



Hong Kong

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## FINANCIAL REPORTING COUNCIL CAN ACCESS PRC AUDIT WORKING PAPERS

On 22 May 2019, Hong Kong's Financial Reporting Council<sup>1</sup> (**FRC**) signed a Memorandum of Understanding<sup>2</sup> with the Supervision and Evaluation Bureau (**SEB**) of China's Ministry of Finance<sup>3</sup> (**MOF**), giving the FRC access to the audit working papers of Chinese companies held by accounting firms in China, including the China offices of the Big Four accounting firms. Previously, China has prevented audit working papers from being handed over to foreign regulators on the grounds that they constitute "state secrets".

The move is welcome. In 2014, the Hong Kong courts ordered Ernst and Young to hand over to the Securities and Futures Commission (the **SFC**) its audit working papers relating to the failed Hong Kong listing application of Mainland China company, Standard Water Company Limited (**Standard Water**).

However, the Memorandum of Understanding fails to address the problem facing IPO sponsors, that notwithstanding their due diligence obligations, which are construed broadly by the SFC, they cannot obtain a listing applicant's audit working papers from the auditor, whether the applicant is Chinese or not. Despite a Listing Rule obligation on listing applicants to enable sponsors' access to reporting accountants' draft and final reports under Listing Rule 3A.05(4), in practice, auditors will not hand over their audit working papers to sponsors. Nor are reporting accountants under any obligation to inform

sponsors of suspicions they may have as to the accuracy of an applicant's financial statements. Sponsors are perhaps understandably aggrieved that there is no positive obligation on audit firms to disclose their working papers or concerns to the sponsor, particularly given the substantial fines the SFC has handed out to sponsors considered to have breached their due diligence obligations. For further details of the fines imposed by the SFC in recent disciplinary actions against sponsors, please see our April 2019 newsletter "SFC Imposes Record Fines for Sponsor Failures"<sup>4</sup>.

### The Standard Water Case

Ernst and Young had been engaged as the reporting accountant and auditor on Standard Water's application to list on HKEx, although the audit fieldwork was conducted by its Mainland joint venture partner, Ernst & Young Hua Ming (**EYHM**). The SFC brought proceedings against Ernst and Young to compel it to provide it with the audit working papers for Standard Water under s.183 of the Securities and Futures Ordinance. Because the statutory provision does not have extraterritorial effect, proceedings were not brought against EYHM to compel production of the documents. Both PRC legal experts had opined that the regulation on which the defence was based did not impose a blanket prohibition on the cross-border transmission of audit working papers, and that transmission is allowed if prior governmental approval is obtained. The issue of whether audit papers are state or commercial secrets was

1 <https://www.frc.org.hk/en-us>

2 [https://www.frc.org.hk/en-us/press\\_release/2019/Press%20release\\_FINAL\\_Eng.pdf](https://www.frc.org.hk/en-us/press_release/2019/Press%20release_FINAL_Eng.pdf)

3 [http://english.gov.cn/state\\_council/2014/09/09/content\\_281474986284115.htm](http://english.gov.cn/state_council/2014/09/09/content_281474986284115.htm)

4 <https://www.charltonslaw.com/sfc-imposes-record-fines-for-sponsor-failures/>

considered to be fact-sensitive and this was not opined on in the case because the working papers were not produced to the court.

In 2015, the MOF issued new rules, the Interim Provisions on Accounting Firms' Provision of Auditing Services for the Overseas Listing of Enterprises in Chinese Mainland (the **Interim Provisions**), which require Mainland companies and overseas audit firms (including Hong Kong firms) to strictly comply with the Regulation on Strengthening Confidentiality and Archives Administration Relating to Overseas Issuance and Listing of Securities (Circular [2009] No. 29 of 20 October 2009) (**Regulation 29**). Regulation 29 stipulates that accounting records of Chinese companies may be subject to claims of state secrecy under Chinese law and that the prior consent of the relevant Mainland authorities is required before they can be taken out of the Mainland.

Similar problems arose when the US Securities and Exchange Commission (the **SEC**) brought proceedings against Chinese companies listed on the New York stock exchanges in relation to fraudulent or misleading financial statements provided in their public offer documents. The Mainland China units of the Big Four accounting firms refused to comply with the SEC's orders that they hand over audit working papers for the listings in question. Their refusal led to the SEC imposing a 6-month ban in 2014 on the Big Four auditors auditing Chinese companies applying to list on US stock exchanges.

## The SFC and SEB Memorandum of Understanding on Audit Regulation

Although China's state secrets laws are still in force, the Memorandum of Understanding signed by Hong Kong's FRC and China's SEB aims to facilitate greater cross-border cooperation and collaboration in relation to audit regulation.

Amendments to Hong Kong's Financial Reporting Council Ordinance (Cap. 588), which take effect in October 2019, will make the FRC Hong Kong's independent regulator of listed entity auditors with direct powers to inspect, investigate and discipline listed entity auditors. The FRC will be able to fine accountants up to HK\$10 million or three times their auditing fee under the revised law. It will also have oversight of the standards of the Hong Kong Institute of Certified Public Accountants (**HKICPA**) on professional ethics and auditing and assurance, and its continuing professional development requirements for auditors. The reason for conferring greater powers on the FRC was that Hong Kong had been criticised for operating a self-regulatory regime where Hong Kong's

audit profession was supervised by the HKICPA which was not sufficiently independent of the firms it supervised. Set up to investigate the auditing failures of listed companies, the FRC was considered to lack regulatory teeth; once it completed an investigation, cases were referred back to the industry body, the HKICPA, to determine the relevant penalty.

The giving of regulatory teeth to the FRC amounts to the biggest overhaul of accountancy regulation in a decade. The Hong Kong government has reportedly allocated HK\$300 million to the FRC which will allow it to triple its headcount involved in the investigation and discipline of listed company auditors.

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