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## Activity Summary and Audit Implications for Reverse Mergers<sup>1</sup> Involving Companies from the China Region:<sup>2</sup> January 1, 2007 through March 31, 2010

### Key Findings

- The PCAOB's inspection staff observed potential audit concerns in certain audits performed by U.S. registered accounting firms of companies with substantially all of their operations in another country.
- The PCAOB's Office of Research and Analysis ("ORA") staff identified 159 companies from the China region that have accessed the U.S. capital markets by means of a reverse merger transaction (a "Chinese Reverse Merger" or "CRM") from January 1, 2007 to March 31, 2010.

- As of March 31, 2010, the market capitalization of the 159 CRM companies identified by ORA staff was \$12.8 billion, less than half the \$27.2 billion market capitalization of the 56 Chinese companies

that completed U.S. initial public offerings ("IPOs") during the period covered by this research note.

- As of March 31, 2010, 59% of CRM companies reported revenues less than \$50 million in their most recent fiscal year, and 58% had assets below \$50 million at the end of that fiscal year.
- As of March 31, 2010, U.S. registered accounting firms audited 74% of CRM companies, while Chinese registered accounting firms<sup>3</sup> audited 24%. Triennial accounting firms<sup>4</sup> audited 94% of CRM companies as of March 31, 2010.

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<sup>1</sup> In this note, the term reverse merger is broadly used to describe any acquisition of a private operating company by a public shell company that typically results in the owners and management of the private operating company having actual or effective voting and operating control of the combined company. Through a reverse merger transaction, although the public shell company is the surviving entity, the private operating company's shareholders control the surviving entity or hold shares that are publicly traded. In a reverse merger transaction, the entity whose equity interests are acquired (the legal acquiree) is the acquirer for accounting purposes. Through such a transaction, the private company, in effect, becomes a SEC reporting company with registered securities without filing a registration statement under the Securities Act of 1933 or the Exchange Act of 1934.

<sup>2</sup> The term "China Region" refers to the People's Republic of China ("PRC"), Hong Kong Special Administrative Region ("SAR"), and Taiwan.

<sup>3</sup> The number of "Chinese registered accounting firms" includes audit firms in the PRC and Hong Kong SAR. While Taiwanese registered accounting firms may have audited CRM companies, none were identified for the period covered in this research note.

<sup>4</sup> The term "triennial accounting firms" refers to registered accounting firms that are required under PCAOB Rule 4003 to be inspected at least once in every three calendar years, and includes both U.S. and non-U.S. firms.

## **Introduction**

In recent years, there has been an increase in the number of reverse mergers between private operating companies based in the China region and public shell companies, the securities of which are registered in the United States (referred to here as a “Chinese Reverse Merger” or “CRM”). While reverse merger transactions, including CRMs, are not inherently problematic, CRMs often result in a company with substantially all of its operations in the China region having its securities trade in the U.S., often with its financial statements audited by a U.S. auditor. Based on observations from the inspection process, the Public Company Accounting Oversight Board (“the PCAOB” or the “Board”) staff has indicated that it is concerned that some U.S. registered accounting firms may not be conducting audits of companies with operations outside of the U.S. in accordance with PCAOB standards. On July 12, 2010, the PCAOB staff published Staff Audit Practice Alert No. 6, *Auditor Considerations Regarding Using the Work of Other Auditors and Engaging Assistants from Outside the Firm* (the “Alert” or “Audit Practice Alert No. 6”).<sup>5</sup> That Alert discussed audits of financial statements for issuers with substantially all of their operations outside of the U.S., including the China region, where factors such as the following may have a negative impact on the audits of such companies:

- the need to understand the local language,
- use of local audit firms or assistants from an outside firm to complete a portion of the audit work,
- additional travel time and expense necessary to complete an audit, and
- the need to understand the local business environment in which the client operates.

To provide further context for the concerns described in Audit Practice Alert No. 6, this research note summarizes data and information on CRM activity during the period between January 1, 2007 and March 31, 2010. As noted below, over the period covered by this research note, the volume of reverse merger transactions identified as involving companies in the China region was significantly greater than the number of IPOs<sup>6</sup> completed in the U.S. by companies from the Peoples Republic of China (“PRC”). The methodology used in identifying reverse mergers, including CRMs, is discussed below. The methodology was intended to provide some indications of the extent, nature and significance of CRM activity during the designated period of time. The results do not present a complete population of Chinese operating companies that are currently active on U.S. markets, whether through an IPO or reverse merger. Further, there may be significant activity in the period subsequent to the study. See “Limitations of this Methodology” below.

## **Methodology**

ORA staff identified reverse merger transactions based on Form 8-K filings that included Item 5.06, *Change of Shell Company Status*. Public shell companies that cease to be shell companies following reverse merger transactions are required to report this change in their status under Item 5.06 of Form 8-K. They are also required to provide detailed information surrounding the transaction and the private operating company under other items of Form 8-K. For the period from January 1, 2007 to March 31, 2010, ORA staff identified 603 Form 8-Ks with Item 5.06 involving reverse merger transactions.

For each of the 603 reverse merger transactions, ORA staff determined the location of the primary operations of the company post the transaction. A reverse merger was classified as a CRM if

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<sup>5</sup> Audit Practice Alert No. 6 is located on the Board’s web site at <http://pcaobus.org/Standards/Pages/Guidance.aspx>.

<sup>6</sup> A high-level summary of certain U.S. IPOs by Chinese operating companies, which were made during the same period as the CRMs identified in this research note, is provided as a frame of reference for the number of CRMs.

the private operating company that merged into the public shell company was incorporated<sup>7</sup> in the China region, headquartered in the China region, or its revenue or production cycle is substantially based in the China region.

### **Limitations of This Methodology**

As previously indicated, ORA staff is not able to provide assurance that the reverse merger activity identified in this research note represents the complete universe of transactions that occurred during the period or that the associated financial data is entirely accurate. Also, there can be transactions that are structured differently, but with the result being similar to a CRM – a U.S. company with substantially all of its operations in the PRC. For example, there may be unidentified reverse merger transactions that occurred during the period of this research note because no Form 8-K Item 5.06 was required to be filed, such as those transactions involving special purpose acquisition companies, or those that did not involve a shell company. In addition, the research excluded reverse merger transactions involving foreign private issuer shell companies filing Form 20-Fs.<sup>8</sup>

## **SECTION 1 – Chinese Reverse Merger Activity**

### ***1.1 – Volume of CRM Transactions and PRC IPOs in the U.S.***

ORA staff identified 159 CRM transactions from January 1, 2007 to March 31, 2010. The 159 CRM transactions represent 26% of the total reverse mergers identified during this period. However, the annual number of CRM transactions has fluctuated over the past three years.

**Table 1: China Region and Total Reverse Merger Transactions January 1, 2007 to March 31, 2010**

<b>Year</b>	<b>Chinese Reverse Mergers</b>	<b>Non-Chinese Reverse Mergers (Primarily U.S.)</b>	<b>Total Reverse Mergers</b>	<b>Chinese Reverse Mergers % of Total</b>	<b>Non-Chinese Reverse Mergers (Primarily US) % of Total</b>
January 1 - March 31, 2010	12	34	46	26%	74%
2009	42	99	141	30%	70%
2008	55	127	182	30%	70%
2007	50	184	234	21%	79%
<b>Total</b>	<b>159</b>	<b>444</b>	<b>603</b>	<b>26%</b>	<b>74%</b>

Source: Form 8-K Item 5.06 filings between January 1, 2007 and March 31, 2010.

Private operating companies from the China region chose to access U.S. capital markets more frequently by means of CRM transactions than through an IPO during the observation period. The ORA staff identified 56 IPOs completed in the U.S. by companies in the PRC.<sup>9</sup>

During 2009, 14 IPOs were completed in the U.S. by PRC companies. This represented 20% of total U.S. IPOs in 2009. In contrast, 42 CRM transactions were identified during 2009, which represented 30% of total U.S. reverse merger transactions in that year. A comparison of Tables 1 and

<sup>7</sup> As of the date of this research note, there were eleven SEC registered companies incorporated in China. The majority of the companies in the research note – both CRM and IPO – are incorporated in the Cayman or British Virgin Islands, but are headquartered and/or have major operations in the China region.

<sup>8</sup> Foreign private issuer shell companies that are parties to reverse merger transactions are required to report information about the transaction on Form 20-F.

<sup>9</sup> ORA staff did not include IPOs completed by companies incorporated in Hong Kong Special Administrative Region (“SAR”) or Taiwan.

2 indicates that the volume of CRM transactions was greater than that of PRC-company IPOs in the U.S. during the period from January 1, 2007 to March 31, 2010.

**Table 2: PRC and Total IPO Transactions Completed in the U.S., January 1, 2007 to March 31, 2010**

Year	Chinese IPOs	Total IPOs	Chinese IPOs %
			of Total
January 1 - March 31, 2010	5	33	15%
2009	14	70	20%
2008	6	60	10%
2007	31	270	11%
<b>Total</b>	<b>56</b>	<b>433</b>	<b>13%</b>

Source: Standard & Poor's Compustat® data

### 1.2 – CRM and PRC IPOs by Market Capitalization

ORA staff identified 135 CRM companies with market capitalizations ranging from \$1 to \$631,000,000, as of March 31, 2010. Twenty-four CRM companies have no measurable market capitalization and have little or no trading activity in their common stock, or they no longer file financial statements with the SEC. As Table 3 shows, total market capitalization for the 135 companies was \$12.8 billion as of March 31, 2010. Two-thirds of the companies had market capitalization below \$75 million, or no market capitalization. CRM companies with market capitalization above \$75 million accounted for the remaining one-third and represented 83% (\$10.7 billion) of the total market capitalization of the 159 CRM companies. Forty of the 53 issuers with more than \$75 million market capitalization, representing an aggregate market capitalization of \$7.6 billion, were audited by 21 firms that have been inspected by the PCAOB, prior to March 31, 2010.

**Table 3: CRM Companies by Market Capitalization as of March 31, 2010**

Market Capitalization	# of Companies	% of Companies	Total Market Capitalization (in \$ millions)	% of Market Capitalization	Average Market Capitalization per Company (in \$ millions)
N/A *	24	15%	\$0	0%	\$0
\$1 - \$10,000,000	28	18%	\$65	1%	\$2
\$10,000,001 - \$75,000,000	54	34%	\$2,058	16%	\$38
\$75,000,001 - \$700,000,000	53	33%	\$10,720	83%	\$202
\$700,000,001 +	0	0%	\$0	0%	\$0
<b>Total</b>	<b>159</b>	<b>100%</b>	<b>\$12,843</b>	<b>100%</b>	

Source: Capital IQ.

\* N/A represents companies which have little or no trading activity in their common shares or no longer file financial statements with the SEC.

One hundred one CRM companies have securities that are quoted on the OTC Bulletin Board (OTCBB). Thirty-four have securities that are listed on NASDAQ and 15 on NYSE Euronext. Nine of these companies do not have securities listed on a U.S. national exchange or quoted on the OTCBB as of March 31, 2010.

The number of IPOs completed in the U.S. by PRC companies was approximately one-third of the number of CRM transactions over the period covered by this research note; however, the total market capitalization for PRC companies that completed IPOs was more than twice that of CRM companies as of March 31, 2010.

**Table 4: PRC IPO Companies by Market Capitalization as of March 31, 2010**

<b>Market Capitalization</b>	<b># of Companies</b>	<b>% of Companies</b>	<b>Total Market Capitalization (in \$ millions)</b>	<b>% of Market Capitalization</b>	<b>Average Market Capitalization per Company (in \$ millions)</b>
\$1 - \$10,000,000	0	0%	\$0	0%	\$0
\$10,000,001 - \$75,000,000	7	13%	\$310	1%	\$44
\$75,000,001 - \$700,000,000	35	62%	\$8,842	33%	\$253
\$700,000,001 +	14	25%	\$18,069	66%	\$1,291
<b>Total</b>	<b>56</b>	<b>100%</b>	<b>\$27,221</b>	<b>100%</b>	

Source: Standard & Poor's Compustat® data and Capital IQ

### 1.3 – CRM Companies by Revenue

As Table 5 shows, 59% of CRM companies had revenues of \$50 million or less based on their most recent financial statements filed with the SEC subsequent to the merger transaction. (ORA staff referenced annual data when available and when an annual report was not available, quarterly data was annualized.) Revenues are concentrated at the upper end of the range: the 41% of companies with revenues over \$50 million accounted for 85% of total revenues.

**Table 5: CRM Companies by Revenue**

<b>Company Size by Revenues</b>	<b># of Companies</b>	<b>% of Companies</b>	<b>Total Revenues (in \$ millions)</b>	<b>% of Revenues</b>
Less than \$50,000,000	95	59%	\$1,517	15%
\$50,000,001 - \$100,000,000	39	25%	\$2,802	28%
\$100,000,001 +	25	16%	\$5,720	57%
<b>Total</b>	<b>159</b>	<b>100%</b>	<b>\$10,039</b>	<b>100%</b>

Source: Capital IQ

### 1.4 – CRM Companies by Assets

As Table 6 shows, 58% of CRM companies had less than \$50 million in assets (based on their most recent financial statements filed with the SEC), but accounted for only 17% of total assets. As with revenues, assets are concentrated at the upper end of the range: the 42% of CRM companies with assets over \$50 million accounted for 83% of total assets.

**Table 6: CRM Companies by Assets**

<b>Company Size (Assets)</b>	<b># of Companies</b>	<b>% of Companies</b>	<b>Total Assets (in \$ millions)</b>	<b>% of Assets</b>
Less than \$50,000,000	93	58%	\$1,743	17%
\$50,000,001 - \$100,000,000	38	24%	\$2,757	27%
\$100,000,001 +	28	18%	\$5,773	56%
<b>Total</b>	<b>159</b>	<b>100%</b>	<b>\$10,273</b>	<b>100%</b>

Source: Capital IQ

## **SECTION 2 – Auditors of CRM Companies**

### **2.1 –Audit Requirements**

Companies, including CRM companies, are required to file audited financial statements with the SEC, and the auditors of those financial statements are required to be registered with the PCAOB. ORA staff found that, after a reverse merger transaction, the auditor of the former shell company frequently is dismissed; the post-merger public company usually retains the Chinese operating company's auditor, which as noted below is often a U.S. accounting firm. This change in auditor must be reported in Item 4.01 of Form 8-K. If the new auditor was not registered with the PCAOB prior to the CRM transactions, it is required to do so before issuing an opinion on the financial statements of the CRM company.

### **2.2 – Auditors of CRM Companies**

ORA staff identified the current auditors for 157 of the 159 CRM companies. (Two companies no longer file financial statements with the SEC.) As of March 31, 2010, triennial accounting firms, as a group, audited the largest number of CRM companies, both by number and by market capitalization. Triennial accounting firms audited 147 companies, or 94% of the total. This represents 97% of the total market capitalization of CRM companies, or \$12.4 billion, as of March 31, 2010. The remaining CRM companies are audited by an accounting firm inspected by the PCAOB annually.<sup>10</sup> U.S. firms audited 116, or 74% of the CRM companies, and Chinese registered accounting firms audited 38, or 24%. Canadian registered accounting firms audited three CRM companies. As Table 8 shows, 24 firms audited 70% of the identified CRM companies.

**Table 7: CRM Auditors by Market Capitalization as of March 31, 2010**

<b>Firm Tier</b>	<b># of Companies</b>	<b>% of Companies</b>	<b>Total Market Capitalization (in \$ millions)</b>	<b>% of Market Capitalization</b>
Annual Inspection	10	6%	\$390	3%
Triennial Inspection	147	94%	\$12,453	97%
<b>Total</b>	<b>157</b>	<b>100%</b>	<b>\$12,843</b>	<b>100%</b>

Source: Capital IQ

<sup>10</sup> The Sarbanes-Oxley Act of 2002 requires the PCAOB to inspect annually those registered accounting firms that regularly provide audit reports for more than 100 issuers.

**Table 8: Auditors of Three or More CRM Companies**

	<b>Audit Firm *</b>	<b>CRM Issuer Engagements as of March 31, 2010</b>	<b>U.S./ Non-U.S. Audit Firm</b>	<b>Date of Last Published Inspection Report **</b>
1	MaloneBailey, LLP (f/k/a Malone & Bailey, PC)	10	U.S.	April 2009
2	Bernstein & Pinchuk LLP	9	U.S.	January 2009
3	PKF (Hong Kong SAR)	7	Non-U.S.	March 2010
4	Paritz and Company P.A.	6	U.S.	July 2009
5	AGCA Inc.	5	U.S.	December 2010
6	Albert Wong & Co. (Hong Kong SAR)	5	Non-U.S.	March 2010
7	Frazer Frost, LLP (f/k/a Moore Stephens Wurth Frazer and Torbet, LLP)	5	U.S.	May 2008
8	Goldman Kurland and Mohidin, LLP (f/k/a Goldman Parks Kurland Mohidin LLP)	5	U.S.	N/A
9	Samuel H. Wong & Co., LLP	5	U.S.	N/A
10	HKCMCPA Company Limited (f/k/a ZYCPA Company Limited)	5	Non-U.S.	February 2010
11	Child, Van Wagoner & Bradshaw, PLLC	4	U.S.	July 2010
12	Friedman LLP	4	U.S.	March 2010
13	Kabani & Company, Inc.	4	U.S.	July 2010
14	Patrizio and Zhao, LLC	4	U.S.	November 2009
15	Sherb & Co., LLP	4	U.S.	June 2007
16	Weinberg & Company, P.A.	4	U.S.	December 2007
17	Acquavella, Chiarelli, Shuster, Berkower & Co., LLP	3	U.S.	N/A
18	BDO Limited (Hong Kong SAR)	3	Non-U.S.	N/A
19	Dominic K.F. Chan & Co	3	U.S.	N/A
20	Etania Audit Group P.C. (f/k/a Davis Accounting Group PC)	3	U.S.	April 2008
21	Kempisty & Company Certified Public Accountants PC	3	U.S.	November 2008
22	Madsen & Associates CPA's, Inc.	3	U.S.	December 2009
23	MS Group CPA LLC	3	U.S.	N/A
24	UHY Vocation HK CPA Limited	3	Non-U.S.	N/A
	<b>Total</b>	<b>110</b>		
	<b>Total CRM companies</b>	<b>157</b>		
	<b>Percentage of total CRM companies</b>	<b>70%</b>		

Source: ORA research

Notes:

\*In certain instances, the audit firm name does not match exactly the name on the PCAOB Registration System or the Inspection Report name. Inspection reports published by the Board are available on the PCAOB's website at [www.pcaobus.org](http://www.pcaobus.org).

\*\* Subsequent inspections have also been conducted for several of the firms listed here, and the subsequent reports are in process. For some firms (marked "N/A"), no report is currently available on the PCAOB's website. In all but one of those cases, an inspection or a report is in process. The exception results from the position taken by authorities in the PRC, which currently prevents the PCAOB from inspecting the U.S.-related audit work of PCAOB-registered firms in the PRC. This is also an obstacle for completing an inspection of one other firm listed above that is in process.

### 2.3 – Concerns Cited in Staff Audit Practice Alert No. 6

As noted in the Alert, the Board's inspection staff observed audit quality concerns in certain audits in which U.S. registered accounting firms performed audits of companies with substantially all of their operations in another country. In some situations it appeared that U.S. firms provided audit services by having most or all of the audit performed by another firm or by assistants engaged from outside the firm without complying with PCAOB standards applicable to using the work and reports of another auditor or supervising assistants.

AU sec. 543, *Part of Audit Performed by Other Independent Auditor*, is applicable when an auditor utilizes "the work and reports of other independent auditors who have audited the financial statements of one or more subsidiaries, divisions, branches, components, or investments included in the financial statements."<sup>11</sup> The Board's inspection staff has identified indications that U.S. firms are

<sup>11</sup> AU 543.01.

not properly applying AU sec. 543 in the audits of companies with substantially all of their operations in another country. For example, in one instance described in the Alert, a U.S. registered accounting firm retained an accounting firm in the China Region, and the audit procedures performed by the other firm constituted substantially all of the audit procedures on the issuer's financial statements. The U.S. firm's personnel did not travel to the China region during the audit, and substantially all of the audit documentation was maintained by the firm in the China Region. As noted in the Alert, AU sec. 543 does not contemplate an auditor taking responsibility for the work of another auditor that has audited an issuer's financial statements substantially in their entirety.

The Board's inspection staff has also observed situations in which U.S. registered firms have engaged assistants from outside the firm for audit work on companies with substantially all of their operations in another country. In one example described in the Alert, in order to perform audit procedures for an issuer operating in the China region, a U.S. firm engaged a consulting firm whose personnel could speak and read the language of the area in which the issuer's operations were located. The Board's inspection staff concluded that the U.S. registered firm's involvement in the audit work performed by the consultants was insufficient for the firm to assert that the audit provided a reasonable basis for the firm's opinion on the financial statements. The Alert describes some key considerations in determining the appropriate level of the firm's involvement in audit work performed by assistants from outside the firm, for example: whether the auditor has adequate information about the knowledge, skill and ability of assistants engaged; whether the auditor is able to plan and supervise the work of the assistants engaged; whether the auditing procedures performed by assistants from outside the firm in combination with the auditor's own work provides sufficient competent evidential matter for an audit opinion; whether the assistants engaged have appropriate language skills; whether the auditor would have the ability to comply with the Board's documentation requirements. In addition to these considerations, the Alert reminds auditors about other obligations under the standards of the PCAOB when engaging assistants from outside the firm.<sup>12</sup>

## **Conclusion**

This research note presents certain CRM transaction data and information relevant to the work of the PCAOB. ORA staff encourages additional research in this and other audit areas by academia, journalists, and other interested parties. To the extent feasible, ORA anticipates making available to the public more of the data and information that it gathers on those topics that may be of interest to policy makers and the general public.

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<sup>12</sup> Subsequent to publishing the Alert, the PCAOB adopted a suite of eight auditing standards related to the auditor's assessment of, and response to, risk in an audit that superseded or amended some of the standards to which the Alert refers. (PCAOB Release No. 2010-004, August 5, 2010.)