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Resolving the Lack of Audit Transparency in China and Hong Kong: Remarks at the International Council of Securities Associations (ICSA) Annual General Meeting

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Thank you, Ken, for that kind introduction. I am glad to be here with you today.[[1]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn1" \o ") As I approach my first anniversary as the Director of the SEC’s Office of International Affairs, it is my pleasure to have this opportunity to share ideas with you on how best to carry out the goal of serving investors. Cooperation between regulators and the industry is critical to the SEC’s mission. I am impressed by the event that SIFMA has organized. The program over the last two days covers some of the most important global issues affecting the international securities industry, including cross-border regulation, crypto, sustainable finance, and, of course, China.[[2]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn2" \o ")

Before I proceed, let me issue the standard disclaimer that the views I express today are my own and do not necessarily reflect the views of the Commission, the Commissioners, or other members of the Commission’s staff.

Today, I would like to focus on the recent regulatory developments related to the lack of US inspections of audits and investigations in China and Hong Kong, and the implications for continued trading of China-based issuers on US exchanges. For more than a decade, local authorities in those jurisdictions have hampered the Public Company Accounting Oversight Board’s (“PCAOB”) ability to obtain audit work papers and interview audit engagement personnel as statutorily mandated. This situation is untenable because, among other things, it exposes US investors to significant risks.

We are now at a critical juncture in the effort to resolve these audit access issues. About $1.7 trillion in securities of China-based issuers are listed on exchanges in the United States. These securities could face trading prohibitions in as little as two years, which means the issuers of those securities will no longer have access to US capital markets because they are not in compliance with regulatory requirements. Today, I am going to discuss how we got here, what is at stake, and what needs to happen for the securities of China-based issuers to remain listed and traded in the United States.

To this end, I want to underscore four main points in my remarks today:

* First, PCAOB-registered public accounting firms must provide the PCAOB with access to their audit work papers, and, any claim that audit work papers cannot be produced because they contain national security materials is questionable at best;
* Second, although there have been ongoing and productive discussions between US and Chinese authorities regarding audit inspections and investigations, significant issues remain and time is quickly running out;
* Third, even if US and Chinese authorities reach an agreement in the near future to commence PCAOB audit inspections and investigations in China and Hong Kong—and I want to emphasize this point—such an agreement will only be the start towards satisfying the PCAOB’s statutory mandate; and
* Finally, should the issuers or the relevant Chinese authorities wish, they can effectuate the voluntary delisting of China-based issuers that they deem “too sensitive to comply” with PCAOB requirements, but allow other companies and audit firms to comply fully with the PCAOB inspection and investigative processes, thereby allowing the remainder of China-based issuers to avoid potential trading prohibitions in the US.

**Background**

By way of background, we have a basic bargain in our securities regime that was established by the Securities Act of 1933 and the Securities Exchange Act of 1934.[[3]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn3" \o ") The bargain was simple: investors get to decide what securities to invest in, and, in return, investors are entitled to receive complete and transparent information so that they can assess the risks associated with an investment. Towards this end, audited financial statements are a key requirement under the US disclosure regime.

Decades later, the Sarbanes-Oxley Act of 2002 was passed by a bipartisan majority in Congress in response to the financial scandals of the early 2000s by public companies such as Enron, Tyco, and WorldCom. Under Sarbanes-Oxley, the basic bargain was expanded to say this: if a company wants to issue securities to the public in the United States, its auditors must be subject to inspections and investigations by the PCAOB. Jurisdictions around the world understand and accept this basic bargain. The only outliers are China and Hong Kong.

Unfortunately, this situation poses serious risks to US investors. Over the last 10 years, US investors have significantly increased their exposure to companies based in China. According to the PCAOB, “[i]n the thirteen month period ended December 31, 2021, 15 PCAOB-registered firms in mainland China and Hong Kong signed audit reports for 192 public companies with a combined global market capitalization (U.S. and non-U.S. exchanges) of approximately $1.7 trillion.”[[4]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn4" \o ") Yet, the PCAOB has never been able to conduct audit inspections of firms in Mainland China, despite efforts dating back to 2007.[[5]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn5" \o ") In Hong Kong, the PCAOB has never been able to inspect any larger, network affiliates, and only inspected a few small firms before being blocked from inspecting all firms after 2010.[[6]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn6" \o ") For more than a decade, Chinese authorities have taken actions and passed laws and regulations that impeded the PCAOB from obtaining audit-related documentation and information for its inspections and investigations.[[7]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn7" \o ")

This begs the question, “Why are PCAOB audit inspections and investigations so important?”

Financial reporting based on high-quality, reliable disclosures is at the very core of our regulatory framework and the SEC’s mission to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation.[[8]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn8" \o ") To achieve this goal, all issuers that access the US public capital markets must meet certain disclosure obligations and legal responsibilities, regardless of where they are based.

Audit inspections and investigations are critical to maintaining the integrity of our capital markets. When the PCAOB is prevented from fulfilling its statutory mandate, it exposes investors to significant risks.

The US capital market attracts companies from around the world not only because of its market depth and liquidity, visibility, efficiency, and brand-name enhancement, but also because of its reputation for integrity and honesty.[[9]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn9" \o ") This reputation is driven by disclosure requirements, regulatory oversight, and, of course, enforcement. Moreover, there is extensive evidence showing that “non-U.S. companies experienced reduced cost of capital, increased liquidity, and increased visibility after cross-listing in the United States. One source of such benefits arises from these cross-listed companies subjecting themselves to the stricter U.S. legal environment and enhanced disclosure requirements to take advantage of the investor protection these systems provide.”[[10]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn10" \o ") PCAOB inspections and investigations are designed to protect US investors and enhance market integrity by making sure that audit firms follow required auditing standards and rules.

As part of the inspection process, the PCAOB needs to review the registered public accounting firm’s audit documentation and interview the firm’s engagement personnel. This audit documentation, otherwise referred to as audit work papers, is the written record required by PCAOB standards as the basis for the auditor’s conclusions that provides support for the auditor’s report. Likewise, in situations where there may be violations of PCAOB rules and standards or relevant US federal securities laws, the PCAOB investigative team must be able to obtain the necessary work papers, documents, and information from firms and take testimony from audit firm personnel.

Given the importance of audit inspections and investigations to investor protection, in 2020, with bipartisan support, Congress said that it was time for all registered public accounting firms to comply with their obligations under Sarbanes-Oxley, and passed the Holding Foreign Companies Accountable Act (or HFCAA). The mechanics of the HFCAA are fairly straightforward.

* First, the HFCAA directs the PCAOB to determine whether it is unable to inspect or investigate completely registered firms located in a foreign jurisdiction because of a position taken by an authority in that jurisdiction.
* Second, the HFCAA directs the SEC to identify issuers that file annual reports that include an audit report prepared by auditors covered by the PCAOB’s determination.
* Finally, after three consecutive years of an issuer being identified by the Commission under this process, the HFCAA requires the SEC to impose a trading prohibition on the securities of those issuers.

Since the HFCAA was signed into law, the PCAOB has determined that there are two jurisdictions—China and Hong Kong—where local authorities prevented the PCAOB from inspecting or investigating audit firms completely. And, in a largely administrative process, the SEC has commenced the process of identifying issuers that have filed annual reports with an audit report prepared by an audit firm in a jurisdiction subject to the PCAOB’s determination under the HFCAA. These issuers may face potential trading prohibitions and, ultimately, delisting as soon as 2024. As of May 20, 2022, the Commission had conclusively identified 40 such issuers.

Now that I have explained how we arrived to our situation today regarding China-based issuers, I will now turn to the four main points I want to highlight today.

**Audit Work Papers Do Not Raise National Security Issues**

First, any claim of national security concerns to justify a refusal to provide the PCAOB with audit work papers should be viewed with skepticism. The PCAOB is able to completely inspect and investigate its registered firms in more than 50 other countries.

Let’s talk about what is involved in an audit inspection. The PCAOB is required by law to assess the auditor’s compliance with PCAOB standards and rules, as well as other regulatory and professional requirements. In addition to reviewing an audit firm’s quality control system, the PCAOB inspection process includes a review of select issuer audit engagements. In conducting its inspection of issuer audit engagements, the PCAOB inspections staff might focus on a number of audit areas, including revenue recognition, allowance for credit losses, goodwill impairment, the assessment of the effectiveness of internal controls over financial reporting, and quality controls.

When the PCAOB conducts inspections, it reviews the audit firm’s work papers related to selected issuer audit engagements. Importantly, the PCAOB only requests materials from the audit firm that support the auditor’s opinion on the financial statements or the internal controls of the issuer, or the quality controls of the accounting firm.

As this audience likely knows, audit work papers generally include:

* General ledgers and summaries;[[11]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn11" \o ")
* Schedules of accounts or transactions;[[12]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn12" \o ")
* Organizational charts, as well as investor and ownership information;[[13]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn13" \o ")
* Audit evidence that supports an auditor’s evaluation of corporate transactions and management’s estimates, judgments, and accounting of those transactions;[[14]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn14" \o ") and
* Information concerning the effectiveness of the company’s internal controls over financial reporting.[[15]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn15" \o ")

Sensitive information pertaining to national security—and by that I mean the ability for the state to cater to the protection and defense of its citizenry—should not be in auditor’s files. This is why claims of national security have not been an issue with other jurisdictions.

**Time Is Running Out**

This brings us to the second point, which is that time is running out for resolving audit issues involving China and Hong Kong. After the SEC adopted amendments to finalize rules implementing the HFCAA in December 2021,[[16]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn16" \o ") both houses of Congress passed legislation accelerating the HFCAA trading prohibition from three consecutive years to two consecutive years. Under this accelerated timeline, almost 200 China-based companies like Alibaba, Yum China, Weibo, JD.com, and Baidu could face a trading prohibition beginning in 2023 when such issuers file their next annual report.

As discussed above, this situation did not happen overnight. After more than a decade of confidence-building measures and pilots, the PCAOB still faces serious challenges relating to the absence of a workable cooperative agreement with Chinese authorities for a regular cycle of inspections, restricted access to required information, and limitations as to engagement selection.[[17]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn17" \o ")

**An Agreement Is Only the Start**

Third, even if the PCAOB and Chinese authorities reach an agreement on proceeding with inspections and investigations, we still have a long way to go. Let me explain.

The US and Chinese authorities are engaged in constructive discussions. If the PCAOB and Chinese authorities reach an agreement—and that is uncertain—the PCAOB would need to determine that it could complete inspections and investigations before it modifies its determinations.[[18]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn18" \o ") All of this needs to happen before the end of the year when the PCAOB must reassess its 2021 determination on non-compliant jurisdictions.

Working backwards from the date of PCAOB’s 2021 determination and allocating a few weeks for PCAOB staff to draft the determination and for its Board to vote to approve it, that means the PCAOB would need to be able to complete inspections and investigations by early November 2022.

**Deemed Too Sensitive to Comply**

Finally, to mitigate the worst-case scenario under the HFCAA, some China-based issuers may opt to delist preemptively from US exchanges.

For Chinese authorities, the audit inspection and investigation issues seem hard to solve. There have been disagreements over matters such as redactions, selection of the audit engagements and potential violations to be examined, and access to firm personnel, audit work papers, and other information.[[19]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_edn19" \o ") In 2016, the PCAOB started a pilot inspection of a China-based audit firm but it was prevented from completing it because Chinese authorities withheld or redacted information that the PCAOB needed. For more than 15 years, the PCAOB has been trying to access the necessary documents from China and Hong Kong-based audit firms. The PCAOB is only seeking access to audit firms that elected to register with the PCAOB, as well as the work papers of audits of issuers that have chosen to list on US capital markets. Yet, to date, every attempt to solve this problem has failed.

Perhaps then Chinese authorities should consider whether there is a subset of China-based issuers that are “too sensitive to comply” with the requirements for US listing and voluntarily delist those entities from US exchanges while bringing the remainder into compliance with PCAOB standards. This decision is of course up to the Chinese authorities.

The SEC has offered to work with Chinese authorities in whatever decision they make, including ensuring a smooth transition for China-based issuers if they have to leave US markets. I anticipate that this work will also involve educating retail investors holding securities of China-based issuers about the risks to their investments in the event the issuers are subject to trading prohibitions and delisting. To this end, investors should talk to their brokers or financial advisors, and investment professionals should talk to their customers, about the risk of continuing to hold these securities.

**Conclusion**

To conclude, I want to leave you with the following thoughts. While there has certainly been progress in the discussions on audit inspections in China and Hong Kong, significant issues remain. If there is one takeaway from my remarks today, it is this: even if an agreement is signed between the PCAOB and Chinese authorities, it will only be a first step. The PCAOB must be able to obtain sufficient cooperation and agreement from Chinese authorities so that the PCAOB Board can make a determination that it can inspect and investigate *completely* in China and Hong Kong.

It is also important to note that the PCAOB’s determination and identification of audit firms under the HFCAA was a jurisdiction-wide determination, and not a firm-specific determination. This means that the PCAOB must be able to access audit work papers from all, not some, China-based issuers and their registered public accounting firms, as well as conduct complete inspections and investigations in China and Hong Kong.

Thank you for having me here today. I am happy to take questions.

[[1]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref1" \o ") The U.S. Securities and Exchange Commission (SEC) disclaims responsibility for any private publication or statement of any SEC employee or Commissioner. This speech expresses the author’s views and does not necessarily reflect those of the Commission, the Commissioners, or other members of the staff.

[[2]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref2" \o ") For purposes of this statement, “China” and “China and Hong Kong” are used interchangeably, and “China” refers to the People’s Republic of China, or PRC, which includes both Mainland China and Hong Kong.

[[3]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref3" \o ") *See* Chair Gary Gensler, *Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs*, (Sept. 14, 2021), *available at* <https://www.sec.gov/news/testimony/gensler-2021-09-14>.

[[4]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref4" \o ") PCAOB Website, *China-Related Access Challenges*, *available at* <https://pcaobus.org/oversight/international/china-related-access-challenges> (last visited May 19, 2022).

[[5]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref5" \o ") *See* *President’s Working Group on Financial Markets: Report on Protecting United States Investors from Significant Risks from Chinese Companies*, p. 21, (July 24, 2020), *available at* <https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf>.

[[6]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref6" \o ") *See* PCAOB, *HFCAA Determination Report*, p. 10 and n.19, (Dec. 16, 2021), *available at* <https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/international/documents/104-hfcaa-2021-001.pdf?sfvrsn=acc3b380_4>.

[[7]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref7" \o ") *See* PCAOB, *HFCAA Determination Report*, p. 6-7, (Dec. 16, 2021), *available at* <https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/international/documents/104-hfcaa-2021-001.pdf?sfvrsn=acc3b380_4>.

[[8]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref8" \o ") *See* SEC Website, Division of Corporation Finance, *Disclosure Considerations for China-Based Issuers*, (Nov. 23, 2020), *available at* <https://www.sec.gov/corpfin/disclosure-considerations-china-based-issuers#_edn2>.

[[9]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref9" \o ") *See* SEC Statement, *Statement on the Vital Role of Audit Quality and Regulatory Access to Audit and Other Information Internationally—Discussion of Current Information Access Challenges with Respect to U.S.-listed Companies with Significant Operations in China*, (Dec. 7, 2018), *available at* <https://www.sec.gov/news/public-statement/statement-vital-role-audit-quality-and-regulatory-access-audit-and-other#_ftnref23>.

[[10]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref10" \o ") *See id.*; *see, e.g.,* Karolyi. G. A., *The World of Cross-Listings and Cross-Listings of the World: Challenging Conventional Wisdom*, 10 (1) Review of Finance 99-152 (2006).

[[11]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref11" \o ") Audit work papers may include general ledgers, summaries or abstracts of significant contracts, memoranda (*e.g.*, documentation of accounting positions or analysis), confirmations received from a third-party, correspondence, detailed schedules of accounts or transactions, audit programs, and letters of representation.

[[12]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref12" \o ") Audit work papers may also include detailed schedules of accounts or transactions, which an auditor often compares to supporting evidence from the company under audit, such as invoices, bills of lading, purchase orders, bank statements, checks, and wires, *etc.* While the audit work papers generally include only the identification of items reviewed, the auditor may also decide to include in the work paper the actual underlying company documents, but is not required to do so.

[[13]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref13" \o ") Audit work papers may include certain information about the organizational structure, including investors and ownership, and information regarding important contracts with customers, suppliers, and lending institutions.

[[14]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref14" \o ") Auditors perform procedures to test equity transactions that may affect the ownership of the company. This may include the auditor’s evaluation of transactions between the company and its related parties. Auditors perform procedures on related party transactions to conclude whether such transactions have been properly identified, accounted for, and disclosed in the financial statements. Information typically found in the audit work papers includes the nature of the transactions, summary of the terms, and the monetary amount of the transactions. The audit work papers may include the contracts associated with the related party transactions, but this is not generally required.

[[15]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref15" \o ") Audit documentation related to internal control over financial reporting includes the auditor’s understanding of the company’s internal controls and how the company’s operating system ensures that financial transactions are processed correctly. Such audit documentation could include, for example, screen shots of system menus showing setup options, rather than specific coding of the system itself. For example, the auditor may describe how access to a relevant financial reporting system is granted or removed (*e.g.*, “access controls”), and whether changes in access were consistent with the company’s established policy. Audit work papers do not typically include the actual software or information that, for example, enables a reviewer of such work papers to gain access to the company’s network or information technology systems.

[[16]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref16" \o ") *See* SEC Press Release, *SEC Adopts Amendments to Finalize Rules Relating to the Holding Foreign Companies Accountable Act*, (Dec. 2, 2021), *available at* <https://www.sec.gov/news/press-release/2021-250>.

[[17]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref17" \o ") PCAOB, *HFCAA Determination Report*, p. 8, (Dec. 16, 2021), *available at* <https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/international/documents/104-hfcaa-2021-001.pdf?sfvrsn=acc3b380_4>.

[[18]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref18" \o ") *See* PCAOB Release No. 2021-004, *Rule Governing Board Determinations Under the Holding Foreign Companies Accountable Act*, p. 37, (Sept. 22, 2021), *available at* <https://pcaob-assets.azureedge.net/pcaob-dev/docs/default-source/rulemaking/docket048/2021-004-hfcaa-adopting-release.pdf?sfvrsn=f6dfb7f8_4>.

[[19]](https://www.sec.gov/news/speech/fischer-remarks-international-council-securities-associations-052422" \l "_ednref19" \o ") *See* *President’s Working Group on Financial Markets: Report on Protecting United States Investors from Significant Risks from Chinese Companies*, p. 19-24, (July 24, 2020), *available at* <https://home.treasury.gov/system/files/136/PWG-Report-on-Protecting-United-States-Investors-from-Significant-Risks-from-Chinese-Companies.pdf>.