
Can the “Visible Hand” Guide the Auditor Choice in China?

Issue: Who will audit Chinese companies listed in Hong Kong?

HKEx's "Chinese dimension"

- *HKEx Monthly Market Highlights - May 2014*
 - 166 H-shares (incorporated in Mainland)
 - 123 red chips (incorporated overseas)
 - 505 private enterprises
 - 56% of marketcap, 67% of trading value
- Many are huge companies
 - 5 of Top 10 Forbes Global 2000 are Chinese companies listed in HK
- Both HK and SH markets grow to be among the world's largest

10 Largest Domestic Market Capitalization: 2013

Largest domestic equity market capitalizations at year-end 2013

Exchange	USD billion end-2013	USD billion end-2012
1. NYSE Euronext (US)	17 950	14 086
2. NASDAQ OMX (US)	6 085	4 582
3. Japan Exchange Group	4 543	3 681
4. London Stock Exchange Group	4 429	3 397
5. NYSE Euronext (Europe)	3 584	2 832
6. Hong Kong Exchanges	3 101	2 832
7. Shanghai SE	2 497	2 547
8. TMX Group	2 114	2 059
9. Deutsche Börse	1 936	1 486
10. SIX Swiss Exchange	1 541	1 233

■ HK + Shanghai = 5,600 bn → 2nd after US

Who audit Chinese firms listed in HK?

- Listing rules: all firms listed in HKEx should be audited by a HK audit firm
 - Big 4 dominate large companies
- “Dual audit”: some firms are required to have two auditors (Mainland and HK), e.g., firms with both H- and A-shares (72 now)
 - Started when Mainland and HK accounting standards were different
- But changing

Reason of Change: Both HK and Mainland Converged to IFRS

- 2005: HK converged with IFRS (word for word)
- 2007: China converged with IFRS (equivalent)
- December 2007: HK and Mainland recognized either other's accounting and auditing standards as equivalent
- Q: Why can't Mainland CPAs audit Chinese firms listed in HK?

Chinese Government's Game Plan

- 2009: Ministry of Finance's "Document 56"
 - "Guidelines for the Development of Auditing Industry"
 - Goal: cultivate 10 firms to be large multinationals in 5 years
- Dec. 10, 2010: authorized 12 firms to audit H-share companies ("H-license")
 - Big 4 in Mainland
 - Next 8 largest ("Big 8")
 - Some domestic, some affiliated with second-tier international firms
 - Dual audit no longer required

Another card government can play

- Mandatory audit firm rotation of SOEs
- Required by State-owned Asset Supervision and Administration Commission (SASAC) in 2005
- Bidding system
 - SASAC identifies a group of qualified firms and oversees the bidding
 - Local SASAC branches do the same
- H-share companies' Mainland auditors are also subject to rotation

China's Domestic Audit Market

- Big-4: small share of clients, but large share of fees
 - Share of clients remains stable, but share of fees declines quickly
 - 2014: KPMG and E&Y no longer top 4 firms in China
- Local Big-8 gaining ground in both clients and fees

	Total clients	Big 4		Big 8	
		Share of clients	Share of fees	Share of clients	Share of fees
2010	1795	6.7%	58.5%	39.8%	20.5%
2011	2056	7.0%	53.6%	45.4%	25.0%
2012	2435	6.2%	48.1%	58.2%	34.2%
2013	2484	6.1%	43.9%	59.5%	37.1%

What has happened to H-share companies? (N=152)

- HK auditors lost 37 clients (24%)
 - Most are dual-audits
 - Most clients are small (bottom 40% of marketcap)
- Mainland Big 4 and Big 8 each gained 17 sole-audits

	N of sole audits			N of dual audits		
	2010	2013	Change	2010	2013	Change
HK Big 4	14	11	-3	91	67	-24
HK Big 8	13	11	-2	12	12	0
HK small	11	8	-3	11	6	-5
Mainland Big 4	2	19	17	64	58	-6
Mainland Big 8	1	18	17	23	15	-8
Mainland small	-	-	-	21	12	-9
Total	41	67	26	222	170	-52

Reduction of audit fees after cancellation or switch (in RMB)

- Tsingtao Brewery: cancelled PwC HK
 - 2009: 7.28M to PwC HK and PwC Zhong Tian
 - 2010: 5.8M to PwC Zhong Tian
 - 20% reduction: reduced work or brand value?
 - Compare: Molson Coors Brewing's 2010 audit fee = US\$2.3M (~RMB15M)
- Zhejiang Shibao: switched from HK Big 4 to Mainland Big 4 to Big 8
 - 2011: 1.2M to E&Y HK
 - 2012: 1.0M to E&Y Hua Ming (~20% reduction)
 - 2013: 0.6M to Pan China (40% reduction)

Conclusion of changes: 2010 to 2013

- HK audit firms
 - Lost 24% of H-share clients, most are small, dual-audits
 - Saving of audit fees (~20%): brand value?
- Larger clients consider HK Big 4 useful, at least as dual auditor → audit firm reputation seems to matter in HK
- Mainland Big 4 and Big 8
 - Net gain of 11 and 9 clients respectively
 - Many became sole auditor
- Government's goal of guiding clients to domestic firms (especially Big 8): success very limited → market force seems to be prevailing for now