

The SFC and the AFRC Signal Intent to Combat Dubious Transfer of Funds by Listed Issuers to Third Parties

25 July 2023

On 13 July 2023, the SFC and the AFRC released a joint statement setting out their observations on certain dubious loans, advances, prepayments and similar arrangements made by listed issuers, and their expectations on the directors, audit committees and auditors of these listed issuers in relation to such arrangements. This marks the first public collaboration between the SFC and the AFRC since the commencement of the new regulatory regime of the accounting profession on 1 October 2022.

In line with the observation made by our International Counsel Samuel Fung to the *China Business Law Journal* last year,¹ the SFC and the AFRC noted in the joint statement an increase in cases of suspected misconduct involved listed issuers channeling company funds to third parties in dubious circumstances under the pretext of loans, which may be called advances, prepayments, deposits, or given some other label. These arrangements often involved the transfer of funds to recipients that are related to or associated with the listed issuer or its management, sometimes on terms so favourable to the recipients that they could not possibly have obtained them elsewhere, resulting in significant impairment losses to the listed issuers after the loans became unrecoverable. The dubious loans may also be used to disguise the misappropriation or otherwise fraudulent use of the listed issuer's funds or create an artificial circulation of funds from and back to the listed issuer in order to dress up the company's financial outlook.

COMMON CHARACTERISTICS OF DUBIOUS LOANS

The SFC and the AFRC pointed out that the dubious loans often had three characteristics:

- **Lack of commercial rationale**—e.g. (a) the granting of a loan at an interest rate far below the cost of funds; (b) the granting of a loan to a third party on an unsecured

¹ "Former Hong Kong SFC counsel moves to Debevoise" – *China Business Law Journal*, 29 August 2022 (<https://law.asia/debevoise-plimpton-samuel-fung/>).

and interest-free basis without any legitimate commercial reason; and (c) the making of prepayments for the purchase of goods in the absence of any requirement to do so.

- **Insufficient risk assessments, due diligence and documentation**—e.g. (a) the granting of unsecured loans to “business acquaintances” with whom the listed issuer had no prior business relationship, without having conducted any or any proper prior credit assessment or background check on the borrowers; and (b) the granting of unsecured loans without having conducted any due diligence on the borrowers’ assets to find out whether they were free from encumbrances or having made any enquiries into the borrowers’ financial ability to make repayment.
- **Inadequate internal controls**—e.g. (a) the granting of loans of significant amounts without proper approval from the listed issuer’s board of directors; (b) the lack of controls to ensure prompt recovery of loans; (c) the repeated extension of repayment periods without any legitimate commercial reason; and (d) the impairment of dubious loans on an arbitrary basis.

EXPECTATIONS ON DIRECTORS, AUDIT COMMITTEES AND AUDITORS

The joint statement makes it clear that the SFC and the AFRC expect the directors, audit committees and auditors of listed issuers to comply with certain standards and procedures in relation to loans and similar arrangements entered into by the listed issuer.

Directors of Listed Issuers

- Ensure that loans are properly evaluated and approved through critical assessment of the underlying commercial rationale, effective vetting, risk assessment and due diligence, and closer scrutiny of significant loans (including related loans that are small individually but are sizeable when aggregated), unsecured loans, loans outside the ordinary and usual course of business of the listed issuer and loans to related parties.
- Ensure that loans (in particular, loans to related parties) and material issues arising therefrom (e.g. recoverability, default, etc.) are properly and adequately disclosed.
- Ensure that the listed issuer maintains proper and clear documentation to evidence the loan process.
- Take reasonable steps to ensure that the listed issuer establishes and maintains appropriate and effective risk management and internal control systems, with processes and procedures for granting loans, monitoring repayment, following up on

overdue amounts, identifying incidences of impairment, assessing the extent of the impairment, related record keeping and internal and external reporting, instead of relying solely on management's representations.

- Invite auditors to attend board meetings at which significant matters arising from the audit, including matters relating to loans, are discussed and addressed by management.

Audit Committees of Listed Issuers

- Ensure that the listed issuer has appropriate and effective internal controls, including for granting loans, monitoring their repayment and determining impairment, and that the loans are appropriately accounted for and disclosed in the financial statements.
- Ensure that the listed issuer has set procedures for loans above a threshold amount to require prior approval by the board of directors, so that the appropriateness of the threshold is regularly reviewed by the committee and the board of directors.
- Maintain a dialogue with the listed issuer's auditors during the audit so that significant matters concerning the loans identified during the audit are duly addressed by the company.

Auditors of Listed Issuers

- In performing audit procedures on loans of a dubious nature:
 - Consider the need to attribute a higher risk of material misstatement;
 - Obtain evidence of the effectiveness of the listed issuer's internal controls over the making and monitoring of the loans, paying particular attention to the possibility of management override;
 - Design and perform audit procedures responsive to the assessed risks of material misstatement and the assessed effectiveness of internal controls;
 - Maintain professional skepticism and critically evaluate management's representations in relation to the loan by corroborating them with independent evidence;
 - Evaluate the accounting policies adopted and the reliability of accounting estimates regarding the impairment of loans, and the adequacy of related disclosures; and

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- Communicate significant issues identified to those charged with governance, including the audit committee.
 - Perform the following audit procedures in connection with dubious loans:
 - Critically evaluate the commercial rationale for the loan;
 - Inspect the original contracts or agreements and antecedent correspondence to verify the validity and terms of the loan;
 - Inspect evidence of credit assessments, due diligence procedures and proper approvals;
 - Obtain independent evidence of the existence and identity of the counterparty;
 - Inspect bank and other documents to confirm that the loan funds were transferred in accordance with the agreed terms; and
 - Obtain direct written confirmation of the principal, terms and outstanding balance of the loan from the counterparty.
 - Ensure that there are adequate quality controls in the form of supervision and review of the audit work and proper review of significant judgments and conclusions made by the audit team.
 - Where appropriate, report observed or suspected fraud to the appropriate authority despite the professional duty of confidence to the client.

POTENTIAL CONSEQUENCES FOR FAILURES

It is important that directors, audit committee members and auditors of listed issuers take these matters seriously, as a failure to comply could have serious consequences.

Disclosure of false or misleading information relating to loans may constitute a criminal offence or market misconduct under the Securities and Futures Ordinance (Cap 571). Further, the SFC may commence civil proceedings against directors and other persons involved in the management of the listed issuer who have committed wrongdoings in relation to the granting or management of loans, seeking orders for disqualification and compensation. If the granting of dubious loans involves conspiracy to defraud, deception, bribery, dishonest conduct or other fraudulent activities, the SFC may also

collaborate with other law enforcement agencies, such as the Hong Kong Police and the Independent Commission Against Corruption, to undertake enforcement action.

Where accounting non-compliance is identified from an enquiry into or review of a listed issuer's financial statements, the AFRC may issue a notice to the directors of the listed issuer requiring removal of the non-compliance within a specified period, failing which the AFRC may apply to the court for mandatory removal of the non-compliance or refer the matter to the Stock Exchange for follow-up action. The AFRC may also initiate an investigation of the certified public accountants and public interest entity auditors (including their registered responsible persons) who are responsible for preparing or approving the non-compliant financial statements and take disciplinary action against those found to have engaged in misconduct.

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Please do not hesitate to contact us with any questions.

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