



PRC MINISTRY OF FINANCE RELEASES DRAFT REGULATIONS ON “CROSS-BORDER AUDIT SERVICES”

Introduction

On 21 April 2014, the Accounting Division of the Ministry of Finance (**MOF**) released for consultation its provisional regulations on “cross-border audit services” (the **Provisional Regulations**) accompanied by the drafting illustrations¹ (the **Drafting Illustrations**). The proposed regulations have raised concerns as to their impact on Hong Kong’s accountancy profession. According to press reports, Securities and Futures Commission (**SFC**) executives will meet visiting Beijing officials this week to discuss the proposed regulations, in particular how they will affect collaborations between Mainland and Hong Kong accounting firms in future and the extent of the proposed ban on taking audit working papers out of China – whether it is a ban on all audit working papers or only those containing state secrets.²

The question of whether Chinese law prevents audit working papers being taken out of the Mainland was central to the recent Hong Kong court decision to order Ernst & Young (**EY**) to hand over to the SFC audit working papers sought by the SFC in relation to its investigation into the failed listing of Mainland company, Standard Water Limited. The court found that EY had failed to establish that the audit working papers contained State or commercial secrets which would have prevented EY’s Mainland affiliate from passing the papers to EY in Hong Kong. For further information on that case, please see our newsletter of 9 June 2014.

¹ Click on http://kjs.mof.gov.cn/zhengwuxinxi/gongzuotongzhi/201404/t20140429_1073223.html for the announcement.

² “SFC to question ministry officials on ‘state secret’ rule for auditors”, Enoch Yiu, South China Morning Post, 10 June, 2014

This newsletter summarises the proposed new rules as set out in the Provisional Regulations and the MOF’s rationale for introducing them.

Background to the Provisional Regulations

According to the Drafting Illustrations, the requirements for providing cross-border audit services are not well understood and the number of overseas accountants entering the Mainland to conduct audit work in breach of the requirements are on the rise. Moreover, communications between Mainland and international accountants as to the sharing of rights and obligations need to be improved.



To address these issues, part 1 of the Drafting Illustrations states that the aim of the Provisional Regulations is to:

- i) “fill in the blanks” in the regulation of cross-border audits and thus regulate the operations of overseas accountants;
- ii) prevent international accounting firms from sending their staff under a temporary licence to audit Mainland corporations that are either seeking an overseas listing, or are already listed, overseas;
- iii) raise standards of local audit services for Mainland corporations seeking to list, or already listed, overseas³; and
- iv) promote cooperation between Mainland and overseas accounting firms, and improve the quality and capabilities of Mainland accounting firms.

The news rules contained in the Provisional Regulations⁴

Clause 2 contains definitions of the following:

1. Cross-border audit services refer to the auditing “for overseas listing” conducted by Chinese mainland and overseas accounting firms.
2. Auditing for overseas listing includes:
 - the auditing of financial statements for an initial public offering (**IPO**); and
 - the auditing or review of periodic financial statements after the IPO.

The Provisional Regulations will apply both to corporations incorporated in the Mainland and overseas incorporated corporations which have operating entities in the Mainland, which are listed or seeking to list overseas. Overseas accounting firms will no longer be allowed to send staff to the Mainland to conduct audit work under a temporary audit licence.

Clauses 3 and 4 require Mainland accounting firms which:

- have either been registered with a foreign regulatory body or recognized by a foreign securities exchange body and authorized to conduct audits for overseas listing; and
- are audited and recommended by the MOF and the SFC, and approved by relevant associations in the HKSAR to undertake audit work for H share companies,

to provide relevant audit services in accordance with the law and accounting practice standards. Firms that breach accounting standards may be liable.

Clause 5 stipulates that overseas accounting firms have to team up with one of the top 100 local accounting firms⁵ (as listed in the rankings of the Comprehensive Evaluation of Job Sectors of the preceding year) to audit a Mainland company. Nevertheless, the international partner firm will have to sign off on the books and will be liable for any audit mistakes made.

In relation to **clause 5**, **clause 8** requires an international accounting firm who has worked with a Mainland firm on an audit to submit a written report (in the form set out in the appendix to the Provisional Regulations) to the MOF within 45 days after the release date of the audit report.

Clause 10 highlights that the Mainland corporation seeking to list overseas (or already listed overseas), its appointed accounting firm and the cooperating domestic accounting firm must strictly comply with the announcement⁶ on “enhancing the regulation of securities issued overseas and confidentiality and file management issues relevant to listing” jointly issued by PRC authorities on 20 October 2009. According to that announcement, the accounting records (including audit working papers) of Chinese companies may be subject to claims of state secrecy under PRC law and the consent of the relevant PRC authorities is required before they can be taken out of the Mainland.

The Provisional Regulations also sets out other procedural rules and penalties for non-compliance. The consultation process ended on 30 May 2014.

³ See also clause 1 of the Provisional Regulations.

⁴ Please note that this newsletter is based on the original Provisional Regulations in Chinese. Readers should not regard this as a substitute for the original Chinese version.

⁵ As determined by the China Association of Certified Public Accountants.

⁶ Please click on <http://www.csrc.gov.cn/pub/zjhpublic/G00306201/200911/P020091113586864060507.doc> for the complete content of the announcement.

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