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Auditors Sharpen Queries In China

Auditors are learning that, in China, they sometimes must go the extra mile to verify even the most basic things about clients—like how much cash they have.

Hong Kong audit firm BDO Ltd. recently dropped a client after raising questions about the accuracy of information provided by the firm, going so far as to allege the company had directed the auditor to a fake website.

Problems with bank "confirmation"—the process by which an auditor checks with a company's bank to verify its balances—have arisen in about 10 recent disputes between U.S.-traded Chinese firms and their auditors, according to Securities and Exchange Commission filings. (There are hundreds of Chinese firms traded on U.S. exchanges.) The auditors have found irregularities through their confirmation efforts or encountered other difficulties in confirming a client's bank accounts, according to SEC filings.

When BDO tried to verify the online bank accounts of Chinese biotech [China-Biotics Inc.](#), for instance, the company's staff directed the auditors to a bank website that BDO said—in a letter to China-Biotics last week in which BDO announced it was dropping the account—was "a suspected fake." China-Biotics filed that letter with the SEC on June 23. BDO said there were errors in a bank document concerning the company's bank interest income; China-Biotics said the errors in the

document were clerical mistakes by the bank, and the company supplied BDO with what BDO characterized in its resignation letter as a "corrected" version of the document.

As a result of these and other issues, according to the letter filed with the SEC, BDO wanted to confirm the company's bank balances and transactions with the senior management of the head office of its bank, the [Bank of Communications](#). But China-Biotics never arranged the meeting, despite repeated requests from BDO, the firm said. The company's chief financial officer and its audit-committee chairman have resigned, and trading in China-Biotics shares on the Nasdaq Stock Market has been halted since June 15 in the wake of the auditor's concerns. A BDO representative declined to comment. The Bank of Communications didn't immediately respond to a request for comment. China-Biotics couldn't be reached for comment.

In some cases, auditors may not have done all they should to seek bank confirmations independently, according to U.S. regulators. In other cases, auditors have suggested in SEC filings that officials at some companies' banks may be helping the companies manipulate the process, verifying bad information to mislead auditors into thinking a company's books are OK.

Deloitte Touche Tohmatsu, for instance, said it received confirmations from bank staff about one

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client, [Longtop Financial Technologies Ltd.](#), that "were said to be false" or had "significant differences" in deposit balances and company borrowings compared with previous confirmations. Those descriptions of the problematic information were contained in a letter Deloitte wrote when it resigned from the Longtop account in May. Longtop couldn't be reached for comment. Details on the bank involved weren't available.

Regulators are concerned, too, as accounting questions raised by auditors and investors beset dozens of Chinese companies. James Doty, chairman of the Public Company Accounting Oversight Board, which regulates U.S. audit firms, told a Senate panel in April that the board had found "even simple audit maxims, such as maintaining the auditor's control over bank confirmations, may not hold given the business culture in China."

A spokesman for the China Banking Regulatory Commission, the country's bank overseer, said in a statement that Chinese banking regulation and supervision "have always been stringent." All levels of a bank are required to provide accurate confirmation information, the CBRC said, and false confirmation is "absolutely prohibited." "The CBRC will deal with this matter seriously and welcomes public supervision and any sharing of evidence," the statement said. The China Securities Regulatory Commission didn't reply to requests for comment.

In a bank confirmation, an auditor submits a written request to an official at the company's bank to verify the firm's assertions about deposit and loan balances, often on a standard form developed by the accounting industry. The bank official responds directly to the auditor to confirm the amounts. Except for authorizing the bank to release information, the company can't be involved in the process in any way. The PCAOB oversees and enforces auditing rules for U.S.-traded Chinese firms just as it does other U.S.-traded companies.

As accounting problems have emerged, auditors in China have taken greater precautions. Some say they are doing more to maintain control of confirmation paperwork, such as observing as

bank officials confirm numbers. In addition, the PCAOB is preparing to tighten rules on the confirmation process for all auditors it oversees. When auditors don't do what they should on confirmation, "the possibility of fraud certainly increases," said Martin F. Baumann, the PCAOB's chief auditor and director of professional standards.

Frauds involving bank confirmation are neither new nor limited to China. At Satyam Computer Services Ltd., U.S. regulators said a failure by PricewaterhouseCoopers affiliates in India to confirm Satyam's accounts enabled the company's fraud to go undetected. PwC agreed to a \$7.5 million settlement but didn't admit or deny wrongdoing and said at the time that it had "worked hard to learn the lessons of the Satyam matter." Satyam said when it settled SEC charges in April that it was in the company's "best interests" to resolve the allegations and noted that the misconduct occurred under previous management.

Bank-confirmation problems are "potentially more of an emerging-markets problem," Mr. Baumann said, with "collusion going on between banks and issuers" in countries that don't yet have a tradition of strong corporate governance and independent oversight. In China, he said, "it appears that banks often have a very close relationship with the company."

In Longtop's case, Deloitte resigned as auditor in May after it said it had made follow-up visits to some of the company's banks that uncovered the allegedly false confirmations and discrepancies. When Deloitte attempted a second formal round of confirmations as a result, Longtop officials interfered by seizing Deloitte working papers and telling the banks that Deloitte wasn't really its auditor, the firm said in its resignation letter.

At China MediaExpress Holdings Inc., another client Deloitte dropped, this time in March, there was "a loss of confidence in bank confirmation procedures carried out under circumstances which [Deloitte] believed to be suspicious," according to China MediaExpress filings. Deloitte requested the confirmations be redone at the banks' head office, according to the filings. But Deloitte felt "the

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Company was not in good faith willing to proceed with the course of action requested," according to the filings. China MediaExpress declined to comment, but in the filings said, "the Company believes that it was working to address these items at the time of [Deloitte's] resignation."

Jeff Willemain, Deloitte Touche Tohmatsu's managing director of quality and regulatory matters, said in a statement that Deloitte's member firms "continue to advocate for improvement" of the confirmation process, including "putting more onus on confirming parties to ensure prompt, accurate and complete responses. Further, there should be consequences for parties who knowingly falsify confirmations."

MaloneBailey LLP, a Houston firm that has a big roster of small Chinese audit clients, has resigned from auditing at least four of them this year, in part because of confirmation problems, according to SEC filings. George Qin, a MaloneBailey partner who runs the firm's China practice, says some bank officials have interfered in the auditor's attempt to confirm its clients' accounts. "I can tell you there are serious problems in China with regard to certain bank employees who collude with companies," Mr. Qin said. "I think that's very troublesome." But he said he didn't think the problems were systemic and said MaloneBailey currently has "about 16" Chinese clients.

The PCAOB's proposed revisions to its confirmation rules are unrelated to the current issues in China. The revisions would require auditors to confirm companies' cash balances—which isn't specifically required under current rules—and a broader range of accounts receivables, or money owed to the company, than is the case now. The revisions also would go into greater detail about what auditors should do to maintain control over the confirmation process, including taking "local customs" into account. A PCAOB representative said, however, that the board's existing rule is "sufficiently robust" to require auditors to do confirmations appropriately in China, and the pace of the changes doesn't need to be accelerated because of the recent problems. The proposals are pending but are expected to be finalized and approved in the coming months.

The effort was begun last year, before the China accounting blowups, but even then, "we thought there would be greater risk in certain environments, and it turns out we were right," Mr. Baumann said. "If you're in an environment where you can't rely as much on an individual's honesty, the auditor has to assess the risk of that."

Even apart from the PCAOB's efforts, some auditing firms say auditors need to toughen their procedures. McGladrey & Pullen LLP, of Bloomington, Minn., which audits one Chinese firm and has other clients with Chinese subsidiaries, said in a newsletter this month that auditors may need to hand-deliver a confirmation request to the bank themselves and wait there while the bank officer completes it. Mr. Qin said MaloneBailey is handling confirmations similarly.

McGladrey also called for "extra diligence" in auditing accounts receivable, because fraud often shows up there first, before it is hidden in exaggerated cash balances.

Robert Dohrer, McGladrey's national director of assurance services, said in an e-mail interview that the alert was intended to remind its people that the auditor "really needs to think through the credibility of audit evidence obtained."

Corrections & Amplifications

The Bank of Communications didn't immediately respond to a request for comment for this article. An earlier version of this article incorrectly said the bank couldn't be reached for comment.

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