

## Asian Chief Audit Executives Leadership Forum 2014

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### **Introduction**

Thank you for inviting me to speak to you this morning.

Auditing – both external and internal varieties – should be an essential part of the overall infrastructure of good governance in responsible and responsive organizations, especially ones entrusted with the savings of the investing public, be they financial institutions or listed companies.

Being responsible and responsive are not really popular concepts.

Our corporate governance program has been in operation now for several years. We have taken on dozens of cases involving poor governance practices that have led to losses of shareholder funds and we have initiated actions that have caused those losses to be reimbursed. Our enforcement interest in corporate governance was originally a rather simple one. A corporate scandal involving loss of shareholder funds is likely to cause as much damage to confidence in our markets as any market manipulation or insider dealing.

For example, we announced recently the commencement of parallel proceedings in the Court of First Instance against the former chairman of Greencool Technology Holdings Limited (Greencool) as well as action in the Market Misconduct Tribunal against the same former chairman and a number of former directors of Greencool alleging the company falsified its financial statements for a number of years. We estimate minority shareholders of Greencool have lost more than \$1.5 billion which we are seeking to recoup from assets we allege the former chairman has hidden from sight in secret nominee accounts. The investigation started not long after I arrived in Hong Kong, more than seven years ago. There has been no delay. It has simply taken a long time to gather the evidence, most of which is not located in Hong Kong.

The point is proving fraud, because that's what is alleged here, is hard and time-consuming. But the signs are not always difficult to detect. And this is why internal and external auditors have a front seat role to play.

It is a commonplace that auditors view themselves as watchdogs rather than bloodhounds. This means a key attribute is the bark. But it would be fair to say we see a lot of fraud but we don't hear a lot of barking.



Even though there are provisions in the Securities and Futures Ordinance granting qualified immunity to auditors for informing the Securities and Futures Commission (SFC) about any suspected misconduct – I call this immunity for barking<sup>1</sup> – very few auditors have crossed the reception of the SFC into a closed door to discuss their engagement, let alone bark. There have been some very notable exceptions but it is startling and troubling that such occasions are distinctly rare and isolated events.

Either auditors in Hong Kong hardly ever come across instances where a reasonable person might suspect something is amiss or they do so but are convinced or persuaded or disinclined to report these issues to the SFC.

Now you might say the statutory protection in Hong Kong only applies to external auditors and so internal auditors are not protected. My response is surely an internal auditor, who is unable to get proper traction on an issue of concern or has legitimate fears that the audit committee or the board itself is part of the problem, would take steps to inform the external auditor immediately so that the external auditor, relying on statutory immunity, can alert the authorities. But as I say this is rarely the case.

So what about auditors themselves? How should we measure audit responsibility and responsiveness in this day and age in Hong Kong? And, taking today's theme as a cue, what ought to be the characteristics of the “next generation chief audit executive”?

I want to talk about three recent cases that might bear upon these questions.

### **Hard Questions and Answers**

Earlier this year we took action against Sun Hung Kai Limited, over its sponsorship of a proposed Growth Enterprise Market (GEM) listing (*Sun Hung Kai International Limited v SFC*<sup>2</sup>). The role of a sponsor involves a risk-based due diligence process and management of the listing process. The sponsor's functions are similar to the auditor's: the sponsor too performs an assurance role in respect of the information in the IPO prospectus.

The case concerned a proposed GEM listing which was initially withdrawn because the company was unable to comply with a new GEM rule on profit test which required an aggregate positive operating cash flow of at least \$20 million over the preceding two financial years. The company was unable to muster sufficient positive cash flow to meet the \$20 million requirement. The company then engaged a new auditor and renewed its listing application with new set of draft accounts which demonstrated that the company could meet the new cash flow test of \$20 million. While the two years used by the first and second auditors were different pairs, there was one year in common in which the cash flow figure was materially different.

The case is an important one because it deals with what can happen when it is clear a question needs to be asked but the person who is required to ask it finds a reason not to do so. The Securities and Futures Appeals Tribunal (Tribunal) found that Sun Hung Kai's team

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<sup>1</sup> Section 381 of the Securities and Futures Ordinance

<sup>2</sup> Application No 3/2013, (see [www.sfat.gov.hk](http://www.sfat.gov.hk)). The decision is dated 27 January 2014. The Securities and Futures Appeal Tribunal constituted The Hon Mr Justice Hartmann, NPJ, Chairman, Professor Eric Chang Chieh, Member, Mr Frederick Tsang Sui-cheong, Member.



was aware the second audit result was materially different to the first result, begging the question as to what had changed. However, as the Tribunal found:

“.....the deal team at SHKI, instead of adopting an attitude of professional scepticism, being alert to the possible ramifications of the discrepancy, chose instead to follow the path of least resistance by supporting Sino-Life’s instructions that the matter should not be further explored. In summary... the only reasonable inference to be drawn, in our opinion, is that the decision was made to ‘let sleeping dogs lie’ by refraining from further investigation, the consequence being an unspoken decision to go with the interests of the client at the potential expense of the integrity of the market.”<sup>3</sup>

Now many of you will say this is a reasonably straightforward case involving an obvious red flag that was recognized but not pursued when it should have been. But it is the relative obviousness of the question that makes it a startling case.

In this case, part of the sponsor’s argument was the second set of draft accounts had been prepared by the company’s new auditor and, despite the material differences, they were entitled to rely upon the second auditor without asking the obvious question themselves.

This is not an unusual “dilemma”. One way of deflecting a train of inquiry is to challenge the investigator’s qualifications to ask the question, or define the question as being beyond the scope or declare the issue is in the safe hands of someone else – in other words – “move along, there is nothing to see here”.

The lesson here is the auditor is a proxy for the honest and reasonable stakeholder who is unable to kick the tyres themselves. Those entrusted with assurance functions must be prepared to ask all the questions that beg to be asked even if the question might cause offence or is hard. Auditors should regard deflection tactics as a red flag and pursue the answer.

### **The Muffled Bark**

The second case I want to talk about involves an external auditor and is rather closer to home.

Recently we took action against Ernst & Young (EY) in Hong Kong over access to audit working papers. EY lost the case and is now appealing part of the decision concerning documents that the court found were in its possession but located in its Mainland affiliate’s office. EY is now in the process of handing over the documents it has in Hong Kong. Some background: EY in Hong Kong was engaged to act as the auditor and reporting accountant for the proposed listing of Standard Water, a Cayman Island company, whose business involves installing water treatment plants and related businesses in the Mainland. In order to perform its work, EY engaged its Mainland affiliated firm, EY Hua Ming, to conduct the field work in the Mainland.

In the course of carrying out this work, EY resigned, citing “inconsistencies”, presumably in the preparation of the company’s financial statements for the IPO prospectus. I say “presumably” because the point of this case is that our interest in the case was, at the beginning, an interest to find out what were these inconsistencies.

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<sup>3</sup> Application No 3/2013, para 91 and 110



This led to Standard Water abandoning its listing application which has never been renewed.

So we asked EY to provide us with details about the “inconsistencies”. Initially they said we won’t tell you because of confidentiality restrictions. So we asked again, this time on a compelled basis. Again, EY said no, this time saying all information was in the Mainland with its affiliate, EY Hua Ming and PRC law restricted them from telling us anything.

We then asked the China Securities Regulatory Commission (CSRC) to assist us by obtaining the materials in the possession of EY Hua Ming. But EY Hua Ming also resisted production of documents to the CSRC as well.

We found all of this difficult to understand and inconsistent with EY’s professional duties and obligations; so we initiated proceedings against EY in Hong Kong.

This action was immediately viewed as similar to related actions taken in the US by the Securities and Exchange Commission (SEC) against Mainland audit firms of US listed companies. These comparisons were understandable but they are wrong and I should digress to point out the differences.

First, our action was not against any PRC firm, as the SEC’s, it was against EY in Hong Kong.

Secondly, and consequentially, we were seeking documents that were in the possession of EY in Hong Kong. In other words, we were not seeking to extend our powers to require production of documents beyond the jurisdiction of Hong Kong.

Thirdly, we were not targeting EY or accounting firms in general. EY was not and is not a subject of any investigation.

Fourthly, the case did not involve any challenge to PRC law, especially any PRC state secrecy. The EY position was that PRC’s state secrecy prohibited any disclosure of material held by EY Hua Ming. We argued, to the contrary, that the PRC position, in fact, contains specific directions to accounting firms about the steps that need to be taken before disclosure can take place to agencies like the SFC and that, in response to a legitimate request for audit working papers held on its behalf by its Mainland affiliate, EY was obliged to initiate the process for disclosure set out under the Mainland rules. This had not happened.

As mentioned, the court ruled in our favour (although EY has initiated an appeal in relation to part of the decision). The Court accepted that EY has possession of the audit work papers under Hong Kong law and has to produce them to us. The Court also accepted that if there is material in the possession of EY Hua Ming, EY must take steps to retrieve it and, if required to do so, it must comply with whatever steps are required under PRC law.

In other words, EY must comply with HK law and, to the extent documents are in the PRC, with PRC law too.

The Court also found that the state secrecy claims were “red herrings”. Of course, there was no evidence that any state secret was contained in any of the documents we were seeking. The proposition that the Mainland has distributed state secrets among companies listed in Hong Kong and that these secrets can be found in the audit working papers of global accounting firms is an untenable one. But of course, who knew global accounting firms could be so good at keeping secrets?



So, in the context of today's discussion, what is this case about?

I have headed this part of the talk "the muffled bark" because, in effect, that is the real issue here and is what the case is really about from the SFC's perspective.

The importance of this case to the SFC is less to do with issues of PRC law and more to do with the extent to which the SFC can rely on Hong Kong auditors – both internal and external - to fulfil the expectations of stakeholders and bark clearly and loudly when circumstances require it. This started with an inquiry into inconsistencies that were sufficient to cause EY to resign its engagement as auditor. Presumably these are serious inconsistencies, perhaps a reason to suspect fraud or misconduct. These are matters that auditors should be unafraid to report in detail to the proper authorities. It is deeply troubling that auditors – wrongly – feel constrained in reporting misconduct to the SFC. Cases like this damage trust in the audit profession.

Let me give you a better example of accountability.

### **Barking Loudly and Clearly**

Recently we took action against Royal Bank of Scotland (RBS), an entity that has seen its fair share of law enforcement agencies in recent years.

Our action concerned inadequate systems and processes around its Emerging Markets Rates Desk here in Hong Kong. In short, the case involved a rogue trader who concealed losses by mis-marking her bond positions and booking, cancelling and amending fictitious bonds and futures trades in RBS' internal system.

The mis-marking was detected one Saturday as part of an internal audit process.

At this point, something quite unique happened. The internal audit function recognized they had detected a serious problem immediately. Lines of communication operated efficiently and, within 24 hours, a decision was taken to inform us. This was on a weekend. So the decision to inform us was not a decision to tell us the next working day but to tell us straight away.

Now usually firms do not self-report suspected misconduct within their organisations until they know the size and scope of the misconduct. Often this may mean awaiting the completion of the internal audit process, the initiation of an internal investigation, a report to the audit committee, a meeting of the audit committee, a briefing to the Chief Executive Officer, engagement of external lawyers and consultants, checking, re-checking, etc. None of this occurred here. Without knowing the size, scope or even full extent of the misconduct – and keeping in mind, RBS knew it was dealing with a rogue trading problem and we know those problems can be very expensive ones – RBS decided to self-report. As I said they didn't even wait until the following Monday. They rang the SFC straight away.

This was the right thing to do. It meant we were able to immediately ring fence the issue and by Monday morning the trader, who is now in jail, had been arrested. Indeed, the trader was arrested at the airport attempting to leave Hong Kong that same weekend. There is no doubt that if RBS had waited until the Monday morning to report the matter, it would have been too late.



I am not going to tell you about the issues in RBS' systems that had contributed to this problem arising in the first place because it is not really relevant for this purpose. In this case, RBS was prepared to do the right thing without knowing what the costs might end up being. For that example of good accountability, RBS was given a substantial reduction in sanction although not quite a 'get out of jail free' card it may have wanted.

This case is an outstanding example of accountability and it is undoubtedly a rare bird, a success story for internal audit and for the right attitude and approach.

The lesson here is an important one. The preparedness of those within an organization who are entrusted with control responsibilities to remediate problems as soon as they arise is perhaps one of the most potent signs that an organization can be trusted not only by its shareholders but also by its customers and wider community.

The control responsibilities here include those who are entrusted with assurance roles, be they internal or external audit responsibilities.

We desperately need more good examples like this one.

### **Closing**

Skeptical, even cynical investors, means assurance functions, like auditing, have never been in greater demand. The level of assurance required is greater and those entrusted with assurance roles, like auditors, need to probe more deeply.

The best measure of that, from the SFC's perspective, will be an increase in reports to the SFC using the statutory immunity gateway.

I have said we see a lot of fraud but we don't hear a lot of barking. It would be great if we could say we are seeing less fraud because there is more barking.

Thank you.

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