

The Crisis and Opportunity of Chinese Concept Stock under Cross-border Supervision

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Abstract

The quality of Chinese concept stock enterprises' financial report and audit report has become a common concern of regulators in China and the United States. However, there are long-standing differences between the two countries in the way of cross-border audit supervision cooperation law enforcement and the handover of audit working papers, which leads to a severe survival crisis for Chinese enterprises listed in the United States. The differences in cross-border audit regulatory cooperation between China and the United States are rooted in the different attitudes of the two countries towards national sovereignty, the differences in the confidentiality requirements of audit working papers, and the different enforcement powers of securities regulators. Following the practice of international securities regulatory cooperation and promoting joint inspections under the framework of bilateral or multilateral cooperation is an effective way to break the deadlock in Sino-US cross-border audit regulatory cooperation. In order to carry out joint inspection smoothly and effectively, measures such as diverting Chinese stock companies and classifying audit working papers are to be considered. In addition, strengthening the domestic supervision of overseas listed Chinese companies and improving the overall quality of Chinese companies are the fundamental solutions to prevent the crisis of Chinese stocks.

Keywords

Cross-border supervision; Audit quality; Regulatory cooperation; Chinese Concept Stock.

1. INTRODUCTION

In February 2020, the exposure of financial fraud at Luck Coffee led to the delisting of Luck Coffee, which intensified the contradiction between cross-border regulation in China and the United States. On December 18, 2020, the U.S. passed the Foreign Companies Accountability Act. On March 10, 2022, the U.S. Securities and Exchange Commission (SEC) added five Chinese companies to the 'pre-delisting list' under the Foreign Companies Accountability Act, mandating audits of companies listed on the concept stocks in accordance with U.S. laws. As of May 31, 2022, the list of pre-delisted Chinese concept stocks involved 147 Chinese concept stock enterprises, and 23 Chinese concept stocks had changed from pre-delisted to confirmed delisted, triggering a new round of delisting crisis of Chinese concept stocks. In the current world situation, Chinese companies face enormous challenges. The solution to the crisis of Chinese concept stocks depends on the development of Sino-US securities regulatory cooperation, and the breakthrough lies in cross-border audit supervision cooperation. However, China and the United States still face many difficulties in the field of cross-border audit supervision cooperation. How to promote China-US audit supervision cooperation on the basis of equality and mutual benefit is an urgent problem to be solved.

Based on the background that the trust crisis of Chinese concept stocks market has triggered the US mandatory requirement for Chinese concept stocks enterprises to provide audit drafts, cross-border regulatory cooperation has reached an impasse, and the survival of Chinese concept stocks enterprises has been threatened, this paper studies and analyzes a series of problems in cross-border audit supervision between China and the United States under the new Chinese concept stocks market crisis. By using the main analysis methods such as content analysis, literature analysis and comparative analysis, based on the relevant policies and regulations such as Sarbanes-Oxley Act and Foreign Corporate Accountability Act, this paper sorts out the essential problems of many Chinese concept stocks market crises, reviews the development process of cross-border audit, and explores the dilemma of cross-border audit supervision cooperation between China and the United States. This paper analyzes the causes of the differences from three perspectives: national sovereignty, confidentiality of audit manuscripts and law enforcement authority. Based on the differences between the two sides, this paper considers the possible measures to improve the deadlock of cross-border audit supervision cooperation from four perspectives: carrying out joint inspection, diverting Chinese stock companies, strengthening domestic supervision and seeking a way out for enterprises, and puts forward some paths and methods for enterprises to resolve the current crisis.

The intensification of cross-border audit supervision contradictions between China and the United States has put the survival of Chinese companies in trouble. Under the new background of China-US securities management consultation on cross-border audit supervision cooperation at this stage, this paper discusses the problems faced by cross-border audit supervision, the methods to coordinate and improve audit supervision cooperation, and the development path of China concept stock enterprises. Not only for the current plight of audit supervision to find a way out to alleviate the plight of China concept stock enterprises ; at the same time, it has certain practical significance for stabilizing the cross-border securities market order, promoting the improvement of capital market rules, and protecting the rights and interests of domestic and foreign investors.

2. THE DEVELOPMENT OF CROSS-BORDER AUDIT SUPERVISION

With the development of economic globalization and the demand for corporate financing, many enterprises have chosen to list cross-border. And cross-border audit supervision also develops accordingly. The issue of Sino US cross-border audit supervision has gone through five stages: finding problems - promoting cooperation - generating differences - deadlock - subsequent negotiation. The following table is a review of the regulatory provisions on Chinese concept stocks.

3. DIFFICULTIES IN CROSS-BORDER REGULATORY COOPERATION OF CHINA STOCKS

Chinese concept stock crisis is essentially a deep and lasting credit crisis, reflecting the lack of effective audit supervision constraints of Chinese concept stock enterprises listed in the United States, which triggered concerns of the U.S. securities regulators and the community about the quality of financial audit of Chinese concept stock enterprises [1].

Table 1. The Development of Cross-border Audit Supervision

Time	Event	Impact
July 2002	U. S. Senate and House of Representatives pass 'Sarbanes-Oxley Act and establish PCAOB as required by law	New regulations have been made in many aspects such as corporate governance and accounting professional supervision.
2007	PCAOB sends board members to Beijing to discuss cross-border audits	Begin discussions on cross-border regulatory cooperation to fill cross-border audit regulatory gaps.
2007-2010	A large number of Chinese enterprises through reverse acquisition to the U.S. capital market financing.	Enhance the risk of violations caused by untimely and inaccurate information communication during the audit process.
2010	First credit crisis breaks out in China concept stocks, China and US hold audit supervision seminar	Introduced each other the audit supervision system and inspection procedures, and exchanged views on deepening cross-border audit supervision cooperation.
2013	Formally signed the Sino-US law enforcement cooperation memorandum. PCAOB need to report in advance and get the consent of the Chinese side to obtain audit information of Chinese listed companies	It is a crucial step to protect the interests of investors in the US capital market, and the gap between China and the US cross-border audit has been truly improved.
2015-2017	China and US launch pilot inspection	Regulate the form, process and results of future China-US joint cross-border audit work and make new breakthroughs in cross-border law enforcement cooperation.
2020	Luck in Coffee financial fraud exposed and U.S. passes Foreign Companies Accountability Act	The contradiction of cross-border auditing has risen from the level of regulatory provisions to the level of US legislation, and China-US regulatory cooperation has reached an impasse.
August 2022	Sign an audit supervision cooperation agreement and start relevant cooperation. Inspection and investigation planned for September 2022 in Hong Kong	This shows that China-US regulatory cooperation remains the general direction, laying the foundation for further cooperation between the two sides and releasing positive signals

3.1. Financial Audit Quality of Chinese Concept Stock Enterprises

US securities regulators concerns about the quality of financial audits by Chinese companies have long been rooted in opaque disclosures under the variable interest entities (VIE) structure. Chinese concept stocks generally adopt the VIE structure for cross-border listing. Through the complex protocol network architecture, Chinese concept stocks have realized the actual control of overseas listed shell companies over domestic operating entities.

The VIE structure of Chinese concept stocks is an intermediate gray area and historical legacy problem that arose when there was no contact and collision between the securities regulatory powers of China and the United States in the early stage. The structure itself is a special means for Chinese concept stocks to evade Chinese laws and go overseas. The listing has the risks of lack of effective supervision, opaque information disclosure, and crossing different jurisdictions [2]. The opaque information disclosure under the VIE structure of Chinese concept stocks and the lack of substantive legal constraints on financial audit issues have always been highly concerned by US securities regulators [3]. Regardless of political factors, the main content of

the Foreign Corporate Accountability Act passed by the US Senate is to strengthen audit supervision to protect the interests of US investors.

3.2. Differences between China and the United States in Cross-border Audit Regulatory Cooperation

The financial audit quality of Chinese concept stock enterprises has always been the focus of common concern of securities regulators in China and the United States, but the differences between the two sides in the way of cross-border audit supervision cooperation have led to a long-term failure to solve this problem well. Chinese concept stocks are Chinese companies listed in the United States, and American regulators have the main audit supervision responsibility for them [4]. However, the operating entities of Chinese companies are located in China. U.S. regulators cannot directly supervise the operating entities of Chinese companies in China, and it is difficult to manage and control the executives of Chinese companies. They can only seek the assistance and support of the Chinese government [5]. For China's securities regulators, the financial fraud of some Chinese companies has seriously damaged the international reputation of Chinese companies. However, the supervision of Chinese companies is faced with the problem that the main body of listing is not Chinese companies, and it is difficult for the China Securities Regulatory Commission to directly supervise overseas listed companies.

At present, there is also a lack of prior notification and cooperation mechanisms between Chinese and American securities regulators for Chinese companies listed in the United States [6]. Focusing on the audit quality of Chinese stock companies, China and the United States have been trying to find effective ways of cooperation in recent years, and have achieved a lot. However, on some key issues, there are still unresolved differences in the audit supervision cooperation between China and the United States. On the one hand, the US securities regulators have always advocated the entry of independent law enforcement activities and the inspection of Chinese accounting firms. For the sake of domestic sovereignty, China advocates that the United States needs to rely on the regulatory enforcement activities of China's securities regulators, or the two sides negotiate to jointly carry out joint inspections [7]. On the other hand, the US SEC and PCAOB advocate direct access to the audit working papers of Chinese stock companies and conduct their own inspections [8]. However, China's law has strict provisions on the provision of audit working papers abroad, and due to the sensitivity of the content of some audit working papers, it is not suitable to provide them abroad.

4. CAUSES OF DIVERGENCE IN CROSS-BORDER AUDIT SUPERVISION COOPERATION OF CHINA CONCEPT STOCKS

Due to the differences between China and the United States in terms of national sovereignty, law enforcement authority of securities regulatory agencies, and confidentiality requirements for audit working papers, there are obvious differences between China and the United States on the issue of cross-border audit supervision cooperation law enforcement and the provision of audit working papers.

4.1. Different Attitudes Towards National Sovereignty between China and the United States

The divergence of views on the way of cross-border audit supervision cooperation between China and the United States is a concrete manifestation of the conflict of sovereignty between the two countries in the field of securities audit supervision [8]. The Chinese government has always adhered to the principle of non-interference in the sovereign internal affairs of the state. In terms of cross-border audit supervision, the Chinese government adheres to the principle of full trust. It is hoped that the audit supervision work will be completed separately by the

country where the accounting firm is located. The use of audit reports should recognize the audit supervision results carried out by the regulatory agencies of the country where the accounting firm is located. The principle of full trust in the field of cross-border securities audit and regulatory cooperation is also a common practice in line with international practice. Compared with China's adherence to the principle of non-interference in the sovereign internal affairs of the state and the principle of complete trust, the United States has always adhered to the principle of long-arm jurisdiction in cross-border audit supervision and expanded its own jurisdiction and administrative supervision. This is the embodiment of the US government's weakening of sovereignty in the field of securities supervision. The difference between the principle of full trust and the principle of long-arm jurisdiction between China and the United States stems from different attitudes towards sovereignty issues, reflecting the different political systems and national interests of the two countries, and has inherent contradictions.

4.2. Differences between Chinese and US audit working paper confidentiality requirements

According to the legal and regulatory rules of the United States, Chinese companies listed in the United States must employ an accounting firm registered in PCAOB to provide audit services. According to the Sarbanes-Oxley Act enacted by the United States in 2002, these accounting firms need to provide the PCAOB and SEC with the relevant audit working papers [9]; the China Securities Regulatory Commission Accounting Department in 2011 and the Ministry of Finance in 2015 regulations have reiterated the principle of audit working papers must not leave the country. Article 177 of the newly revised Securities Law in 2019 has raised this provision to a legal height.

As a public company that issues and trades securities in the United States, the Chinese concept stock company should be subject to the supervision of the US securities regulatory agency in accordance with US law; the U.S. securities regulator's request to strengthen the supervision of the audit reports of Chinese concept stock enterprises and obtain the corresponding audit working papers undoubtedly has the legitimacy and rationality of American law. However, these actions of the United States to safeguard the interests of its own markets and investors will undoubtedly also conflict with the relevant legal provisions on the confidentiality of audit working papers in other countries. In terms of providing audit working papers abroad, China's laws and regulations have stricter provisions. Therefore, in the absence of an effective and normalized audit regulatory cooperation agreement between China and the United States, the differences in the legal provisions on the confidentiality of audit working papers have become an important obstacle across China-US cross-border audit regulatory cooperation.

4.3. Differences in Enforcement Jurisdiction between Chinese and American Securities Regulators

The difference in the enforcement authority between China and the United States securities regulators is also a major reason for the differences in the enforcement methods of cross-border audit regulatory cooperation between China and the United States. The differences in the working procedures, rhythm and focus of the regulatory authorities of the two countries often lead to difficulties in cooperation. There are also differences between the China Securities Regulatory Commission and the United States SEC and PCAOB due to differences in law enforcement authority, especially in investigation and evidence collection and supervision of accounting firms. The U. S. SEC's enforcement authority is very broad, can independently carry out reconnaissance activities. In contrast, the China Securities Regulatory Commission's law enforcement authority is very limited, there is no corresponding investigation authority, many investigations need other ministries to cooperate [10]. Compared with the extensive authority

of the SEC and PCAOB in the United States, although the amount of fines imposed by China's securities regulatory agencies for accounting violations has increased, it still lacks sufficient deterrent force, and is mainly based on unit penalties. The punishment of illegal natural persons is single and small.

5. SETTLEMENT OF DIFFERENCES BETWEEN CHINA AND THE UNITED STATES IN CROSS-BORDER AUDIT REGULATORY COOPERATION

5.1. Joint Inspection Under Bilateral or Multilateral Cooperation Framework

Reasonable cross-border audit supervision mechanism plays an important role in market operation and protection of investors rights and interests [11]. Strengthening cross-border audit supervision cooperation has become crucial. When conducting cross-border supervision, national regulators often adopt bilateral or multilateral cooperation mechanisms to obtain the cooperation and assistance of overseas regulators. Over the years, China and the United States securities regulators have used bilateral and multilateral cooperation mechanisms to carry out some cross-border audit supervision cooperation. The specific core content mainly lies in: exchanging and sharing audit information within the jurisdiction of the audit regulators of both parties; assist the counterpart audit supervision institution to carry out activities including obtaining audit information, conducting inspection and investigation; both parties establish a corresponding confidentiality mechanism to ensure the security of audit information, and return all audit information files after the inspection. On the basis of the existing cooperation results and the basic principles of respecting national sovereignty, China and the United States need to resolve the contradictions and differences between the two sides on political, sovereignty and confidentiality issues in the form of bilateral cooperation agreements, and further promote bilateral audit supervision cooperation, which is undoubtedly a win-win choice for both countries.

5.2. Division of China Concept Stock Company and Audit Working Paper

Distinguish between China concept stock companies, clarify whether China concept stock companies and their audit working papers can be provided overseas, and negotiate to define the scope of regulatory cooperation and joint inspections between the two sides. It is not appropriate to carry out joint inspections of these confidential information and companies for companies that have been listed overseas in Chinese concept stocks companies involving national economy and people's livelihood, state secrets and specific technology patents. These Chinese stock companies can consider returning to the domestic market at an opportunity, or divesting of confidential business and then listing overseas. For those overseas listed Chinese companies that are not classified and have no financial problems, especially private enterprises engaged in general competitive industries, they can take a more open attitude.

5.3. Strengthening Domestic Regulation of Overseas Listed Chinese Companies

A profound study of the essence of the crisis leads to the conclusion that Chinese overseas listing enterprises are comparatively lack of supervision [12]. Strengthening the domestic supervision of overseas listed Chinese companies, minimizing the space for financial fraud, and improving the financial quality of China concept stock companies are the fundamental solutions to solve the crisis of China concept stock and reshape the international reputation of China concept stock companies. China's relevant institutions should strengthen the prior supervision of overseas listed companies. First, we can crack down on securities fraud by improving relevant regulatory standards, accelerating the revision of laws and regulations such as company law and criminal law, and strengthening the punishment of securities fraud by Chinese concept stock enterprises. Prevent similar incidents from the source. The second is to expand the regulatory power of the CSRC and properly coordinate multiple supervision. Third, we can

learn from the mature company listing system of other countries and constantly promote the construction of the rule of law in the capital market [13].

5.4. Enterprises Seek Their Own Interests and Sustainable Development

Chinese concept stocks enterprises should have sufficient knowledge of the information disclosure mechanism and relevant laws and regulations of the capital markets of the two countries, be familiar with cross-border audit supervision processes and rules, strictly abide by relevant market laws, accept the supervision of overseas regulators, and safeguard the interests of the company to the maximum extent. At the same time, enterprises should focus on strengthening their own internal control, to eliminate financial fraud, to ensure that financial information is true and reliable. For some confidential enterprises that are not suitable for public disclosure and face the risk of delisting, they can re-carry out business layout and strategic planning through privatization, restructuring and listing after delisting, issuing common shares in the mainland, and realizing secondary listing in Hong Kong. The most important thing is that enterprises must attach great importance to the quality of their products, and fundamentally enhance their market competitiveness and brand reputation in order to sustained and healthy development in the capital market.

6. CONCLUSIONS

With the further development of global economy, seeking cross-border listing has become the choice of many Chinese companies. To safeguard the rights and interests of global investors and promote the sustainable development of Chinese concept stocks, all parties need to participate and solve the problem together. Although there are many contradictions between China and the United States on cross-border regulatory issues due to political system, cultural background and other reasons, through joint inspections under the framework of bilateral or multilateral cooperation, it will not only play an important role in alleviating the crisis of Chinese stocks, but also achieve remarkable results in jointly combating financial violations and safeguarding the legitimate rights and interests of investors. China-US capital markets are two-way, and promoting the improvement of the cross-border regulatory system provides a solid foundation for cooperation between the two sides. China-US cross-border audit regulatory cooperation, including joint inspections and exchange of audit drafts, will undoubtedly achieve win-win results.

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