At A Glance

Reverse Mergers

Forensic Accounting and Financial Investigations

Background

Private companies that wish to gain access to public capital markets in the United States generally do so with an initial public offering (IPO) of stock. However, the IPO process is costly and complex. Another option available to companies that want to go public is to engage in a "reverse merger." Ordinarily, in a merger between a public company and a private company, the public company gains control of the private company and the private company becomes part of the public company. In a reverse merger, a private company gains control of a publicly-held "shell company."[1] With control of the shell company, the private company merges itself into the public company. Hence, the once-private company becomes public by being a part of the already public shell company—avoiding the intense scrutiny that typically would have occurred if the private company went public through an IPO.[2]

While reverse mergers have been used for a long time, it has become increasingly common for foreign private companies to use a reverse merger to become a US domestic issuer (with foreign operations). Between 1 January 2007 and 31 March 2010, at least 159 companies from the China region (the People's Republic of China, Hong Kong Special Administrative Region, and Taiwan) have become listed on US stock exchanges by engaging in reverse mergers.[3] While the reverse merger technique has allowed many of these companies to have a smooth entrance to the US capital markets, others have experienced litigation. Many have been named as defendants in lawsuits that generally allege misrepresentation of financial information and accounting irregularities.[4] The causes most often cited are deficient legacy financial reporting and questions about audit quality.

Regulatory Scrutiny

The Public Company Accounting Oversight Board (PCAOB), which performs inspections of US-registered accounting firms, has become concerned about the quality of audits performed for certain foreign-based domestic issuers. Frequently, the actual on-site audits are performed by an auditor other than the one who signs the audit opinion in the US. On 12 July 2010, the PCAOB staff published an Audit Practice Alert to clarify the requirements when the principal auditor is relying on work performed by other auditors and assistants from outside their own firm.

The recent increase in reverse merger activity and subsequent litigation has also caught the attention of the SEC. Domestic issuers are subject to the registration and reporting requirements under US federal securities laws, regardless of where the primary place of business is located. Hence, they are subject to scrutiny by the

SEC's Division of Enforcement. Since 2006, when the SEC filed its first accounting fraud case against a foreign-based issuer, it has brought other cases involving market manipulation, accounting and disclosure violations, actions against auditors and accountants, trading suspensions, and administrative proceedings to revoke companies' registration statements.[5] Currently, the SEC has a number of investigations underway, targeting firms from the China region that undertook reverse mergers.

NERA's Expertise in Forensic Accounting and Financial Investigations

When a foreign private company goes public by a reverse merger, there are myriad accounting, auditing, financial, and economic issues. With the increasing number of reverse mergers that have occurred in recent years, now more than ever, counsel involved in legal proceedings will need expertise that spans many functional business disciplines. Many NERA experts possess cross-functional skills that can provide valuable input and advice with regard to the issues in each case.

Because much of the litigation relates to the integrity of legacy accounting data and auditing procedures prior to becoming public entities, there is likely to be a heightened need for experts that have a deep understanding of accounting and auditing standards and that have excellent investigative skills. NERA's forensic accounting experts combine deep experience in financial reporting systems, methodologies, and disclosure requirements with statistical and econometric expertise to identify patterns, trends, and concerns in the interpretation of reported data. Our experts have deep experience with regard to regulatory compliance for publicly-traded companies.

About NERA

NERA Economic Consulting (**www.nera.com**) is a global firm of experts dedicated to applying economic, finance, and quantitative principles to complex business and legal challenges. For half a century, NERA's economists have been creating strategies, studies, reports, expert testimony, and policy recommendations for government authorities and the world's leading law firms and corporations. We bring academic rigor, objectivity, and real world industry experience to bear on issues arising from competition, regulation, public policy, strategy, finance, and litigation.

NERA's clients value our ability to apply and communicate state-of-the-art approaches clearly and convincingly, our commitment to deliver unbiased findings, and our reputation for quality and independence. Our clients rely on the integrity and skills of our unparalleled team of economists and other experts backed by the resources and reliability of one of the world's largest economic consultancies. With its main office in New York City, NERA serves clients from more than 20 offices across North America, Europe, and Asia Pacific.

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1 The SEC defines a shell company as "a registrant with no or nominal operations and either no or nominal assets, assets consisting solely of cash and cash equivalents, or assets consisting of any amount of cash and cash equivalents and nominal other assets." (SEC Release No. 33-8587).

2 It is not uncommon that the industry of the private company bears no relation to the industry in which the shell company operated.

3 Public Company Accounting Oversight Board, Activity Summary and Audit Implications for Reverse Mergers Involving Companies from the China Region: 1 January 2007 through 31 March 2010, Research Note #2011-P1 (14 March 2011) http://pcaobus.org/Research/Documents/Chinese_Reverse_Merger_Research_Note.pdf.

4 China Region reverse merger companies account for 23% of all securities lawsuits filed in 2011. (Source: http://www.dandodiary.com/2011/04/articles/securities-litigation/securities-suits-against-chinese-companies-continue-to-mount/.)

5 Letter from Mary Schapiro to Patrick McHenry, 27 April 2011, available here: http://s.wsj.net/public/resources/documents/BARRONS-SEC-050411.pdf.