Markets

China Urges State Firms to Drop Big Four Auditors on Data Risk

- SOEs encouraged to use local auditors when contracts expire
- Guidance reiterated even after China reached US audit deal

By Bloomberg News

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Chinese authorities have urged state-owned firms to phase out using the four biggest international accounting firms, signaling continued concerns about data security even after Beijing reached a landmark deal to allow US audit inspections on hundreds of Chinese firms listed in New York.

China's Ministry of Finance is among government entities that gave the so-called window guidance to some state-owned enterprises as recently as last month, urging them to let contracts with the Big Four auditing firms expire, according to people familiar with the matter. While offshore subsidiaries can still use US auditors, the parent firms were urged to hire local Chinese or Hong Kong accountants when contracts come up, one of the people said, asking not to be identified discussing private information.

China is seeking to rein in the influence of the US-linked global audit firms and ensure the nation's data security, as well as to bolster the local accounting industry, the people said. Beijing has been giving the same suggestion to state-backed firms for years, but recently re-emphasized that companies should use other auditors than the Big Four, the people added. No deadline has been set for the changes and replacements may happen gradually as contracts expire.

While the China-US audit deal last year was hailed as a sign that the competitive superpowers can still work together on some issues, Beijing's audit guidance is a reminder that decoupling is still proceeding in sensitive areas like SOEs and advanced technology. One risk for China is that shifting to lesser-known auditors will make it harder for SOEs to attract capital from international investors.

"It builds in a further hurdle for Chinese SOEs in terms of appealing to international capital," said Richard Harris, chief executive officer of Hong Kong-based investment business consultancy and fund manager Port Shelter Investment Management. "I'm not sure if the data held secret as a result is likely to be important enough to justify inhibiting that access to international capital as accountants have a legal obligation to be confidential."

China's finance ministry and representatives of the Chinese offices of PricewaterhouseCoopers LLP, Ernst & Young, KPMG and Deloitte & Touche LLP – collectively known as the Big Four auditing firms – didn't respond to requests seeking comment. As for the global arms, PwC, KPMG and Ernst & Young declined to comment, and Deloitte didn't immediately respond to a request for comment.

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The US Securities and Exchange Commission on Wednesday declined to comment on Chinese authorities' move on accounting firms. Generally, SEC rules don't require companies to work with one of the Big Four accounting firms. But companies must use accounting firms registered with the US Public Company Accounting Oversight Board, an auditor watchdog agency overseen by the SEC.

Companies traded on US exchanges risk being delisted if the PCAOB isn't able to fully inspect and investigate the work papers of their auditors after three years in a row.

"The PCAOB continues to demand complete access to inspect and investigate all registered firms in China, and there will be no loopholes and no exceptions whether those firms are part of a global network or not," Erica Williams, the board's chair, said in a statement Wednesday. "Should PRC authorities obstruct or otherwise fail to facilitate the

PCAOB's complete access at any point, in any way, the board will act immediately."

The PCAOB in December completed its first-ever on-site work paper inspection of some of the largest Chinese companies and said it was able to sufficiently review audit documents during the trip to Hong Kong, which was hosted by PwC and KPMG. The PCAOB is planning further reviews this year.

Several big state firms including China Eastern Airlines Corp., China Life Insurance Co. and Petrochina Co. have voluntarily applied to delist from the American exchanges.

Voluntary delisting, however, doesn't protect issuers' "audit engagements from being selected for PCAOB inspections or investigations," a PCAOB spokesperson said. "PCAOB inspections of firms are retrospective. So if a company delists in a given year, PCAOB may still inspect audits from previous years while it was listed or investigate the audit work."

Winners and Losers

Getting shut out of Chinese state-owned business would be a blow to the accounting firms. The Big Four earned combined revenue of 20.6 billion yuan ($3 billion) from all Chinese clients in 2021, according to the finance ministry.

Some 60 Hong Kong-listed companies with Chinese headquarters – state-owned and private – have changed auditors since September last year, when the PCAOB started its historic review. Smaller Chinese and Hong Kong firms gained almost 20 jobs from the Big Four, according to Hong Kong exchange filings.

Those changing to smaller audit firms in recent months include property developer Sino-Ocean Group Holding Ltd. and its subsidiary Sino-Ocean Service Holding Ltd., which dropped PwC, citing good governance practices to rotate auditors after long years of service. Furniture maker Red Star Macalline Group Corp. proposed to end a contract with EY because they "failed to reach consensus on the work schedule and expenses."

While the Big Four dominate China at the moment, smaller rivals are edging up. Potential winners of new business could include close rivals such as Pan-China Certified Public Accountants, BDO China Shu Lun Pan CPAs, Moore Global, and RSM China.

Homegrown Winners

Local Chinese auditors due to fill the Big Four void at state-owned companies

Source: Ministry of Finance, the Chinese Institute of Certified Public Accountants

More than 80 listed companies in Shanghai and Shenzhen also changed auditors since December, Chinese news outlet Jiemian reported. Chinese regulators have expressed concerns over some smaller firms' quality of work and ability to handle troubled listed clients.

"The Big Four have grown because of their perceived independence and size, and being global and subject to different regulators reinforces this perception of trust, on which the Western financial system depends," Harris said. "While smaller firms should adopt the same internal controls and external regulation, they have to try much harder to justify that trust that it has taken the big names decades to build."

– With assistance by Kiuyan Wong, Jonas O Bergman, Claire Che, Lydia Beyoud and Amanda Iacone

(Updates with attempts to reach firms' global offices, comments from PCAOB starting in sixth paragraph.)

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