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Lessons For Directors From Auditing Meltdown At China-Based Issuers

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The drumbeat of negative publicity about alleged accounting and financial irregularities at China-based issuers listed in the U. S. recently reached a crescendo with the SEC's decision to charge the Shanghai-based affiliate of a Big Four accounting firm with violations of the Sarbanes-Oxley Act for refusal to turn over audit work papers for an undisclosed audit client. In 2011 alone, at least 30 Chinese companies listed on U.S. exchanges saw their auditors resign, and another 25 Chinese companies were delisted. While some of these companies were products of "reverse mergers" with preexisting shell companies, many followed the traditional route of an initial public offering. While the specific allegations of the reported problems at those companies and the diverse, and mostly unsuccessful, attempts by the companies to respond are beyond the scope of this article, the escalating reaction of U.S. and Chinese regulators offers a proverbial "teachable moment" for directors, and we provide some practical, common sense tips for directors to follow before a crisis erupts.

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The Mounting Concerns Of U.S. And Chinese Regulators

The apparent trend of alleged financial problems reported in the press and the increased number of reported disagreements between Chinese issuers and outside auditors has been tracked by clearly worried U.S. regulators. The director of the Enforcement Division has bluntly expressed the SEC's concern: "Not having proper accounting and reliable audit review for publicly traded companies with operations in China is just not acceptable. We have to find a path to resolution of this issue." The agency's response has been aggressive. In addition to the recent administrative action against Deloitte China for refusal to turn over audit work papers, the SEC has requested a federal judge to enforce a subpoena issued to the same firm relating to another Chinese company delisted in 2011 after a much-publicized resignation by Deloitte China, and has apparently dismissed concerns that compliance could subject the firm to severe sanctions under Chinese secrecy laws. If successful, the SEC could seek penalties ranging from censure to denial of the "appearance and practice" privilege, which would be severe given that Deloitte China audits more than 40 China-based companies trading in the U.S.

The SEC has also recently approved new rules aimed at tightening standards for companies created by reverse mergers. A company resulting from a reverse merger will not be able to apply to list until it has completed a one-year "seasoning period" in the over-the-counter market or another regulated exchange and maintained the requisite minimum share price for at least 30 of the 60 trading days prior to its application.

In addition to the SEC, the U.S. Department of Justice and the Public Company Accounting Oversight Board ("PCAOB") are reportedly investigating accounting irregularities at China-based issuers. The PCAOB is in negotiations with the China Securities Regulatory Commission to allow its inspectors to inspect local audit firms in China. The pressure on regulators to reach some accord with China is intense. Senator Charles Schumer, a member of the Senate Finance Committee, has demanded that PCAOB deregister Chinese audit firms, including China-based affiliates of U.S. auditors, if they refuse to cooperate with PCAOB inspections.

The Chinese authorities are also clearly aware of the widely reported problems at China-based issuers and have also taken action. In perhaps the most extraordinary development, China's financial regulators have demanded that the Big Four audit firms provide the Chinese government with details regarding any information that may have been provided by the auditors to overseas regulators. That demand, coupled with newly announced Finance Ministry rules requiring that Chinese citizens be put in charge of local operations of foreign accounting firms, could certainly complicate efforts to assure investors that the recent spate of reported problems are anomalies and not indicative of more systemic problems.

Steps That Directors Should Take Before A Crisis Erupts

It is clearly too early to tell whether this proliferation of problems is the result of a breakdown in auditing standards in China rather than deficiencies in internal controls at individual companies. But continued scrutiny of these foreign issuers – and government action – is highly likely just as enforcement and criminal prosecutions followed the extensively covered "dot com" collapse in the late 1990s, the options backdating scandal of the 2000s, and the more recent meltdown in the subprime mortgage sector. However, these recent developments offer a proverbial "teachable moment" for directors of public companies since any company can unfortunately find itself in an unexpected "perfect storm" of allegations of financial misconduct, media scrutiny, government inquiries and civil litigation. We suggest some proactive, common sense steps for directors to take before the crisis happens.

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Review And Understand Corporate Governance Documents

Directors need to understand the scope of their authority in the event of a crisis requiring board level action. Directors should carefully review the company charter, the bylaws, the audit committee charter, and any code of business ethics and conduct. Those corporate governance documents dictate the structure and powers of the board and key committees such as the audit committee. These documents should enable the board to establish special committees if necessary to oversee an internal investigation or to review a particular transaction. The documents should clearly require the company to fund expenses incurred by any such board committee and authorize the independent directors to retain qualified independent counsel or other professional advisors to assist with conducting an internal investigation or responding to a government investigation.

Review And Understand The Company's Compliance And Whistleblower Programs

Directors should review and understand the company's whistleblower programs. Does the company maintain an ethics hotline and, if so, how are its complaints resolved? Are directors made aware of the type and nature of ethics complaints received on a regular basis? Does the program make clear when an issue must be raised to the board level rather than resolved by management? If no such policies are in place, why not? Are whistleblower complaints promptly and completely investigated? Does management regularly review the procedures for prompt resolution of any employee or whistleblower issues? Is the company focused on whether particular types of issues or problems are repeated?

Board level attention to the content and implementation of the company's compliance programs has become even more important since inauguration of the SEC's new whistleblower program in August 2011. The program awards whistleblowers between 10 percent and 30 percent of any financial recovery from "wrongdoers" exceeding $1 million. Companies continue to have a strong interest in maintaining a comprehensive compliance program since the SEC and the DOJ credit companies for their compliance programs and for seeking out, self-reporting and rectifying illegal conduct in making charging decisions. Also, under the Federal Sentencing Guidelines, a company is eligible for a reduced sentence if it had an effective compliance and ethics program in place at the time of the offense. While the extent of a company's compliance program depends on the business, at a minimum, companies that do business anywhere in the developing world must have an effective Foreign Corrupt Practices Act compliance program in place.

Make The Most Of Meetings With Outside Auditors

The unusual number of reported disagreements between outside auditors and China-based issuers is an important reminder that directors should meet regularly with the company's outside auditors. Directors should use these meetings, typically conducted at least in part without management present, to receive updates on the topics required by U.S. securities laws and also to listen to any issues or concerns regarding the level or extent of cooperation provided by management, the nature of any differences regarding accounting issues or adjustments, whether any unusual accounting methods are being used or repeated, and most important, to anything relating to the "tone at the top" of the company. Detection of problems in the relationship between management and the outside auditors as early as possible is critical given the disastrous consequences that typically follow from resignation of outside auditors.

Review Materials Provided By Management And Ask Questions

Although it may appear simplistic, one of the most useful tools a director has at his disposal is the ability to ask questions of management. Directors should insist that materials and packages provided to the board are complete, are intelligible, and are provided sufficiently in advance of meetings to enable meaningful review. Directors should make sure that any questions they ask are responded to appropriately and that management follows up as necessary. If a company does not provide training for directors, there are a number of publicly available resources for boards and directors looking to become more effective.

Review D&O Insurance Policies

Like the Chinese issuers recently in the press, companies facing disclosure of financial or accounting irregularities often face civil litigation as well as regulatory or government investigations. In those situations, management as well as directors may ultimately need to retain experienced counsel. Public companies typically indemnify their directors and officers for acts undertaken in the ordinary course of exercising their duties and responsibilities. Many companies advance fees to retained counsel instead of requiring a director or officer to pay legal fees on an ongoing basis and seek reimbursement from the company at the end of an investigation or litigation, which could take years. It is critical that directors regularly review the company's directors and officers ("D&O") insurance policies to ensure that they provide sufficient coverage for all of the possible scenarios. Boards of Chinese reverse merger companies should particularly review their D&O policies because increased regulatory scrutiny is causing some insurance companies to institute multiple rate increases.

Most D&O policies have three types of coverage, typically called Side A, Side B and Side C. Side A protects the personal assets of insured officers and directors if the company is unable or unwilling to indemnify an individual. Side B covers a company's costs when it is permitted or required to indemnify individual officers or directors. Side C reimburses the company itself for losses in connection with securities class actions and formal SEC investigations. Because D&O coverage for class actions is not universal, particularly outside the U.S., directors of foreign issuers should ensure that their policy covers class actions. Directors should also determine whether their policy covers informal investigations (i.e., the proceedings before a formal order of investigation or subpoena has been issued). Other issues include whether the policy provides sufficient coverage in the event of a company bankruptcy or whether the company will advance defense costs on a current basis.

Prepare For The Crisis Before It Happens And Identify Potential Specialists To Help

In the face of crisis situations like those discussed above, outside directors are likely to play a special role. They often become the face of the company to regulators, stock exchanges, outside auditors and other entities seeking answers. Directors will likely need outside advisors to successfully navigate the process, particularly if it includes formation of a special committee or management of an internal investigation. Directors should consider identifying professionals, including attorneys, accountants and investor relations' specialists, who can be available to advise in a crisis before it happens, particularly since there are many scenarios in which directors may not be able to rely on regular outside counsel or the company's outside auditors for advice.

Conclusion

The perfect storm facing so many China-based U.S. issuers presents an opportunity for directors of public companies to learn, or perhaps to relearn, important lessons about their role and to consider the unthinkable. While the basic steps we suggest may be easy to overlook in the ordinary press of daily business or viewed as expensive overkill, directors of rapidly growing companies, especially those in the technology space, younger companies whose compliance infrastructure and internal controls have not kept pace with the growth and complexity of their businesses, and any company operating regularly in foreign countries, should not be tempted to skip the time or expense necessary to understand their rights, powers and duties, as well as the substance of the company's compliance programs before the crisis erupts and they are faced with the perfect storm.