and the real power lies in being able to influence the chairman. Since there is limited rule of law in China, there is extremely limited ability of U.S. regulators to enforce the fiduciary duties of board members of U.S. public companies in overseeing internal controls and corporate governance and hold board members who are Chinese citizens accountable. For U.S. citizens who serve in this capacity, not only are board members assumed to be taking on those obligations, but severe consequences can also be imposed for failure to perform.

The process of board construction for a Chinese company cannot rely on these safeguards. Even if a company could find qualified Chinese directors, there is no guarantee that they will understand their responsibilities with clarity; there is little enforceability of laws in China that compels them to do their duty, and as a result, there are no available consequences for a failure to perform. If you decide to sue a former director, you have little leverage to impose consequences in China.

Editor: Are Chinese companies recognizing these issues and looking for ways to build in more structure and accountability? If so, what is the impact on outside investment?

Bernstein: Yes. The larger companies in China that have gone public are going after top-name talent. We do some work for a company called Baidu, which is China's equivalent of Google. Baidu's CFO, Jennifer Li, formerly served as CFO of General Motors China and controller of GMAC's North American operations, which should give a sense of the caliber of people being sought by Chinese companies looking to step up their game.

Now, the name of the game in terms

of investor confidence is credibility, and investor relations (IR) is one of the biggest problems we face, even though it doesn't relate to accounting. Public companies in China need professional assistance in communicating with investors, and the reality is that if you polled non-institutional investors about a company and its business, a majority probably could not accurately explain how the company actually derives its revenue. The point is that public companies in China face a big hurdle in educating investors about their business and, therefore, in building confidence.

From an accounting standpoint, IR puts more weight on our shoulders because the investing public derives most of its information from company filings, not from the company's press releases. Investors expect all their questions to be answered in the financials, so the onus is on us to ensure that management delivers accurate, complete, and informative financial statements.

Editor: If you had only three minutes to give professional advice to Jack Ma or any executive from a publicly traded Chinese company, what would you say?

Bernstein: Keeping in mind all of the trends and challenges we've been talking about, I would advise him to remember a few prime directives. First, hire great people because they bring credibility to your company. Second, I would counsel Jack Ma to disclose *as much as possible* in his filings. I would advise him to tell them everything and more because in China, as in other emerging markets, everything a company does leaves it open to misunderstanding. My last piece of advice is to stick to the company's strategic focus. This will ensure that investors understand what you're doing with their money, and as we've seen with Alibaba's forays into non-core businesses, it is critical to the success of Chinese companies.

Editor: How does MarcumBP address the challenges we've been discussing and ensure a high-quality product?

Bernstein: Most significantly, we employ all of our own people in China. As a firm, we decided from the beginning not to rely on consulting arrangements. Our employees are our most valuable asset, and we invest in fully training them about the firm's culture and standards for quality and service. Personally, I commute to China almost every month, and we fly Marcum's quality control people to China to assist with training our employees on the ground. Among other benefits, these efforts result in an extremely low turnover for our staff in China. In the last eight or nine years, no more than six senior people have left the firm. And because MarcumBP is a true partnership with Marcum, all of our audit work conforms to the exact same process and adheres strictly to Marcum's quality standards. By comparison, most of our competitors in China are affiliates, which has potentially severe implications for clients who believe they are working with a reliable, big-name company. In the event of a dispute, for instance, those clients may be dismayed to learn that their only legal recourse is against a small, independent office.

From a practical standpoint, MarcumBP is at the forefront in developing audit procedures that specifically work in China. Some of these are derived from my own experiences as a board director, audit committee chair, and leader of one of the largest investigations by a special committee in China. Each of these experiences has provided a unique perspective in understanding issues from both sides. As it stands, we've done an enormous amount of due diligence work in China, which only amplifies the value of low staff turnover. Some of our senior managers have handled due diligence for as many as 75 companies, and for our clients walking in the door, there's just no substitute for that kind of experience.

On the process side, offering a seamless system is the sine qua non to having a successful business in China, notwithstanding that our work is produced in two countries that are 7,500 miles apart. Over and above meeting the challenges we've already discussed, we ensure that staff from both countries understand the work that their colleagues are producing overseas. Most of Marcum's quality control partners have been to China and met our staff, and they have actually gone into Chinese companies. As a result, they truly understand what they are reviewing.

Along with working around the clock, which many of us do, these measures enable the delivery of excellent work product and efficient service at a reasonable cost. This is Marcum's central message, and we have worked very hard in China to build our brand, which is our number two asset. When somebody sees the Marcum name, they know exactly what they are getting: quality service and no surprises.

Editor: What about new developments in the Chinese market?

Bernstein: Right now, we are seeing a tremendous amount of cross-border business. The Chinese have become the second-largest purchasers of real estate in the United States, after Canadians. They dominate the EB-5 program and are buying businesses under all sets of circumstances, including through the bankruptcy process. Engaging with cross-border business is a strategic direction for Marcum, and very much aligned with our deep presence in China. We want to be able to prepare a tax return for a Chinese investor in the United States, deliver it to him or her in China, and then explain it in Chinese. We want to serve the Chinese market without any need for a local affiliate, and we have the infrastructure in place in both countries to work seamlessly and deliver. This means that if you have a business in China, we can help. If you are a Chinese investor looking for U.S. assets, we can help. If you want in-depth expertise on everything from local transactions to cross-border deals, we can pick up the phone and immediately assemble the right team of trusted, experienced Marcum employees.

Editor: Give us some final thoughts on what makes Marcum unique.

Bernstein: Marcum is one of just a few U.S. firms practicing in China right now. Most of our competitors, including the Big Four, conduct their operations through local, independently registered firms. We take a very different approach as a Top 15 U.S. firm that is operating from its own offices in China and leveraging Chinese talent as actual employees of the firm. Many smaller accounting firms leverage local partner firms to do all of the fieldwork, which is a formula for disaster in my opinion, as the people on the ground do not understand the requirements under SEC accounting rules, and the auditors back in the U.S. are very poorly versed in the reality of how business is done on the ground in China. We think that our approach has a much higher probability of delivering opinions that are backed by reliable evidence, evaluating the risks of fraud or internal controls lapses, and integrating fieldwork with deep SEC accounting understanding and a fully integrated quality control process. We think that by marrying the firm's global talent and expertise we can deliver much more reliable opinions to investors and regulators, while also delivering quality service in a convenient, economical way to Chinese clients.

Finally, I always enjoy pointing out the irony of being a financial firm for which our two greatest assets, our people and our brand, do not appear on the balance sheet. It's kind of funny, but I wouldn't have it any other way.