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[online version](http://www.charltonslaw.com/hkex-publishes-consultation-paper-on-proposals-to-allow-mainland-companies-listed-on-hkex-to-use-mainland-accounting-and-auditing-standards-and-mainland-audit-firms/)

# HKEx Publishes Consultation Paper On Proposals To Allow Mainland Companies Listed On Hkex To Use Mainland Accounting And Auditing Standards And Mainland Audit Firms

## Introduction

HKEx has published a consultation paper (the "Consultation Paper") on proposals to accept financial statements prepared under the Chinese Mainland accounting standards, China Accounting Standards for Business Enterprises ("CASBE") for Mainland incorporated companies listed in Hong Kong, and to allow certain Mainland auditors to service these issuers. The Consultation Paper proposes that the Listing Rule amendments should become effective on 1 January 2010 and apply to annual accounting periods beginning on or after that date.

As a reciprocal arrangement, the Mainland would allow companies incorporated or registered in Hong Kong which are listed on the Mainland to prepare financial statements using Hong Kong Financial Reporting Standards ("HKFRS") or International Financial Reporting Standards ("IFRS"), and be audited by Hong Kong audit firms using Hong Kong Standards on Auditing or International Standards on Auditing.

The background for these proposed changes is the convergence of CASBE with IFRS and HKFRS, and the convergence of Mainland auditing standards with Hong Kong auditing standards. The Hong Kong regulators believe that the proposals will:

1. provide Mainland incorporated listed issuers with alternative accounting standards and audit firms that may be used;
2. increase market efficiency and reduce compliance costs of Mainland incorporated companies listed in Hong Kong;
3. promote more timely disclosure of information to investors to enable them to make informed and timely investment decisions; and
4. provide sufficient investor protection.

The Consultation Paper is available on the HKEx website [here](http://www.hkex.com.hk/consul/marketconsultation.htm).

## Accounting Standards

### Current Main Board rules on accounting standards

#### 1. Annual Reports

Under Note 2.1 of paragraph 2 of Appendix 16 to the Rules, the annual financial statements of Main Board issuers must conform to either:

1. HKFRS; or
2. IFRS, together with an explanation of differences between IFRS and HKFRS and a statement of the financial effect of these differences.

Mainland incorporated companies which adopt IFRS are not subject to the requirements to include an explanation of the differences between HKFRS and IFRS and their financial effect. The annual reports of Mainland companies may also include in a separate part financial information conforming with applicable Mainland accounting rules, but the financial statements must contain a statement of the financial effect of the material differences from either HKFRS or IFRS. The main requirement is therefore that either HKFRS or IFRS financial statements must be prepared, which may be supplemented by additional financial statements prepared under CASBE.

#### 2. Accountants' Reports

Under Main Board Rule 19A.10 the accountants' report must "*normally*" be prepared under HKFRS or IFRS. The word "*normally*" allows some flexibility and effectively allows accounting standards other than HKFRS and IFRS to be used.

### GEM current rules on accounting standards

#### 1. Annual Reports

Under GEM Rule 18.04 the annual financial statements of GEM issuers must conform to either HKFRS or IFRS. Where IFRS are adopted, there is no equivalent of the Main Board requirement to explain the differences between HKFRS and IFRS and include a statement of the financial effect of the material differences. The GEM Rules prefer the adoption of HKFRS or IFRS, but allow financial statements to be drawn up in conformity with US GAAP for companies which are also listed on the New York Stock Exchange or NASDAQ. In exceptional circumstances, the Exchange may allow annual financial statements of an overseas issuer to be prepared in accordance with other accounting standards, but a statement is normally required as to the financial effect of the material differences and a summary of any material differences in disclosure from either HKFRS or IFRS.

#### 2. Accountant's Report

Under GEM Rule 7.12, the accountants' report for GEM issuers must "normally" be drawn up in conformity with HKFRS or IFRS. Again, the word "normally" provides for some flexibility in the accounting standards adopted.

### Background for proposed changes

In February 2006, China's Ministry of Finance ("MOF") announced the implementation of new Mainland accounting standards that brought substantial convergence between Mainland accounting standards and IFRS. All companies incorporated in China and listed on Mainland stock exchanges were required to use the new standards as from 1 January 2007. In December 2007, the China Accounting Standards Committee and the HKICPA signed a joint declaration on the convergence of CASBE with HKFRS, and committed to maintain this convergence. In effect therefore there is a commitment to converge CASBE with IFRS since HKFRS are converged with IFRS on an ongoing basis.

### Proposed amendments to Rules

#### 1. Reconciliation

Due to convergence between HKFRS and IFRS, the requirement for reconciliations between IFRS and HKFRS will no longer be necessary. Likewise, given the convergence between CASBE and HKFRS, the requirement for reconciliation between CASBE and HKFRS or IFRS will no longer be necessary.

#### 2. Five-year historical summary

The existing Rules require listed issuers to provide a five-year historical summary of financial data. An issuer adopting CASBE may not have financial data based on CASBE for five years since CASBE was only introduced from 1 January 2007. Accordingly, if an existing listed issuer has a history dating before 1 January 2007, the issuer is expected to explain the reasons and show financial information for the earlier years under HKFRS or IFRS, as these would have been prepared under the existing Rules.

#### 3. Transaction Circulars

An issuer that elects to adopt CASBE for annual financial reporting purposes would also be required to prepare financial information included in transaction circulars under CASBE.

## Auditing Standards

### Current Main Board rules on auditing standards

#### 1. Annual Reports

Main Board Rule 19A.32 states that the annual financial statements of Mainland incorporated companies must be audited to a "*comparable*" standard to that required by the Hong Kong Institute of Certified Public Accountants ("HKICPA") or by the International Auditing and Assurance Standards Board of the International Federation of Accountants ("IAASB").

#### 2. Accountants' Reports

Main Board Rule 19A.09 requires that financial information given in accountants' reports should be audited to a standard "*comparable*" to that required in Hong Kong. As HKICPA standards are converged with International Standards on Auditing, in substance the requirements for accountants' reports are the same as for annual reports.

### GEM current rules on auditing standards

#### 1. Annual Reports

GEM Rule 25.26 requires annual financial statements to be audited under auditing standards "comparable" to the HKICPA or IAASB standards.

#### 2. Accountants' Reports

GEM Rule 25.01(3) indicated that the general GEM rules apply. GEM Rule 7.08(3) therefore applies so the accountants' report is required to be prepared in accordance with the HKICPA Auditing Guideline "Prospectuses and the reporting accountant". In substance this means that HKICPA auditing standards are expected to be adopted since these are referred to in the guideline.

### Proposal for acceptance of Mainland auditing standards

On 6 December 2007, the China Auditing Standards Board and the HKICPA jointly announced the convergence of China auditing standards with the Hong Kong Standards on Auditing. As HKICPA adopts International Standards on Auditing, this declaration means the convergence of Mainland auditing standards with International Standards on Auditing.

HKEx considers that audit reports prepared under Mainland auditing standards should be acceptable for Hong Kong listed issuers and it proposes to amend the current Rules to make it clear that Mainland auditing standards are acceptable.

### Commencement Date

HKEx's suggested commencement date for the amended Rules (assuming the proposals are adopted), is 1 January 2010. The revised Rules would therefore apply to annual accounting periods beginning on or after 1 January 2010.

## Proposed Framework For Acceptance Of Mainland Audit Firms

The principle underlying the proposals is that Mainland audit firms of companies listed in Hong Kong should be subject to a level of regulation equivalent to that in Hong Kong. The framework governing Mainland auditors includes the following elements:

1. reliance and co-operation with existing Mainland regulatory authorities that regulate Mainland audit firms;
2. approval and registration of the audit firms that will be eligible to service companies listed in Hong Kong;
3. monitoring and continuing oversight of the quality of the work of the approved audit firms;
4. arrangements for investigation and sanctions against approved audit firms;
5. the approved audit firm's familiarity with the Hong Kong listing rules, the Hong Kong Companies Ordinance, the Financial Reporting Council Ordinance and Hong Kong local practices as required by Mainland audit firm professional standards.

### Approval and registration of Mainland audit firms

Under the proposed framework, a Mainland audit firm proposing to act as an auditor or a reporting accountant for a Mainland incorporated company listed in Hong Kong will have to be separately approved and registered by MOF and CSRC. The qualification requirements will be agreed between the Hong Kong and Mainland regulators. The agreed qualification requirements are required to cover the relevant auditing standards, quality control standards and code of ethics for professional accountants and the experience, resources and capabilities of the audit firms in auditing listed companies (paragraph 6 of the Proposed Framework for Implementation at Appendix 1 to the Consultation Paper). The Mainland regulators may add to the agreed qualification requirements. The Hong Kong regulatory authorities will be notified of approved Mainland audit firms and the Exchange will maintain a list of such firms on its website.

One issue considered by the Hong Kong regulators in formulating the proposals, was whether the Exchange should have the right to reject a Mainland audit firm. It was decided that this was not necessary since the Exchange already has the power to pre-vet listed companies'/listing applicants' documents (e.g. prospectuses and transaction circulars) prior to their release and may reject documents. The powers to reject documents are contained in Main Board Rules 9.07 and 13.52 (GEM Rules 12.15 and 17.53) under which documents may not be issued until the Exchange has confirmed that it has no further comments. In particular cases, the Exchange may refuse to accept documents that have not been properly prepared.

In the case of documents that are post-vetted (e.g. annual and interim reports and announcements), the Exchange can require supplementary announcements to be published and can make a complaint to the FRC or the HKICPA to take appropriate action. Under the proposed framework, complaints in relation to a Mainland auditor of a Hong Kong listed issuer can be referred by FRC to MOF and CSRC.

### Deregistration of Mainland audit firms

The MOF and CSRC will remove a Mainland audit firm from the approved list if they become aware that the firm ceases to meet the qualification requirements for registration or fails to take appropriate steps to rectify the position. They will advise the Hong Kong regulators of withdrawals of approvals and the Exchange will remove the firm from the approved list.

### Monitoring and continuing oversight of Mainland firms

Monitoring and continuing oversight of approved Mainland audit firms will be carried out by MOF and CSRC. Those firms will be subject to monitoring through practice review inspections by on-site visits and reviews of audit working papers and other files. In their oversight of such firms, MOF and CSRC will assess and monitor compliance with the China Standards on Quality Control and other Mainland auditing standards. Generally speaking, the Hong Kong regulators will not request practice review inspections of Mainland audit firms, as these will be conducted by MOF and CSRC.

### Investigations and Sanctions

Mainland audit firms will be required to respond promptly to any enquiries from MOF or CSRC and will be subject to any sanctions which such bodies consider appropriate. If the Hong Kong regulators have reason to believe that a Mainland audit firm should not be an approved audit firm, the FRC will be able to ask MOF and CSRC to investigate the matter and advise the Hong Kong regulators of the outcome. MOF and CSRC are also able to initiate enquiries. To facilitate enquiries, Mainland audit firms are required to retain their working papers for at least 10 years from the date of the auditors' report. This is more stringent than the Hong Kong requirement which requires retention of working papers for a minimum of 5 years.

As is the case for all audit firms servicing Hong Kong listed companies, Mainland audit firms servicing such companies will be subject to the provisions of the Financial Reporting Council Ordinance. As the FRC and HKICPA have no statutory power to impose fines and penalties on Mainland audit firms, the MOF and CSRC will be responsible for imposing appropriate disciplinary actions and sanctions against Mainland audit firms.

## Conclusion

The Exchange believes that any concerns arising from the proposals are not insurmountable and will diminish with time as parties become accustomed to the new regime. There should be no loss or gain of information on the adoption of CASBE as CASBE are in substance already converged with IFRS. The benefits of allowing Mainland audit firms to service Hong Kong listed companies are expected to outweigh the costs of implementing the system. The Exchange expects that the reduction in the time and cost of producing financial information by Mainland listed companies will allow the financial information to be released to the market in a more timely manner.

## Consultation Questions

Interested parties are welcome to submit their comments on the proposed framework.

*Question 1* Do you agree with the proposed framework? Please state the reasons for your views.

*Question 2* If the proposed framework is adopted, do you agree that the effective commencement date for the new rules should be **1 January 2010** and should apply to annual accounting periods beginning on or after **1 January 2010**? Please state the reasons for your views.

*Question 3* What are your views on the likely effect of the proposed new Rules to implement the framework? Please provide qualitative and quantitative data. Please state the reasons for your views.

*Question 4* Do you have any other comments or suggestions or alternative approaches? Please state the reasons for your views.

*The purpose of this note is to provide a summary only of information included in the Hong Kong Stock Exchange's "Consultation Paper on Acceptance of Mainland Accounting and Auditing Standards and Mainland Audit Firms for Mainland Incorporated Companies Listed in Hong Kong (August 2009)". Its contents do not constitute legal advice and specific advice should be sought in relation to any particular situation.*

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