



Hong Kong

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HONG KONG ACCOUNTANTS' EXEMPTION FROM RESTRICTIONS ON FOREIGN ACCOUNTANTS AUDITING CHINESE COMPANIES LISTING OFFSHORE

Hong Kong, Macau and Taiwanese audit firms have been exempted from new rules which prevent foreign auditors from auditing Mainland Chinese companies unless they team up with a Mainland Chinese accounting firm. The exemption applies to audits of Mainland companies which apply to list, or are already listed, on the stock exchange of the relevant jurisdiction (Hong Kong, Macau or Taiwan), of which at least 50% of the shares are held by investors in the relevant jurisdiction. Auditors in the three exempted jurisdictions are however still subject to the rules' ban on taking audit working papers out of Mainland China and sending staff to audit Mainland companies under a temporary licence.

The new rules, the Interim Provisions on Accounting Firms' Provision of Auditing Services for the Overseas Listing of Enterprises in Chinese Mainland (the **Interim Provisions**), were published on 26 May 2015 and came into force on 1 July 2015. The inclusion of the exemption for Hong Kong, Macau and Taiwanese auditors has been welcomed and follows efforts by the Hong Kong Institute of Certified Public Accountants and the Hong Kong Government to obtain this relaxation. For a summary of the original proposals set out in the Ministry of Finance's (**MOF**) April 2014 Provisional Regulations on Cross-Border Audit Services (**Provisional Regulations**), please see our newsletter of 13 June 2014.¹

The aim of the Interim Provisions is to standardise overseas accounting firms' audits of the financial statements for offshore listings of Mainland Chinese companies.

Scope

The Interim Provisions govern "auditing services for overseas listing" which are defined to include:

- i) the audit of financial statements in relation to direct or indirect issues of stocks, bonds, or other securities and overseas listings (including pre-IPO) of Mainland companies; and
- ii) the audit of annual financial statements of offshore-listed Mainland companies. (Interim Provisions Article 2).

Article 3 allows Mainland companies to choose whether to appoint a domestic or an overseas audit firm, depending on the regulatory requirements of the relevant listing jurisdiction.

Hong Kong's Listing Rules require listing applicants to appoint Hong Kong-based accounting firms to act as their Hong Kong IPO reporting accountants. The exception is H-share companies (i.e. companies incorporated in Mainland China which are listed in Hong Kong) which prepare financial statements using China Accounting Standards for Business Enterprises. These companies are allowed to appoint certain

¹ Charltons. "PRC Ministry of Finance Releases Draft Regulations on "Cross-Border Audit Services" at <http://www.charltonslaw.com/prc-ministry-of-finance-releases-draft-regulations-on-cross-border-audit-services/>. 13 June 2014.

Mainland audit firms approved and registered with the MOF and the China Securities Regulatory Commission (**CSRC**) to act as their reporting accountants and auditors.

In the United States, Mainland listing applicants must hire an audit firm registered with the US Public Company Accounting Oversight Board and the Securities and Exchange Commission (**SEC**). Mainland companies seeking a US listing typically appoint an international accounting firm to audit their books. Under the Interim Provisions, the international firm will have to team up with a Mainland accounting firm to perform the audit.

Restrictions on Overseas Audit Firms

Requirement to Partner with Chinese Accounting Firms

An overseas accounting firm appointed to audit a Mainland company is required to enter into a “business cooperation agreement” with a Mainland accounting firm by Article 5 of the Interim Provisions. The Mainland partner firm must be one which: (i) is legally established in Mainland China; (ii) is experienced in auditing financial statements for listing applications or auditing the financial statements of listed companies; (iii) has sound business practices and professional ethics; and (iv) has not been subject to any administrative penalty suspending its practice for 6 months or more in the previous 3 years (Article 6). The requirement for the Mainland partner to be one of China’s top 100 accounting firms (as listed in the rankings of the Comprehensive Evaluation of Job Sectors of the preceding year), which was included in the Provisional Regulations, has been dropped from the Interim Provisions. In practice, however, a Mainland accounting firm which has experience of auditing IPO accounts is likely to be one of the larger firms.

There is no specified format for the business cooperation agreement although it should include the following matters specified in the Interim Provisions: the division of work, the parties’ rights and obligations and provision that audit working papers produced in China must be retained by the Mainland accounting firm in Mainland China.

The HKICPA has published guidance on matters to be included in a business cooperation agreement² between Hong Kong and Mainland audit firms in its update on the Interim Provisions.³

2 HKICPA example content for a business cooperation agreement between Hong Kong and Mainland audit firms available on its website at http://www.hkicpa.org.hk/file/media/section6_standards/standards/Audit-n-assurance/bcagreement.pdf.

3 HKICPA Update on Financial Reporting and Auditing Issue 21 (July 2015) available on its website at http://www.hkicpa.org.hk/file/media/section6_standards/standards/Audit-n-assurance/alert21.pdf.

A key concern for overseas accountants is that the Interim Provisions require the overseas accounting firm to sign off on the audit report and be responsible in law for the audit work performed. As a result, the overseas firm will be liable for any failures of the Mainland partner firm.

A further restriction prohibits overseas accounting firms from sending their staff to China to audit companies under a temporary licence (Interim Provisions Article 2).

Documentary Requirements

An overseas accounting firm is required to submit the following documents to the provincial public finance department at the place where the Mainland company is located for its records, with a copy to the MOF, at least 7 days before providing the audit services in China:

- i) a photocopy of the audit engagement signed with the Mainland company;
- ii) the written business cooperation agreement signed with the Mainland accounting firm; and
- iii) a report letter in the form set out in Annex 1 to the Interim Provisions.

The overseas accounting firm is also required to submit a written report in the form specified in Annex 2 of the Interim Provisions within 60 days of the business reporting date. The written report must be submitted to the provincial public finance department where the Mainland company is located, and copied to the MOF. The reporting deadline has been extended to 60 days from the 45 days originally proposed in the Provisional Regulations.

If an overseas accounting firm fails to file the required documents, or files information which is false or incomplete, the public finance department (at the provincial level or above) will issue a notice of criticism to the relevant supervisory authority of the offending overseas accounting firm and may require the correction of any false/incomplete information. In serious cases, a 5-year ban on auditing Mainland companies applying to list or listed offshore may be imposed. This 5-year ban may also be imposed on an overseas accounting firm which fails to cooperate with its Mainland partner firm or ensure that the working papers are retained in Mainland China, as required by the Interim Provisions.

Confidentiality Requirements

The Interim Provisions (Article 12) stipulate that Mainland companies and overseas accounting firms must strictly comply with the Provisions on Strengthening the Relevant Confidentiality and Archives Management Work Relating to the Overseas Issuance of Securities and Listing (Announcement No. 29 [2009], CSRC, National Administration for the Protection of State Secrets and State Archives Bureau). Under those provisions, the accounting records (including audit working papers) of Chinese companies may be subject to claims of state secrecy under Chinese law and the consent of the relevant Mainland authorities is required before they can be taken out of the Mainland.

Article 12 further stipulates that where the listing of a Mainland company becomes the subject of a legal action or other matter and an overseas judicial or regulatory authority requires access to the audit working papers in respect of that company, or where an overseas regulatory authority requires access to the audit working papers for a Mainland company, access should be sought in accordance with the relevant supervision agreement entered into between the regulatory authorities of Mainland China and the relevant overseas jurisdiction. The Interim Provisions are however silent on how foreign courts or regulatory bodies should obtain access to Chinese audit working papers where there is no supervision agreement in place between the country in question and Mainland China.

The restriction on taking Chinese audit papers out of China creates problems for accountants, and IPO sponsors and regulators which want to see the papers. In recent years, both the Hong Kong Securities and Futures Commission (SFC) and the US SEC have sought access to Chinese audit working papers. In May 2014, the Hong Kong courts ordered Ernst & Young (EY) to hand over to the SFC audit papers held by EY's Mainland affiliate, EY Hua Ming, in Mainland China. The audit papers related to work on the failed listing of China-incorporated Standard Water Limited. EY's argument that it was prevented from producing the documents by PRC state secrecy laws was rejected by the Court; the Hon Mr. Justice Ng described the argument as "a complete red herring". Both PRC law experts agreed that the relevant regulation "does not impose a *blanket* prohibition on cross-border transmission of audit working papers to overseas securities regulatory authorities - such transmission is permissible if prior approval from the relevant government departments has been obtained".

In a recent development, EY discontinued its appeal against the May 2014 court order compelling production of audit working papers held by its Mainland affiliate. In its notice of the discontinuation,⁴ the SFC reminds Hong Kong auditors of their obligation to comply with SFC requests for audit working papers, including those held by their Mainland affiliates, made under the Securities and Futures Ordinance. Where audit working papers of Chinese companies are held in China, the auditor is responsible for obtaining clearance from the Chinese authorities to produce the papers to the SFC.

The MOF has apparently agreed to consider setting up a system and procedures that would allow offshore securities regulators to access audit working papers for the purpose of their investigations.

Exemption for Hong Kong Auditors

Hong Kong audit firms are exempted from the Interim Provisions' requirement to partner with Mainland accounting firms in order to audit Mainland Chinese companies applying to list, or already listed, in Hong Kong provided that at least half of the Mainland company's shares are held, directly or indirectly, by Hong Kong investors. A similar exemption applies to Macao and Taiwanese auditors (Interim Provisions Article 2).

If the 50 per cent. ownership threshold is not met, Hong Kong auditors must still team up with a Mainland audit firm to conduct the audit. However, the requirements for the Mainland partner firm (see above) of the Hong Kong auditor are relaxed. Instead of being required to have IPO or listed company audit experience, the Mainland partner firm of a Hong Kong auditor must have at least 25 certified accountants. The same relaxation applies to Macau and Taiwanese auditors of companies not meeting the 50% local ownership requirement and opens up the pool of potential Mainland audit partners considerably.

Hong Kong, Macau and Taiwanese auditors however remain subject both to the prohibition on using temporary licences to work in Mainland China and the ban on taking audit working papers outside the Mainland.

⁴ SFC. "EY's appeal over audit working papers discontinued". 23 July 2015. Available at <http://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=15PR79>

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Hong Kong Office

Dominion Centre

12th Floor

43-59 Queen's Road East

Hong Kong

Tel: + (852) 2905 7888

Fax: + (852) 2854 9596

www.charltonslaw.com