



By email (response@hkex.com.hk) and by hand

13 December 2018

Our Ref.: [REDACTED]

Hong Kong Exchanges and Clearing Limited
8th Floor, Two Exchange Square
8 Connaught Place, Central
Hong Kong

Dear Sirs,

Re: Consultation Paper on Proposal relating to Listed Issuers with Disclaimer or Adverse Audit Opinion on Financial Statements

Thank you for agreeing an extension to the original deadline for the Hong Kong Institute of CPAs ("the Institute") to consult members and submit comments in response to the above consultation paper. Clearly, we are one of the main stakeholders in relation to this consultation, as the body authorised by law to register and grant practising certificates to certified public accountants in Hong Kong, where holding a practising certificate is a precondition for performing statutory audits.

In principle, the Institute supports initiatives that strengthen market regulation and investor protection and maintain Hong Kong's position and reputation as a major international market.

In relation to Question 1, we understand HKEX's concern and the objective of further enhancing investor protection, by safeguarding the quality and reliability of the financial information published by listed issuers, and encouraging issuers to maintain appropriate and effective risk management and internal control systems. We acknowledge that disclaimers of opinion and adverse opinions are potentially indicators of serious issues – in the words of the standards "significant and pervasive". For this reason, we would also agree that audit disclaimers/ adverse opinions may be a factor in determining whether a suspension should be called for. Nevertheless, we have reservations about the current proposal, in which they would automatically trigger a suspension of trading because there are other considerations that may need to be weighed in the balance. The proposal appears to envisage that issuers will be incentivised to address the issues underlying audit disclaimers/ adverse opinions more promptly in order to avoid a trading suspension and, potentially thereafter, being delisted. We believe that this may reflect an overly simplistic view.

In the course of our internal consultations, members of the Institute have pointed to various pitfalls and problems with the proposed new rule, which would create a direct cause and effect relationship between an audit disclaimer/ adverse opinion and a suspension of trading. Further details about these concerns are contained in

Appendix 1 to the questionnaire.

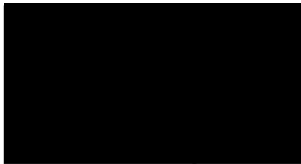


At a technical level, we would also draw your attention to certain considerations and constraints under the companies law and accounting and audit standards, in relation to performing an update audit or a single financial statement audit as a precursor to resuming trading, which need to be taken into account.

The completed questionnaire and relevant appendices, which explain the Institute's views in more detail, are attached.

Should you have any questions on the Institute's submission, please feel free to contact me at the Institute.

Yours faithfully,



Chris Joy
Executive Director



Encl.

Part B Consultation Questions

Please indicate your preference by checking the appropriate boxes. Please reply to the questions below that are raised in the Consultation Paper downloadable from the HKEX website at:

<http://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/September-2018-Adverse-Audit-Opinion/Consultation-Paper/cp201809.pdf>

Where there is insufficient space provided for your comments, please attach additional pages.

1. Do you agree with the proposal to add a Rule to require trading suspension if an issuer has published a preliminary annual results announcement and its auditor has issued, or has indicated that it will issue, a disclaimer or an adverse opinion on the issuer's financial statements?

Yes

No

If your answer is "No", please give reasons for your views.

In principle, the Institute supports initiatives that strengthen market regulation and investor protection and maintain Hong Kong's position and reputation as a major international market. However, while we do not object to the idea of a disclaimer of opinion/ adverse opinion in the auditor's report being a factor in considering whether a suspension of trading in the relevant issuer's shares is called for, we have reservations about the current proposal, in which a disclaimer of opinion/ adverse opinion would automatically trigger a suspension of trading. This is because in our view there are other considerations that may need to be weighed in the balance.

Please refer to Appendix 1 for our detailed comments.

2. Do you agree with the proposed Rule 13.50A to require the issuer to address the issues giving rise to the disclaimer or adverse opinion, provide comfort that a disclaimer or adverse opinion in respect of such issues would no longer be required, and disclose sufficient information for investors to assess its updated financial position before trading resumption (as described in paragraph 32 of the Consultation Paper)?

Yes

No

If your answer is “No”, please give reasons for your views.

Subject to our comments on Question 1, in principle we agree that if an issuer's shares have been suspended and one of the factors is that the issuer has received a disclaimer of opinion/ adverse opinion in the auditor's reports, the underlying issues given rise to the audit opinion need to be addressed.

However, at the same time, we are concerned that there may be an implicit view that there is an onus and responsibility on the auditors to take steps to ensure that the issues giving rise to disclaimers and adverse opinions are addressed and remedied. This would not be a correct or helpful perception, and it must be made clear that the primary responsibility for addressing the underlying issue lies with issuer.

We would also like to bring to HKEX's attention the technical comments set out in Appendix 2 .

- End -

Hong Kong Institute of CPA's comments on HKEx Consultation Paper on Proposal Relating to Listed Issuers with Disclaimer or Adverse Audit Opinion on Financial Statements

Q1. Do you agree with the proposal to add a Rule to require trading suspension if an issuer has published a preliminary annual results announcement and its auditor has issued, or has indicated that it will issue, a disclaimer or an adverse opinion on the issuer's financial statements? If not, why?

Our response:

In principle, the Institute supports initiatives that strengthen market regulation and investor protection and maintain Hong Kong's position and reputation as a major international market.

We understand concerns raised by HKEX and the objective of further enhancing investor protection, by safeguarding the quality and reliability of the financial information published by listed issuers, and encouraging issuers to maintain appropriate and effective risk management and internal control systems. Disclaimers of opinion and adverse opinions are potentially indicators of serious issues with the financial reporting of an issuer – in the words of the standards "significant and pervasive". For this reason, we would also agree that audit disclaimers/ adverse opinions may be taken into account in determining whether a suspension should be called for. Nevertheless, we have reservations about the current proposal, in which they would automatically trigger a suspension of trading, because there are other considerations that may need to be weighed in the balance. The proposal appears to envisage that issuers will be incentivised to address the issues underlying audit disclaimers/ adverse opinions more promptly, in order to avoid a trading suspension and, potentially thereafter, being delisted. We believe that this may reflect an overly simplistic view.

While the threat of suspension may expedite action by the issuer to address the issues leading to the disclaimer/ adverse opinion, given the limited timeframes within which any matters leading to a suspension would need to be resolved, under the recently-revised delisting regime (18 months for a main board listed issuer and 12 months for GEM listed issuer), the proposal may also create pressures that could precipitate the collapse of a company rather than encourage it to "get its house in order".

While we accept, therefore, that an audit disclaimer/ adverse opinion may be a factor leading to a suspension of trading, and this can be clearly expressed to issuers, we would not support the establishment of a direct cause and effect relationship between an audit disclaimer/ adverse opinion and a suspension of trading, i.e., that disclaimer/ adverse opinion would trigger an automatic and immediate suspension.

The proposals in the consultation paper, or specific aspects of them, have been referred to and discussed by various committees within the Institute, including the Audit and Assurance Standards Committee, the Small and Medium Practitioners Committee, the Professional Accountants in Business Committee, the Corporate Finance Advisory Panel and the Restructuring and Insolvency Faculty Executive Committee. Institute members have highlighted the following possible drawbacks and concerns in relation to the proposals:

- (i) Audit disclaimers/ adverse opinions are not a black and white issue. HKEX should seek to understand the underlying reasons for their issuance and consider whether, e.g., the impact has already been reflected in the issuer's share price and the extent to which the related information leading to the opinion has already been fully disclosed to the public, before deciding whether to suspend trading of the issuer's shares. The disclaimer/ adverse opinion should not be the sole and dominant factor triggering a suspension.

It may be, for example, that an issuer has overseas investments and more time may be required to obtain a valuation report for audit purposes. A disclaimer of opinion could be issued in the absence of the valuation report as at the date of audit report only. The listed issuer may not be involved in any irregularities or misconduct but, if the proposed is implemented, would be subject to suspension primarily for technical reasons.

- (ii) An issuer's bank/ loan covenant could be breached due to the suspension and the bank/ creditors may call in the loans from the issuer, potentially precipitating its collapse. The suspension could also provide an opportunity for the issuer's controlling shareholders to buy out the company at a significantly discounted price. These scenarios would be detrimental to minority shareholders.

- (iii) A trading suspension of a financially distressed issuer's shares would dramatically increase the difficulties for it to be restructured/ rescued, on the basis that it, upon suspension, it would become more difficult to raise funds from financial institutions or to attract investors.

A provisional liquidator/ liquidator would normally appoint new auditors when restructuring a financially-distressed issuer and inviting interest from potential "white knights", with the aim of effecting a resumption trading of the shares. Commonly, the new auditors would issue a disclaimer opinion due to the winding-up petition or going concern issues. It could also be that historical records may be missing and key management personnel cannot be contacted. In this situation, auditors will issue a disclaimer. Under the proposal, the restructuring plan could not be executed as a resumption of trading would not be allowed, unless and until the disclaimer were removed.

In Appendix II to the consultation paper, there are examples where disclaimers were given, the issues were finally resolved and the company resumed trading. If the proposed rule had been implemented at that time, the relevant companies could have collapsed due to the high risk of delisting perceived by the potential "white knight".

- (iv) There are various situations beyond the control of the issuer that could lead to a disclaimer or adverse audit opinion on the financial statements. In many cases, the underlying cause for the opinion is the issuer's governance, internal control and risk management matters. These matters may not be easily resolved within a short period of time, even where the management is cooperating with the auditors and HKEX to resolve the issues.
- (v) Concerns have been expressed by some auditors that the proposals will lead to additional pressure from clients not to issue disclaimers of opinion or adverse opinions. In an international market like Hong Kong with mature and professional relationships between client and auditor, and an audit profession that prides itself on ethics and integrity, we believe that auditors will continue to issue disclaimers of opinion or adverse opinions when, and only when, they are justified and necessary, and will not be dissuaded from doing so where they are called for. However, at the same time, we are concerned that there

may be an implicit view that there is an onus and responsibility on the auditors to take steps to ensure that the issues giving rise to disclaimers and adverse opinions are addressed and remedied. This would not be a correct or helpful perception, when the primary responsibility clearly lies with the issuers.

- (vi) It is noted that, in the United Kingdom, the Financial Conduct Authority is authorised to suspend trading of a listed issuer's shares if the issuer is unable to assess accurately its financial position and inform the market accordingly. At the same time, in contrast to the current proposal, this does not mean that an issuer in the United Kingdom will immediately be suspended from trading upon issuance of a disclaimer/ adverse opinion.

- (vii) One possible option might be to make clear that the likelihood of suspending trading of an issuer's shares will substantially increase if an issuer receives a disclaimer or an adverse audit opinion for two years consecutively. Listed issuers would be fully aware of the consequence when they receive a first disclaimer or an adverse audit opinion and, if they have failed to take sufficient action to show that the underlying issues have been, or shortly will be, resolved, then a suspension would clearly be called for.

Q2. Do you agree with the proposed Rule 13.50A to require the issuer to address the issues giving rise to the disclaimer or adverse opinion, provide comfort that a disclaimer or adverse opinion in respect of such issues would no longer be required, and disclose sufficient information for investors to assess its updated financial position before trading resumption (as described in paragraph 32 above)? If not, why?

Institute response

The consultation paper states:

"32. Once suspended, an issuer must remedy the issues to bring itself into Rule re-compliance and resume trading. Under proposed Rule 13.50A, the issuer should resolve the issues giving rise to a disclaimer or adverse audit opinion, produce financial information to reflect the updated financial position, and provide comfort from the auditor that the disclaimer or adverse opinion would be removed. For example, this may involve:

- (i) a full financial year audit¹⁴ or a special interim audit of the issuer's financial statements (see example in paragraphs 35 and 36); or
- (ii) a special engagement of the auditor to perform audit on a single financial statement of the issuer (e.g. the statement of financial position) or a specific element, account or item of a financial statement¹⁵.

Footnote 14 For example if the issuer is suspended due to a disclaimer of opinion on its FY2019 financial statements, this may require i) an audit of the issuer's financial statements for FY2020; or ii) an update audit of the FY2019 financial statements.

Footnote 15 Under HKSA 805 (Revised), the auditor can perform an audit of a single financial statement (e.g. statement of financial position) or of a specific element, account or item of a financial statement (e.g. accounts receivable). The auditor shall apply the requirements in HKSA 700 (Revised) in forming an opinion on whether the single financial statement or an element of a financial statement (i) presents fairly, in all material respects, or (ii) gives a true and fair view, in accordance with the applicable financial reporting framework. The appropriateness of this comfort would depend on the circumstances of the issuer giving rise of the modified opinion.

Subject to our comments on Question 1, in principle, we agree that if an issuer's shares have been suspended and one of the factors is that the issuer has received a disclaimer of opinion/ adverse opinion in the auditor's reports, the underlying issues giving rise to the audit opinion need to be addressed. However, at the same time, we are concerned that there may be an implicit view that there is an onus and responsibility on the auditors to take steps to ensure that the issues giving rise to disclaimers and adverse opinions are addressed and remedied. This would not be a correct or helpful perception, and it must be made clear that the primary responsibility for addressing the underlying issues lies with issuer.

We would also like to bring the following comments on Question 2 to HKEX's attention:

1. In Footnote 14 in the consultation paper, HKEX gives an example of re-performing an update audit of the financial statements resulting in a disclaimer of opinion. Whilst, in principle, we may be more supportive of option (i) to perform an audit of a full year or interim financial statements, it is not a common practice to perform an update audit of the same set of financial statements.
2. The Companies (Revision of Financial Statements and Reports) Regulation (Cap. 622F)(Regulation) provides a statutory mechanism that enables the directors of a company to revise financial statements where it appears to the directors that the original financial statements did not comply with the Companies Ordinance.

Section 14(1) of the Regulation requires the auditor's report on revised financial statements to state the auditor's opinion as to whether the revised financial statements give a true and fair view. HKEX may wish to consider the implications of the Regulation on the example in Footnote 14.

3. As set out in paragraph 3 of the consultation paper, the proposal seeks to afford better investor protection by safeguarding the quality and reliability of financial information published by listed issuers.
4. With regard to Footnote 15, we are of the view that publishing a single financial statement may not be sufficient to better protect investors as to the quality and reliability of financial information for the reasons set out below:
 - (i) Given that the auditor has issued a disclaimer or adverse or opinion, this means that the auditor has concluded that the misstatements (individually

or in the aggregate)/ possible effects on the financial statements of undetected misstatements, if any, are, or could be, both material and pervasive to the financial statements.

- (ii) As the auditor's opinion is on the financial statements as a whole, performing an audit engagement on a single financial statement would not reverse the disclaimer/ adverse opinion. It is common that the disclaimer /adverse opinion is based on multiple uncertainties and their possible cumulative effect on the financial statements; in which case, without performing an audit engagement on the full set of financial statements, it is unlikely that the auditors would be able to reach an opinion on whether issues have been resolved.

Hence, it is envisaged that only in rare circumstances would an audit of a single financial statement (e.g., statement of financial position), or of a specific element, account or item of a financial statement (e.g., accounts receivable), provide sufficient information to investors on the resolution of the issue causing the disclaimer/ adverse opinion. If the proposal, or a modified version of it, proceeds, the use of this option may need to be restricted to limited and rare circumstances.

- 5. Likewise, our comments on performing an audit of a single financial statement for the same reporting period are also relevant. In addition, there are requirements in HKSA 805 (Revised) *Special Considerations—Audits of Single Financial Statements and Specific Elements, Accounts or Items of a Financial Statement* which an auditor needs to comply with:

- (i) "16. If the auditor concludes that it is necessary to express an adverse opinion or disclaim an opinion on the entity's complete set of financial statements as a whole but, in the context of a separate audit of a specific element of those financial statements, the auditor nevertheless considers it appropriate to express an unmodified opinion on that element, the auditor shall only do so if:
 - (a) The auditor is not prohibited by law or regulation from doing so;
 - (b) that opinion is expressed in an auditor's report that is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion; and

- (c) the element does not constitute a major portion of the entity's complete set of financial statements.

17. The auditor shall not express an unmodified opinion on a single financial statement of a complete set of financial statements if the auditor has expressed an adverse opinion or disclaimed an opinion on the complete set of financial statements as a whole. This is the case even if the auditor's report on the single financial statement is not published together with the auditor's report containing the adverse opinion or disclaimer of opinion. This is because a single financial statement is deemed to constitute a major portion of those financial statements."

Under the circumstances, performing a special purpose audit on a single financial statement of the issuer, as suggested in paragraph 32(ii) of the consultation paper, would not be an option, if it were intended to cover the same period as the disclaimer/ adverse opinion.