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HKSA introduces a comprehensive and robust set of standards and guidance to help maintain quality of financial information in Hong Kong as a major capital market

In an effort to enhance the quality of financial information to maintain Hong Kong's status as an international financial and capital market, the **Hong Kong Society of Accountants (HKSA)** will introduce a comprehensive and robust package of new reporting requirements governing the preparation of accountants' reports and other reports on financial information relating to listing documents for IPOs and other capital market transactions. The proposed new requirements will also provide guidance on the preparation of financial information by listing applicants/listed companies for inclusion in listing documents including prospectuses.

All these new requirements, which will be open to public consultation in the form of an Exposure Draft (ED), are set out in 7 proposed professional standards and guidance notes. The proposals are the results of three years' strenuous efforts by the HKSA Accountants' Report Task Force aiming at bringing Hong Kong's reporting standards in line with international best practices, and facilitating reporting accountants to cope with today's market reporting requirements, in light of continuous changes in market practices and expectations in the past two decades.

The proposed new standards will also clearly define the roles of reporting accountants and directors of listing applicants/listed companies, and promote consistency both in the reporting and presentation of financial information.

Introducing the ED, **Mr. Kennedy Tat-yin Liu, Chairman of the HKSA Accountants' Report Task Force**, said the new standards and guidance, which will help the investing public better understand and utilize the listing documents, have recommended various changes from the current reporting practices.

The key proposals in the ED include:

1) Enhancement of completeness and objectivity of financial information

The new requirements will clearly spell out that the financial information covered by the accountants' reports has to be based on historical financial statements of the relevant reporting entities prepared under the Generally Accepted Accounting Principles (GAAP).

Accountants' reports will incorporate only the actual historical results and financial positions of the listing applicants/listed companies, as well as the results and financial positions of all the relevant operations, to enhance the comparability and objectivity of financial information. Guidance will be provided on the principle for reporting under carved-out situations.

2) Clarification of the respective roles and responsibilities of reporting accountants and directors of listing applicants/listed companies in relation to historical financial information included in listing documents

Under the new requirements, directors will be responsible for the preparation of historical financial information; while reporting accountants will be responsible for reporting on the historical financial information as prepared by the directors.

This proposal will result in changes in the format and contents of the accountants' reports, and the discontinuation of existing practices of making reference to previous auditors in the accountants' report.

The resulting benefits will be an enhancement of the independence of reporting accountants, with the directors taking responsibilities of the integrity of financial information under the corporate governance framework, while reporting accountants will take overall responsibilities of their opinions.

3) Setting out of new reporting framework for

- i) The preparation of pro forma financial information by the directors of listing applicants/listed companies, and its reporting by the reporting accountants under the new requirements of the Listing Rules;
- ii) The reporting by the reporting accountants on other financial information required of the directors of listing applicants under the Listing Rules including working capital sufficiency statement and letter of indebtedness; and
- iii) The issuance by the reporting accountants of comfort letters to sponsors.

According to **Mr. Richard George, Deputy Chairman of the HKSA Accountants' Report Task Force**, the above new reporting framework would be able to provide guidance to HKSA members on the new reporting requirements under the Listing Rules, and bring all accountants' reports under the HKSA's assurance framework.

Mr. Liu added that the HKSA has started a dialogue with the Securities and Futures Commission and the Hong Kong Stock Exchange in developing the ED. "We have held a number of meetings and presentations with them to exchange views on these proposals. Both the SFC and HKEx have indicated to us their support of our Accountants' Report Project to update the HKSA's existing guidance, and they will review and comment on the ED once it is issued. The Accountants' Report Task Force will work closely with the two parties on the proposals before finalizing them," he said.

The HKSA invites comments from its members and other interested parties on the ED by 14 August 2004.

An Explanatory Memorandum to the ED is enclosed for further details of the proposals, while the full ED has been published on the HKSA website at: www.hksa.org.hk/professionaltechnical/assurance/artf/exposure_draft.pdf.

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The HKSA is the only statutory licensing body of accountants in Hong Kong responsible for the regulation of the accounting profession, with a membership of over 22,000 and close to 11,000 registered students.

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Hong Kong Society of Accountants
Exposure Draft of Proposed Standards And Guidance For
HKSA Members In Performing Listing Engagements

EXPLANATORY MEMORANDUM

1. Introduction

- 1.1 In view of the changes in market practices over the past two decades, the Hong Kong Society of Accountants' (HKSA) Council appointed the Accountants' Report Task Force (ARTF) to develop new standards and guidance to HKSA members on the reports and letters that are issued by reporting accountants, and on the preparation by the directors of listing applicants of financial information, in connection with the issuance of investment circulars including prospectuses.
- 1.2 This Explanatory Memorandum explains the proposed new reporting framework to be introduced by the Exposure Draft (ED) of a suite of seven professional pronouncements under the Accountants' Report Project and the related key proposals. It also highlights the significant proposed changes from current practice.
- 1.3 The proposed new reporting framework may require changes to the Listing Rules and current market practices, and the ARTF will consult the Securities and Futures Commission (SFC) and Hong Kong Exchanges and Clearing Limited (HKEx) in this respect. If changes are necessary, the effective date of the proposed new reporting framework is subject to such changes being made.
- 1.4 The seven proposed professional pronouncements developed by the ARTF, with the exception of the proposed HKSIR 400, are largely based on the equivalent UK standards and guidance which include Statements of Investment Circular Reporting Standards issued by the UK Auditing Practices Board (APB) and other relevant guidance issued by the APB or the Institute of Chartered Accountants in England and Wales, with necessary local amendments. The proposed HKSIR 400 is largely based on the equivalent standards and guidance issued by the Canadian Institute of Chartered Accountants, with necessary local amendments.

2. Consultation with the SFC and HKEx

- 2.1 In developing the ED, the ARTF has started a dialogue with the SFC and HKEx. A number of meetings and presentations were held to exchange views on the HKSA's proposals. The SFC and HKEx have indicated to the HKSA that they support the Accountants' Report Project to update the HKSA's existing guidance, and will review and comment on the ED once it is issued.
- 2.2 The ARTF will continue to work closely with the SFC and HKEx on the proposed professional pronouncements before finalizing them.

3. Scope of the ED

- 3.1 The seven proposed professional pronouncements included in the ED for consultation are:
 - HKSIR 100 "Investment circulars and reporting accountants"

- HKSIR 200 “Accountants’ reports on historical financial information in investment circulars”
- HKSIR 300 “Accountants’ reports on pro forma financial information in investment circulars”
- HKSIR 400 “Comfort letters and other assistance to sponsors”
- PN 2000 “Other letters issued in relation to investment circulars”
- AG 2.211 “Preparation of historical financial information for inclusion in investment circulars”
- AG 2.212 “Preparation of pro forma financial information for inclusion in investment circulars”.

3.2 The proposed HKSIRs (Hong Kong Standards on Investment Circular Reporting Engagements) is a new series of standards governing the work of reporting accountants. The proposed PN (Practice Note) 2000 is to assist reporting accountants where they are requested by the directors of listing applicants to issue letter on cash flow forecasts or projections and letter on schedule of indebtedness. The two proposed AGs (Accounting Guidelines) are issued to assist the directors of listing applicants in preparing financial information for inclusion in investment circulars.

4. **Proposed new reporting framework introduced by the ED**

4.1 *Historical financial information*

4.1.1 Respective roles of reporting accountants and directors of listing applicants

Under the proposed new reporting framework, the directors of listing applicants will be responsible for the preparation of the historical financial information for inclusion in investment circulars, and the reporting accountants will be responsible for reporting on the historical financial information as prepared by the directors.

Currently, reporting accountants are responsible for the preparation of an accountants’ report, which includes the historical financial information as well as an opinion by the reporting accountants on the truth and fairness of the historical financial information.

4.1.2 Format and contents of the accountants’ reports

Reporting accountants will issue an accountants’ report expressing a true and fair opinion on the historical financial information.

The proposed new accountants’ report will adopt the style of a “short-form SAS 600 auditors’ report” issued by the auditors on the annual financial statements.

The historical financial information will not form part of the accountants’ report.

4.1.3 Statement of adjustments

Since the directors of listing applicants will be responsible for the preparation of the historical financial information for inclusion in investment circulars under the

proposed new reporting framework, the preparation of the statement of adjustments will also rest with the directors.

Paragraph 42 of the Third Schedule to the Companies Ordinance provides that an accountants' report shall either:

- (a) indicate by way of note any adjustments as respects the figures of any profits or losses or assets and liabilities dealt with by the report which appear to the persons making the report necessary; or
- (b) make those adjustments and indicate that adjustments have been made.

Based on legal advice obtained by the HKSA, reporting accountants will comply with alternative requirement (a) of paragraph 42 of the Third Schedule to the Companies Ordinance if they refer in the accountants' report to a note in the historical financial information which contains the adjustments that have been made by the directors.

4.2 *Pro forma financial information*

With effect from 31 March 2004, the Listing Rules require the preparation of pro forma financial information for inclusion in investment circulars in certain cases and the reporting thereon by the reporting accountants. As a result, the HKSA has developed the proposed AG 2.212 and HKSIR 300 to provide guidance to the directors of listing applicants and reporting accountants in the preparation of and reporting on pro forma financial information respectively.

Where the pro forma financial information is included in an investment circular, reporting accountants will issue an accountants' report expressing a "proper compilation" opinion.

4.3 *Other financial information*

Main Board Listing Rule 9.12(10) requires that where the listing document is required to contain a statement by the directors as to the sufficiency of working capital, a letter from the sponsor or, in the case of a listed issuer, the issuer's financial advisers or auditors is required to be lodged with the Stock Exchange, confirming that they are satisfied that the statement in the listing document as to the sufficiency of working capital has been made by the directors after due and careful enquiry and that persons or institutions providing finance have stated in writing that such facilities exist.

The reporting accountants' work will be aligned with HKSA ED/SAS 730 "The examination of prospective financial information". Instead of reporting on the directors' statement of working capital sufficiency, under the proposed PN 2000, the reporting accountants will report on the appropriateness of the best-estimate assumptions used in the preparation of the cash flow forecast which is the basis for the preparation of the statement of working capital sufficiency, and whether the forecast is properly prepared on the basis of the best-estimate assumptions.

4.4 *Comfort letters*

At the request of the directors of listing applicants, the reporting accountants may accept an engagement to issue a comfort letter to assist the sponsors in discharging their responsibilities. Such a comfort letter will be a private letter addressed to the directors of listing applicants as well as the sponsors provided that the sponsors are also party to the engagement letter.

Reporting accountants will perform an agreed-upon procedures engagement in connection with the issuance of the comfort letter in accordance with the proposed HKSIR 400.

4.5 Respective roles and responsibilities of reporting accountants and directors of listing applicants

The table below summarizes the respective roles and responsibilities of reporting accountants and directors of listing applicants under the proposed new reporting framework.

Proposed new reporting framework	
Role and responsibilities of directors of listing applicants	Role and responsibilities of reporting accountants
<p>4.1 <u>Historical financial information</u></p> <p>Preparation of GAAP compliance historical financial information for inclusion in investment circulars in accordance with the proposed AG 2.211.</p>	<p>Under the proposed HKSIR 200, reporting on the historical financial information as prepared by the directors.</p>
<p>4.2 <u>Pro forma financial information</u></p> <p>Preparation of pro forma financial information for inclusion in investment circulars to provide investors with relevant information about the impact of the transaction that is the subject of the investment circular by illustrating how that transaction might have affected the financial information presented in the investment circular, had the transaction been undertaken at an earlier date in accordance with the proposed AG 2.212.</p>	<p>Under the proposed HKSIR 300, reporting on the pro forma financial information as prepared by the directors.</p>
<p>4.3 <u>Other financial information</u></p> <p>Preparation of other financial information relating to an investment circular as required by the Listing Rules, such as statement of working capital sufficiency and letter of indebtedness.</p>	<p>Under the proposed PN 2000, reporting on certain financial information relating to an investment circular to assist the directors in discharging their responsibilities under the Listing Rules.</p>
<p>4.4 <u>Comfort letters</u></p> <p>Engaging the reporting accountants to issue a comfort letter to assist the sponsors in discharging their responsibilities.</p>	<p>Performing an agreed-upon procedures engagement in connection with the issuance of the comfort letter in accordance with the proposed HKSIR 400.</p>

5. Significant changes from current practice introduced by the ED

5.1 *Requiring sponsors to be party to the engagement letter in relation to the accountants' reports*

Under the extant HKSA Auditing Guideline 3.340 "Prospectuses and the reporting accountant", reporting accountants address their reports jointly to the directors of listing applicants and to the adviser (who is normally the sponsors).

Under the proposed new reporting framework, reporting accountants will address the accountants' reports only to those parties who are party to the engagement letter. Consequently, sponsors will continue to be one of the addressees of the accountants' reports only if they are party to the engagement letter.

5.2 *Discontinuing the practice of making reference to previous auditors*

Under the proposed new reporting framework, the reporting accountants will carry out appropriate procedures in order to express an opinion on the truth and fairness of the historical financial information for inclusion in investment circulars regardless of whether the historical financial information has previously been audited. As the reporting accountants will take on the responsibility for expressing an opinion on the historical financial information for the whole track period, the reference to the previous auditors does not add value to the opinion of the reporting accountants and may cause confusion regarding responsibilities. It is therefore recommended that this practice be discontinued to make clear the reporting accountants' responsibility.

5.3 *Discontinuing the practice of making reference to previous audit qualifications*

Under the current practice, where the reporting accountants conclude that they need not, for the purpose of their report, repeat a previously qualified audit opinion, they should indicate in their accountants' report how the matter was resolved.

For the same reason mentioned above regarding reference to previous auditors, under the proposed new reporting framework, it will no longer be necessary for the reporting accountants to indicate in their report how a matter which led to a previously qualified audit opinion was resolved. Furthermore, the reporting accountants will report on the truth and fairness of the historical financial information as a whole and it is not appropriate for reporting accountants to deal with specific matters covered by a previously qualified audit opinion.

5.4 *No involvement in signing verification notes*

Under the proposed new reporting framework, the reporting accountants will not be involved in signing any separate verification notes.

6. Completeness

6.1 Profit forecasts are not mandatory. However in limited circumstances, it may be appropriate to include a profit forecast in which case the reporting accountants will report in accordance with HKSA ED/SAS 730 "The examination of prospective financial information" (<http://www.hksa.org.hk/professionalttechnical/assurance/exposedraft/ed-sas730.pdf>).

ED/SAS 730 was issued by the HKSA in May 2002 for consultation adopting International Standard on Auditing 810 of the same title in Hong Kong under the HKSA International Convergence Programme.

6.2 The suite of seven proposed professional pronouncements identified in paragraph 3.1 above together with HKSA ED/SAS 730 represent the new standards and guidance that will be required in respect of all matters relating to an investment circular issued in Hong Kong.

7. HKSA professional pronouncements to be withdrawn

7.1 Upon the finalization of the seven proposed professional pronouncements in the ED, the following HKSA Auditing Guidelines will be withdrawn:

- Auditing Guideline 3.340 “Prospectuses and the reporting accountant”
- Auditing Guideline 3.341 “Accountants’ report on profit forecasts”.

8. Commentators guide and consideration of specific issues

8.1 The HKSA invites comments from any interested party on all aspects of the ED, and specifically on the proposed new reporting framework and the proposed significant changes from the current practice as detailed in paragraphs 4 and 5 respectively above. Comments would be most helpful if they indicate the specific paragraph(s) to which they relate, contain a clear rationale and, where applicable, provide a suggestion for alternative wording.