REGULATION

CRITICS SAY AUDIT REFORM FALLS SHORT

Calls for change grow in the wake of a string of listed-company scandals, though there is disagreement over who pays for the oversight

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A government proposal to expand the powers of the Financial Reporting Council would add to its independence but would not help prevent corporate scandals, according to industry players.

The Financial Services and Treasury Bureau is in the process of reviewing comments it received during a three-month consultation that ended last month on its proposal to change the law to expand the powers of the FRC and let it take over the inspection and disciplinary powers wielded by the Hong Kong Institute of Certified Public Accountants (HKICPA).

The government set up the FRC in 2006 to take over the institute's investigative powers, following an international trend of independent bodies doing such jobs.

A number of corporate scandals in recent years involving problems at newly listed companies shortly after their initial public offerings has led to market doubts about local auditing standards and calls for further reform.

HKICPA chief executive Raphael Ding Wai-chuen said the group supports reforms designed to improve market quality but the current proposal could not address the key issues necessary to prevent corporate scandals.

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> MIKE WONG MING-WAI

"The current government proposal to expand the powers of the FRC would increase the independent regulation of auditing, which is only part of the financial reporting supply chain," he said. "The reform has not allowed the FRC to investigate or regulate listed companies and require them to have proper internal controls and internal accounting functions. As such, even if the current proposed reform goes ahead, it will not solve the major loophole in the system."

Ding said that in the United States, Singapore and Australia, the corresponding regulatory bodies had the power to regulate both auditors and listed companies' boards and management.

For instance, the Securities and Exchange Commission in the US had the power to take action if companies failed to maintain proper internal controls or had poor quality in-house staff and systems for preparing financial reports.

"The FRC, even after the current proposed government reform plan, would not have investigative power over listed companies on alleged accounting misconduct in the preparation of their financial statements," he said. "It would only have the power to investigate and punish auditors. But what if the problems arise from false data provided by the listed companies?"

Ding said that if the problem was caused by a listed company deliberately trying to fool its auditor, or if the company had a very poor quality internal financial reporting system, enhanced regulation of companies themselves had to be part of the solution.

He said the government should address the issue by letting the financial regulator's reach extend to listed companies' accounting departments.

The Hong Kong Business Accountants Association, formed by accountants who work in commercial organisations, has suggested to the government that the Securities and Futures Commission take over regulation of listed companies' auditors because it already has oversight of companies.

HKICPA chief executive Raphael Ding supports reform but says current proposals will not help stop corporate scandals. Photo: SCMP Pictures

The SFC has taken action against some listed companies alleged to have committed accounting fraud but it lacks the power to target auditors. In 2012 it successfully sought a court order requiring Hontex International pay back HK$1.03 billion to small shareholders for allegedly misleading financial information in its listing prospectus.

Calls for audit reform have increased along with concerns over the quality of companies seeking to list in Hong Kong after Fujian Nuoqi chairman Ding Hui disappeared in July – six months after the company's IPO – after transferring HK$291 million in cash from its accounts.

The unusually large money transfer, coupled with a number of profit warnings from other recently listed companies, have shone a spotlight on issues such as investor protection and regulatory oversight as well as the professionals involved in IPOs – from sponsors and lawyers to auditors.

Raphael Ding said internal control problems at newly listed companies could not be solved by just tightening regulation on auditors, who came in after the fact.

Jane Cheng, the Hong Kong head of the Association of Chartered Certified Accountants (ACCA), a British-based accounting body with global operations, said transfer part of the responsibility to the FRC should lead to more effective regulation.

"Regulatory frameworks that incorporate effective investigation and enforcement should serve as a deterrent to the behaviour that result in scandals involving accountants," she said. "However, promoting adherence to a strong ethical code and the existence of good corporate governance both have important roles to play."

At present, the FRC is equally funded by the government, the HKICPA, the SFC and the stock exchange. After the proposed reform, the government wants to change this model so that listed companies, investors and accountants pay, but that suggestion has been rejected by industry players.

The FRC wants a funding model that is secure and free from influence by auditors.

Cheng said the FRC should be funded directly by HKEx, which would determine the various levies. Ding said investors should pay as the reform was aimed at protecting them. He suggests a levy on each share transaction, with the levy stopping when a cap was accumulated.

Mike Wong Ming-wai, chief executive of the Chamber of Hong Kong Listed Companies, said the government should pay for the FRC.

"Issuers are paying high audit fees to auditors for their services," he said. "If the government believes it is necessary to have stronger and more effective oversight, we would not dispute that, but listed issuers should not be the ones to foot the bill.

"It places an unreasonable and unfair burden on buyers of a service if they are required to pay for the regulation of that service at the same time."

Since 2006, the FRC has conducted 22 investigations and referred 21 cases to the HKICPA, which has issued six warning letters and reprimanded auditors in four cases. It is still reviewing the remaining cases.

FRC chairman John Poon said last month that the council supported the reforms, which would ensure the independence of accounting regulation in the city.

The lack of independent oversight of accountants means that Hong Kong has been unable to join the International Forum of Independent Audit Regulators, something the government's proposal seeks to address.