Hong Kong Institute of
Certified Public Accountants
香港會計師公會

16 September 2014

By mail and email: rpirrlea@fstb.gov.hk

Division 4, Financial Services Branch
Financial Services and the Treasury Bureau
15/F, Queensway Government Offices
66 Queensway
Hong Kong

Dear Sirs,

Proposals to Improve the Regulatory Regime for Listed Entity Auditors – Consultation Paper

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only statutory licensing body of accountants in Hong Kong responsible for the professional training, development and regulation of the accountancy profession. The HKICPA sets auditing and assurance standards, ethical standards and financial reporting standards in Hong Kong. We welcome the opportunity to comment on the above consultation paper, the outcome of which will have significant impacts on the future role and activities of the HKICPA.

Regulation of listed entity auditors is an important part of the overall system of regulation of the Hong Kong capital market. Some years ago the HKICPA recognized that Hong Kong was no longer in step with international best practice and began research and outreach work to propose changes that would meet international expectations and maintain the standing and reputation of Hong Kong's capital market and auditing profession.

From 2012 the HKICPA worked with the FSTB and the Financial Reporting Council (FRC) to develop a proposed framework that was the basis of a member consultation that concluded in January 2014. The member consultation was a major element of extensive engagement with members and other stakeholders over this very significant initiative. There were 42 written responses to the consultation paper and around 4,500 members completed an online questionnaire. There was strong support for the Council position set out in the member consultation documents.

The current public consultation is the next stage in bringing independent regulation of listed entity auditors to Hong Kong. The HKICPA remains committed to this objective. We are pleased to see that a number of significant matters and concerns raised in our member consultation have been addressed in the public consultation paper, although there are some proposals with which we still take issue. Our responses to specific consultation questions are provided in the attachment. The commentary below highlights particular matters that we believe are not the best solutions to achieving the overall objective of reform.

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Before commenting, we would like to clarify two incorrect statements included in the consultation paper.

Paragraph 3.2 states "there are 5,915 practice units qualified to sign an auditor's report in Hong Kong" and goes on to explain the make-up of this number as "4,224 CPAs (practicing), 1,259 firms of CPAs (practicing) and 432 corporate practices". The number of CPAs (practicing) is actually the total number of practicing certificate (PC) holders, the great majority of whom are partners or directors in firms and corporate practices. The HKICPA in fact has 3,600 registered practice units comprising firms, corporate practices and individual PC holders who have registered "own name" practices. Taking into account duplicate registrations of more than one mode of practice and dormant practices there are around 2,500 active practice units. The number of practice units that audit listed entities varies from time to time but is generally just over 50, as indicated in the consultation paper.

Paragraph 7.3 refers to 26 cases referred from the FRC to the HKICPA for seven of which the HKICPA Council has "initiated disciplinary proceedings and convened Disciplinary Committees". In fact at least 14 of the FRC cases have been referred to a Disciplinary Committee and others have been concluded without convening a Disciplinary Committee in accordance with formal HKICPA complaint handling procedures. Most of the FRC referrals have been made in the last two years and at 30 June 2014, 10 of the 26 cases were still being dealt with by the HKICPA, of which nine are being considered by Disciplinary Committees.

In the view of the HKICPA Council and membership the following are significant matters that need to be further considered before new regulatory arrangements are finalized.

1. Lack of detail of operations and processes

The consultation is a key stage in a very significant change in regulation in the listed entity market and affects a number of stakeholders. It is development beyond the experience of many market participants and we suggest that it would be for the benefit of all stakeholders to be provided with additional detail on how a number of proposed operations and processes are expected to work.

We have made detailed comments on these areas in this letter and in responding to specific questions. In summary we believe that further examples or details on the following areas would provide comfort to stakeholders on the reasonableness and appropriateness of the proposals and should be available at the same time that draft legislation is presented to the Legislative Council.

- Circumstances that would result in the FRC giving directions to HKICPA while exercising oversight of HKICPA activities in registration, continued professional development and standard setting.

- Circumstances in which a systemic failure in quality control would be considered to have occurred.

- Vetting procedures to be applied by FRC in making decisions about registration of non-Hong Kong auditors and the provisions that would be in mutual or reciprocal cooperation agreements with overseas regulators.
- Checks and balances to confirm separation of inspection and disciplinary processes and exercise of fairness in regulatory actions against auditors.
- Guidance on determination of appropriate regulatory action or sanctions that ensure any action taken is relevant and proportionate to the identified irregularity.
- Composition of decision making bodies.

2. Enforcement / disciplinary mechanism

We recognize the need for a regulatory body to have appropriate enforcement powers to ensure effectiveness and efficiency of the regulatory system. However, we believe that fairness and due process should not be compromised in the interest of efficiency. In our view it is critical that there should be clear separation of inspection/investigation and disciplinary responsibilities and activities within the regulatory body. The consultation proposals give some assurance that the FRC will be required to put in place arrangements to achieve this separation. However, there is at this stage no indication of how this will be done and the consultation paper implies that all decisions on inspection, investigation, disciplinary action and registration will be made by the Council of the FRC.

In our view introducing a model where all power and decision making is concentrated in a single entity within the FRC is totally unacceptable and it is not supported by models of auditor regulation operated in other significant jurisdictions. We regret that the Government has seen fit to make its preferred outcome known to the press before conclusion of the consultation.

As a result of the consultation paper putting together some elements of the current HKICPA practice review system with enforcement provisions modeled on other Hong Kong financial market regulators and some concepts and terminology from auditor regulation regimes in other jurisdictions, there is a lack of clarity about how inspection, investigation and disciplinary action will fit together. In our view there should be a more holistic approach to regulatory activities and decision making and the application of sanctions where necessary. In our responses to Questions 20 and 30 and in **Annex 1** we have provided a suggested structure and procedures that link inspection and sanctioning processes in a way that is fair, practical and efficient.

3. Type and application of sanctions

We recognize that the range of sanctions proposed in paragraph 7.27 of the consultation paper covers sanctions generally available to auditor regulators in other jurisdictions and are, with the exception of our reservations set out below, appropriate to address issues of audit quality.

We continue to have significant concerns over the proposal to set the maximum financial penalty as "the greater of – (i) $10,000,000, or (ii) three times the amount of the profit gained or loss avoided by the listed entity auditor as a result of the irregularity". The "profit/loss" measure has been taken directly from sanctions available to financial market regulators in Hong Kong. We do not believe it is an appropriate measure for penalties under an auditor regulatory regime because auditors are not market participants in the same sense as financial services providers – they do not sell financial products or hold client assets, but rather provide a service to listed companies in the same way that lawyers provide legal services. We also believe that the figure of $10,000,000 is a direct lift from financial market regulation systems. Many small and medium sized firms have expressed the view that the figure is too high and may drive firms out of the listed entity audit market.

We are not suggesting that financial penalties do not have a place in the range of sanctions but propose that it would be sufficient to have a simple monetary cap of $5,000,000 with clear and strong guidance on how to determine the appropriate amount of a penalty.

We welcome the proposal in paragraph 7.29 that the FRC will be required by law to issue guidelines to explain how it exercises its power to order a financial penalty. We believe that such guidance should extend to the exercise of all sanctions and that the guidance should be developed and presented for consideration at the same time as the main legislation. In our response to Question 32 and in **Annex 2** we provide suggested guidance on sanctions determination and application.

4. Composition of decision making bodies

We mention in this letter and in our responses to a number of consultation questions the critical importance of having appropriate skills, up to date auditing experience and knowledge and a full understanding of the audit process in any decision making organ within a regulator of auditors. We have suggested a dedicated committee is created to determine inspection outcomes but the consultation paper suggests that the FRC Council will become the decision making body in respect of all inspection and investigation work and sanctioning. As we have mentioned above this is not an acceptable model of auditor regulation. However, if it is introduced then all the above requirements, skills, experience and knowledge should apply to the FRC Council.

It must be recognized that the depth of knowledge and breadth of understanding about auditing to successfully carry out all of the proposed roles of the FRC will be far greater than needed for the currently much more limited role of the FRC. There is a big difference between deciding that an investigation report shows reasonable suspicion of an irregularity, with the final decision on sanctions left to another body, and reaching a conclusion that evidence provided by an inspection is sufficient to prove an irregularity and determining a sanction that is reasonable and proportionate.

5. Criminal offences

The consultation proposals include criminal offences for an unregistered auditor entering into an audit engagement with a listed entity and failure to comply with requirements concerning inspections and investigations or tribunal proceedings. We have made detailed comments in response to specific questions. We would like to stress our view that as a matter of principle an auditor regulation system should not need to include criminal offences as the regulatory powers available to the regulator should be sufficient to reach an appropriate resolution, the ultimate sanction being exclusion from the register and market for listed company audits.

6. Regulation of non-Hong Kong auditors

The consultation proposes that in addition to Hong Kong auditors, which will be registered based on existing HKICPA criteria for PC holders, there will be two groups of non-Hong Kong auditors registered as auditors of entities listed in Hong Kong. For one of these groups the FRC will take over approval for registration from HKEx, using broad recognition criteria that are an improvement on those currently in the Listing Rules. One of the criteria is that there must be an "agreement of mutual or reciprocal cooperation" between the FRC and the audit regulator of the home jurisdiction of the overseas auditor. Given that there is very little precedent for effective existing cross border regulation, other than the examples of PCAOB inspection arrangements, we have concerns over how effective regulation of these non-Hong Kong auditors will be achieved. Auditor regulation is not converged internationally. IFIAR is the forum in which national independent audit regulators meet and exchange knowledge and experience but IFIAR membership criteria focus on independence from the profession and do not include measures of the quality of national regulation. Furthermore, the implications of developments in overseas regulatory regimes may add complications e.g. mandatory audit firm rotation that has recently been introduced in Europe could result in an increase in the number of non-Hong Kong auditors of Hong Kong listed entities seeking recognition and approval by the FRC. The second group of non-Hong Kong auditors is the group of auditors approved by Mainland authorities to audit Mainland firms listed in Hong Kong.

We understand that regulation of non-Hong Kong auditors is not the topic of the consultation but we believe it is a very important related matter that should be addressed as part of the current audit regulatory reform. To enhance investor confidence and protection in an international business environment there needs to be confidence that auditor regulation is equally robust across jurisdictions.

7. Definition of "irregularity"

In our response to Question 28 we have expressed our view that the definition of "irregularity" should be revisited to reflect the impact of the proposed new regulatory system that will result in much changed responsibilities and scope of work of the FRC and a new relationship between the FRC and the HKICPA. The current definition was developed to meet the original remit of the FRC – an investigator of Hong Kong auditors of companies listed in Hong Kong – and to work in the situation where the PAO is the main legislation concerned with regulation of

auditors. The definition needs to be changed to focus on compliance with professional standards and, more importantly, to clearly define the authority of the independent regulator over, and its regulatory relationship with, all non-Hong Kong auditors of entities listed in Hong Kong.

8. Funding

The consultation paper proposes a three party (investors, listed entities and listed entity auditors) funding system for the future operations of the FRC, a significant change from the current four party (HKSAR Government, SFC, HKEx and HKICPA) arrangement. In our view a strong case can be made that investors, through a transaction levy, should be the main if not only funding party. We believe that regardless of the identity of future funding parties there should be an attempt to quantify future operating costs. Without this any funding party will be suspicious that they are being asked to enter into a commitment with no knowledge of the amounts involved or how FRC operational costs will be controlled in future. We believe that to give sufficient comfort over accountability and prudent financial management of the FRC the government, if not continuing as a funding party should have a representative on the Council of the FRC in addition to the FRC's annual budget being approved by the Secretary for Financial Services and the Treasury.

We believe that the comments above and included in our responses to the consultation questions are relevant to the determination of the future system of listed entity auditor regulation in Hong Kong. The HKICPA is committed to helping to scope, develop and implement a system of listed entity auditor regulation that will be internationally recognized and is effective in maintaining confidence in the quality of audit in the Hong Kong market. There should be no need for the system to include features that are not necessary to achieve such objectives. Whilst we recognize the tight deadlines and the need to proceed in accordance with a strict timetable to get an updated regulatory system in place, we suggest that given the need to provide substantially more detail to give stakeholders sufficient understanding of the operation of the new regulatory system, it would be appropriate to consider the need for some form of re-exposure of revised proposals.

If any clarification or additional information is required please contact Chris Joy [chris@hkicpa.org.hk].

Yours sincerely,

Clement Chan
President

CONSULTATION QUESTIONS AND RESPONSES

Question 1
Do you agree with the proposed objective of the reform, i.e. to enhance the independence of the regulatory regime for auditors of listed entities from the profession itself with a view to ensuring that the regime is benchmarked against international standards and practices and continues to be appropriate in the local context?

Yes. We believe that this action is appropriate to maintain Hong Kong's position and reputation as a major international capital market.

Question 2
Do you agree that the new regulatory regime should only cover auditors of public interest entities, which will be defined to cover listed entity auditors?

Yes. The intention from the outset has been that the new regime would only cover auditors of listed entities.

Question 3
Do you agree that the definition of public interest entities should be set out in the main legislation such that any change in future could only be made by way of an amendment bill?

Yes. This proposal gives more confidence that any future changes will be made only subject to due consideration and process,

Question 4
Do you agree that FRC should become the independent auditor oversight body with respect to listed entities in Hong Kong by enlarging its regulatory remit?

It is acceptable for the FRC to take on proposed new activities.

Question 5
(a) Do you agree that a listed entity auditor must be a practice unit as defined under the existing PAO and a fit and proper person to be registered as a listed entity auditor?

Yes. For Hong Kong auditors the existing definition of a practice unit in the PAO remains appropriate. Requiring individuals responsible for listed company audits to be "fit and proper" is an acceptable extension of the existing practicing certificate requirements.

(b) If yes, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for considering whether a

person is fit and proper to be registered as a listed entity auditor, i.e. by reference to the existing fit and proper test for becoming a CPA?

The current requirements meet international best practice and do not need to be changed to meet the overall objectives of reform.

Question 6
(a) Do you agree that in order for an application for registration as a listed entity auditor to be approved, the individuals who are authorised by the auditor to perform the roles of an audit engagement authorised person, an engagement quality control reviewer or a quality control system responsible person should be fit and proper persons to perform such roles?

Yes. It is appropriate to require persons with specific and important responsibilities to be fit and proper.

(b) If so, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for individuals taking up such roles with respect to a registered listed entity auditor when considering whether they are fit and proper to perform those roles?

Assuming this means that current HKICPA fit and proper requirements for membership will in future apply to all three categories of individual we agree with the proposal. The current requirements meet international best practice and do not need to be changed to meet the overall objectives of reform.

Question 7
Do you agree that an individual, partnership or body corporate who wishes to enter into an audit engagement with a listed entity in Hong Kong should be required to register as a listed entity auditor, and that it shall be a criminal offence if an unregistered person entered into an audit engagement with a listed entity?

We agree that an individual, partnership or body corporate that wishes to enter into an audit engagement with a listed entity in Hong Kong should be required to register as a listed entity auditor. We do not believe that it is necessary to make it a criminal offence if an unregistered person enters into such an audit engagement. If a CPA (firm) takes on a listed entity audit without registering as a listed entity auditor the matter should be dealt with by HKICPA disciplinary procedures. Non-CPAs providing or offering to provide audit services is already a criminal offence under s.42 of the PAO.

In any event we do not believe that an unregistered person would be appointed as auditor of a listed entity. Appointment procedures followed by the audit committee would inevitably include checking the register of listed entity auditors.

Question 8

(a) Do you agree that HKICPA Registrar should be assigned the role of Registrar of Listed Entity Auditors and be vested with the registration functions and powers as outlined in paragraph 3.23, and FRC should exercise oversight through arrangements as proposed in paragraph 3.24?

Given that we agree that HKICPA should maintain the register of listed entity auditors it is appropriate that the HKICPA Registrar should have appropriate functions and powers to carry out the role. We agree in principle that FRC should exercise oversight as described in paragraph 3.24 subject to additional explanation of how and when FRC will issue directions to HKICPA. Directions should only be made to protect the public interest and not used to circumvent due process of registration. We also believe that in the event that it needs to issue directions the FRC should be required to give full reasons for its actions to the HKICPA and the government.

(b) Do you agree that FRC should publish the periodic reports received by the HKICPA Registrar as mentioned in paragraph 3.24(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?

Paragraph 3.24(a) refers to reports received by the FRC <u>from</u> the HKICPA Registrar. We have answered the question on this basis.

The FRC should provide public information on its oversight role and activities through its own report. Reports received by the FRC from the Institute should not be published as a matter of course as to do so may inhibit co-operation and full and frank dialogue between the FRC and the HKICPA.

Question 9

Do you agree that any person subject to a registration decision by the HKICPA Registrar may appeal against the decision, and any such appeal should be handled by an appeal mechanism which is independent of both the HKICPA Registrar and FRC?

Yes. The appeal mechanism should also apply to registration decisions made by the FRC. We suggest that refusal to allow registration, and any subsequent appeal, should not be made public. Until an auditor is registered its activities are not a matter of public interest and it does not come within the scope of the new regulatory system. Refusal of registration may occur because any of the registration criteria are not met and not all such decisions will be based on the competency of the auditor. Publicity about refusal of registration could unduly affect an auditor's reputation in other aspects of its professional activities and may influence the outcome of future registration applications.

Question 10
Do you agree with the proposal that registration shall remain in force until 1 January in the year following the year in which the auditor was so registered, and each registration is subject to annual renewal?

Each registration should remain in force for one year (subject to exercise of sanctions) and should be subject to annual renewal. We suggest that the "registration year" should run from 1 July to 30 June to avoid registration happening during the "busy season" for listed entity audits which predominantly have 31 December year ends, or registration could be staggered over calendar quarters.

Question 11
Do you agree that the register of listed entity auditors should include the types of information on each registered listed entity auditor as proposed in paragraph 3.27?

The registration information proposed in paragraph 3.27 is reasonable and is mostly the same as is already included in the HKICPA record of auditors and audit firms. We support the proposal.

Question 12
Do you agree that FRC should be vested with statutory powers to take over SFC/HKEx's existing roles in receiving and making decisions on applications for recognizing overseas auditors of specific overseas entities which have been approved for listing in Hong Kong on a case-by-case basis?

Yes. It appears sensible that the role of recognizing overseas auditors of specific overseas entities should be moved to the FRC as part of the reform of the regulatory regime.

Although it should not be directly copied the FRC could, by way of reference,use the current SFC investor protection criteria for a foreign company listing in Hong Kong as an example of how a vetting mechanism could be operated.

Question 13
Do you agree that an applicant must meet the criteria as proposed in paragraph 3.30 for being recognised as an overseas auditor of the overseas entity listed in Hong Kong as set out in its application?

The criteria for recognition of an overseas auditor of an overseas entity listed in Hong Kong are a development of the criteria currently set out in the Listing Rules and as a "strengthened status quo" are acceptable in principle. However, we are concerned that a lack of detail in the proposal for "mutual or reciprocal" cooperation agreements between the FRC and overseas regulators may cast doubt on the effectiveness of regulation of non-Hong Kong auditors. We suggest that there should be an explicit requirement for FRC to communicate with relevant overseas regulators to confirm that there will be equivalent regulation of non-Hong Kong auditors.

We suggest that to give additional comfort that non-Hong Kong auditors are being assessed for registration on an equivalent basis as Hong Kong auditors there should be the same requirements for registration of engagement partners, EQC reviewers and individuals responsible for quality control. It could also be clarified that the FRC assessment of a non-Hong Kong auditor for registration would include confirmation of equivalent regulatory and sanctioning procedures and powers in the home jurisdiction. Within the membership of IFIAR there are a number of different regulatory models and IFIAR does not exercise any formal quality control over the work of member bodies. There is no certainty over consistency of approach or quality between national auditor regulators.

Furthermore, the implications of developments in overseas regulatory regimes may add complications e.g. mandatory audit firm rotation that has recently been introduced in Europe could result in an increase in the number of non-Hong Kong auditors of Hong Kong listed entities seeking recognition and approval by the FRC. The HKSAR Government policy to attract more overseas companies to list in Hong Kong will also affect the number of registration applications by non-Hong Kong auditors. We note the intention of the proposals is to ensure only competent and suitably resourced non-Hong Kong auditors are recognized as suitable to audit Hong Kong listed entities and trust that this key principle will be adhered to.

Question 14
Do you agree that the recognition of an overseas auditor of an overseas entity listed in Hong Kong should remain in force until the following 1 January or the time when the overseas auditor ceases to be the auditor of the listed entity in question, whichever is earlier, subject to renewal of the recognition?

Yes, subject to our suggestion on the "registration year" in response to Question 10.

Question 15
Do you agree that the HKICPA Registrar shall maintain and update a list of overseas auditors who were recognised by FRC for entering into audit engagements with specific overseas entities listed in Hong Kong, and make available for public inspection/publish on HKICPA's website the list?

Yes. The registration details of all auditors of Hong Kong listed entities should be kept in the same place. The Mainland audit firms identified by Mainland authorities as being qualified to audit Mainland companies listed in Hong Kong should also be included in the HKICPA Register.

Question 16
(a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers with regard to setting CPD requirements for listed entity auditors, subject to independent oversight by FRC in accordance with paragraph 4.6?

Yes. We agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers to setting CPD requirements for CPAs (practicing). HKICPA CPD requirements meet international standards (International Education Standards set by the International Accounting Education Standards Board) and are reviewed by other professional bodies that recognize the HKICPA qualification.

We also agree in principle that FRC should exercise oversight of the performance of such functions and the exercise of such powers by HKICPA which are applicable to listed entity auditors, subject to additional explanation of how and when FRC will issue directions to HKICPA. Directions should only be made to protect the public interest (e.g. if HKICPA proposed to introduce a standard, without good reason, that deviated significantly from international standards) and not to circumvent exercise of due process by the HKICPA. We also believe that in the event that it needs to issue directions the FRC should be required to give full reasons for its actions to the HKICPA and the government.

(b) Do you agree that FRC should publish the periodic reports received by it as mentioned in paragraph 4.6(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?

The FRC should provide public information on its oversight role and activities through its own report. Reports received by the FRC from the Institute should not be published as a matter of course as to do so may inhibit co-operation and full and frank dialogue between the FRC and the HKICPA.

Question 17

(a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing and assurance to be observed, maintained or otherwise applied by CPAs (practising), and FRC should exercise oversight of the performance of such functions and the exercise of such powers by HKICPA which are applicable to listed entity auditors as proposed in the arrangements set out in paragraph 5.8?

Yes. We agree HKICPA should continue to perform its statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing and assurance to be observed, maintained or otherwise applied by CPAs (practicing). We also agree in principle that FRC should exercise oversight as described in paragraph 4.6 subject to additional explanation of how and when FRC will issue directions to HKICPA. Directions should only be made to protect the public interest and not to circumvent exercise of due process by the HKICPA. We also believe that in the event that it needs to issue directions the FRC should be required to give full reasons for its actions to the HKICPA and the government and that any directions given should follow due process equivalent to HKICPA standard setting process.

Standards on professional ethics, audit and assurance issued by HKICPA are fully converged with international standards and this should remain a key principle of standard setting under the new system. Convergence with international standards and the rigour of due process at international and local level are a strength and positive feature of the Hong Kong capital market.

(b) Do you agree that FRC should publish the periodic reports received by it as mentioned in paragraph 5.8(a) on its website, and provide information on the results of its quality review and the written instructions given by it in its annual report?

The FRC should provide public information on its oversight role and activities through its own report. Reports received by the FRC from the Institute should not be published as a matter of course as to do so may inhibit co-operation and full and frank dialogue between the FRC and the HKICPA.

Question 18
Do you agree that HKICPA and FRC should establish procedures to ensure that the HKICPA Council would duly take into account FRC's views before it makes any decision on the setting of standards on professional ethics, auditing and assurance in relation to listed entity auditors?

Arrangements should be put in place to ensure that FRC can effectively carry out its oversight function. FRC will be able to put forward its view during the standard setting process, as will other stakeholders. We believe that the proposals should result in an arrangement like IAASB model where PIOB can influence the standard setting agenda but cannot dictate the conclusion. This mechanism will ensure FRC views are heard but should not constitute directions by another name.

Question 19
Do you agree with the proposal to transfer statutory functions for conducting recurring inspections of listed entity auditors in respect of their listed entity audit engagements from HKICPA to FRC, with FRC being given the necessary powers as set out in paragraph 6.13 (which are similar to the powers which HKICPA is equipped with under its practice review programme)?

Yes. This is a necessary step to ensure international recognition of the enhanced regulatory regime.

Question 20
Do you agree that FRC's inspection programme should adopt the statutory procedures as set out in paragraph 6.14 with reference to the existing arrangements for HKICPA's practice review programme?

Paragraph 6.14 largely reflects existing HKICPA practice review arrangements which are benchmarked to international best practice and have proved to be effective over several years of use. Therefore they should be adopted by FRC.

However, the relationship between inspection process and outcome and disciplinary proceedings and sanctions needs to be clarified. Is it the intention that all suspected auditing/reporting irregularities will trigger investigation/disciplinary processes? Will inspection results be sufficient to support disciplinary sanctions or will an investigation be required?

We believe that there needs to be more clarity on how inspection and discipline interact. The proposals deal with inspection and discipline almost as two disconnected activities whereas in an effective regulatory system they are part of the same process. In our responses to the consultation we have tried to use terms such as "regulatory action" rather than language that seems to emphasise the separation of the two activities.

We support the need for an inspection programme to be efficient and effective and suggest that regulatory actions available to FRC as outcomes of the inspection process should include the corrective actions proposed in paragraph 7.27. We are already considering making changes to the powers of the HKICPA practice review committee to achieve this and enhance regulatory effectiveness. We further expand on this in our response to Question 30, explaining how to balance the accepted need for effective and timely regulatory actions with the need for fairness and due process.

To facilitate a better understanding of what we see as fully co-ordinated and efficient regulatory system we attach proposals for such a system at **Annex 1** and a diagrammatic representation of how the system would operate at **Annex 3**.

The proposed inspection powers in paragraph 6.17 (subject to our response to Question 23 on 6.17(a)) are equivalent of existing FRC investigation powers and in our view should provide sufficient evidence to support regulatory action without an additional investigation.

Question 21
Do you agree that FRC may delegate its inspection functions and relevant powers to committees formed under its auspices?

Yes. The FRC should be able to adopt operational procedures that ensure efficiency and effectiveness of the enhanced regulatory regime.

Question 22
What are your views on whether FRC should be allowed to delegate to HKICPA its functions and powers to inspect listed entity auditors in respect of their listed entity audit engagements; and if so, what checks-and-balances measures should be introduced to ensure proper delegation and accountability for the quality of the work so delegated to HKICPA?

Our views on this are neutral. We see benefits in using existing HKICPA skills and experience to develop similar capacity in FRC, especially during the initial stages of establishment of the new regime. There would need to be appropriate checks and balances to ensure proper delegation and accountability for the quality of the work so delegated but these need not be unduly complicated and could be established in a MoU between FRC and HKICPA. However, we have some concerns that without proper forward planning and control delegation could result in fluctuating demand and have a negative effect on HKICPA management of costs and resources.

Question 23
Do you agree that FRC reviewers should be given the proposed statutory powers as set out in paragraph 6.17 in relation to their inspections?

Most of the proposed statutory powers are the same as currently exist for the HKICPA system of practice review and we therefore consider them to be appropriate for the FRC reviewers. However, the proposed power of entry to auditors' premises does not exist in the PAO or the FRCO. We consider it is excessive and unnecessary for a routine inspection programme. The other proposed powers are quite sufficient to ensure access to all information that would be required to carry out a full inspection.

Question 24
(a) Do you agree with the proposal to provide for criminal offences against a person who fails to comply with the requirements in relation to FRC's inspections?

We do not agree with this proposal. The proposal is based on investigation arrangements of the FRC and other financial market regulators and fails to recognize that a routine inspection programme carried out by the regulator of listed entity auditors is entirely different to an investigation into a suspected and specific incidence of wrong-doing. Failure to comply with requirements in relation to FRC inspections should be dealt with under the enforcement powers and sanctions of the regulatory system and not criminal law. The ultimate sanction against an auditor that fails to comply with its regulator should be exclusion from the register and the listed entity audit market.

If a failure to comply with inspection requirements, or any inspection findings, raise suspicions of or reveal criminal activity by an auditor then other enforcement agencies will have powers to take action.

In its current role the FRC has no relationship with auditors that allow it to take action against failure to comply with investigation proceedings. The creation of a register of listed entity auditors and specified individuals will create a regulatory relationship and therefore criminal offences will not be needed in respect of inspections.

(b) If so, do you agree that the provisions on such criminal offences should be modelled on the existing provisions in the FRCO concerning failure to comply with requirements in relation to an investigation into relevant irregularities?

N/A

Question 25
Do you agree that the secrecy provisions in the PAO and the FRCO should be suitably amended to provide that both HKICPA and FRC could share their inspection results with each other to facilitate them to coordinate their inspection activities?

Yes. The secrecy provisions in the PAO and the FRCO should be amended as necessary to facilitate coordination of HKICPA and FRC inspection activities so as to minimize duplication of work and disruption to auditors.

Question 26
Do you agree that FRC should continue to be responsible for conducting independent investigations into relevant irregularities by listed entity auditors?

Yes. There is no reason to make any changes to this existing function of FRC.

Question 27
Do you agree that a disciplinary action may be imposed on a listed entity auditor, a person approved to be its audit engagement authorised person and/or a person approved to be its engagement quality control reviewer if the listed entity auditor and/or the person concerned (as the case maybe) is proved to have committed an irregularity in relation to an audit engagement?

We agree with this proposal – subject to our comments on the definition of "irregularity" in responding to Question 28 below. Both firm and/or individual, if proved responsible for an irregularity should be subject to regulatory action.

Question 28
Do you agree that the definition of "irregularity" under the new regulatory regime should be refined to cover irregularities in respect of all audit and assurance engagements undertaken by listed entity auditors with listed entities as required under the Listing Rules?

The regulatory regime should cover all audit and assurance engagements related to listed entities as required by the Listing Rules. However, we believe that the definition of "irregularity" should be revisited and refined to reflect the expanded scope of work of the FRC. The major activity of the FRC as an independent regulator of listed entity auditors will be regular inspections of auditors and reaching reasonable conclusions and outcomes based on the results of inspections. The main focus of inspections will be compliance with professional standards. The current definition of irregularity was developed to allow the FRC to undertake its original purpose – to investigate Hong Kong auditors. Recognizing that the HKICPA has regulatory responsibility for

inspection and disciplinary actions, the current definition of irregularity refers widely to the powers of the HKICPA under the PAO and has no provision for regulation of non-Hong Kong auditors of entities listed in Hong Kong. The definition should therefore be reviewed to reflect the proposed authority and scope of work of the FRC, to eliminate overlap with continuing statutory responsibilities of the HKICPA and to address authority over non-Hong Kong auditors.

Question 29
What is your view on whether the new regime should specifically provide that the individual/individuals who assume(s) ultimate responsibility for the system of quality control of a practice unit would be held accountable for the absence/systemic failure of such system, and whether it should stipulate expressly that such responsible person(s) shall be the practice unit's chief executive officer (or equivalent) or, if appropriate, members of the practice unit's managing board of partners (or equivalent)?

The description of the individual(s) with responsibility for a firms system of quality control is lifted from HKSQC1 and therefore we have no objection to the same description being stipulated in legislation.

However, we believe there would generally be no need to take action against individuals as systemic failures are the collective responsibility of all partners of a CPA firm. It would be useful to understand how and when the FRC would expect to take action against stipulated individuals e.g. what would be considered a "systemic" failure.

Question 30
Do you agree that FRC, as the future independent auditor oversight body, should be vested with disciplinary powers, including powers to make decisions on disciplinary cases, concerning listed entity auditors, subject to the requirements for ensuring fairness and a due process as proposed in paragraphs 7.21 to 7.24?

We accept that for the future regulatory regime to be effective the FRC will need to have appropriate decision making and sanctioning powers. In principle the proposed requirements for ensuring fairness and due process in disciplinary action go some way to establishing appropriate checks and balances which are a necessary part of disciplinary procedures. In particular, we welcome the proposal in paragraph 7.24 that inspection and investigative staff will not be involved in the determination of sanctions. However, we have some continuing concerns about how regulatory powers will be exercised in practice:

1. Paragraph 7.21 implies that a regulatory decision will be made by the FRC before a hearing takes place and therefore that the hearing will effectively be an appeal against an initial decision. We believe that an audit firm should be heard at and involved in all stages of sanctioning proceedings.

2. We appreciate that the proposal in paragraph 7.22 to form an expert panel to advise the FRC is attempting to address previously expressed concerns about regulatory decisions needing to be based on appropriate knowledge of professional standards and audit process. However, we believe that such knowledge should be within the decision making body (in the proposal the FRC) itself and that bringing in an expert panel to provide non-binding advice to the decision making body does not go far enough in addressing our concern and will only add complexity and potential confusion to the process.

3. We agree that the sanctioning mechanism must be independent from the audit profession but believe that it is also important that there is a clear separation between inspection/investigation and the sanctioning mechanism within the independent regulatory body (the FRC). The information in paragraphs7.9, 7.10 and 7.11 indicates that there are a number of different models in other jurisdictions but does not make a case for not segregating inspection and sanctions. Notwithstanding our comment above about the proposals in paragraph 7.24 it appears that the decision making entity at every stage (inspection, investigation and discipline) will be "the FRC". There is no indication that separate boards or committees will be established within the overall organization to ensure the separation of activity and responsibility that we believe is necessary. The proposed concentration of powers in a single entity is a significant step back from the current system and is not in line with international practice in auditor regulation. In our view this model is totally unacceptable.

The comments we have provided in response to Question 20 and the proposals we have made for a decision making structure to deal with inspection outcomes (**Annex 1** and **Annex 3**) are also relevant to this question. There needs to be further consideration and explanation of how inspection and sanctions are linked together to balance the different demands for efficiency and effectiveness in the new regulatory system.

We do not believe it is appropriate or efficient for all decisions on inspection and investigation outcomes, participation in disciplinary proceedings and determination of sanctions based on all three activities to be undertaken by the same body (the Council of the FRC),a body which in our view should be focusing on strategy and direction rather than involvement in operational activities. We have therefore suggested that a committee is established, responsible to the Council of the FRC, consisting of suitably skilled and experienced individuals to consider the results of inspections and decide on appropriate outcomes, including the exercise of sanctions if necessary. An auditor should have the right to the same level of representation before the committee as the

FRC inspection team. An independent tribunal will be established to hear non-acceptance of the committee's decisions and to judge on the application of more serious sanctions. Consideration should be given to remunerating volunteer members of the committee and tribunal members to facilitate timely conclusion of consideration of inspection results and appeals.

In addition to actions set out in paragraph 6.14 ((d) (to initiate disciplinary processes if an irregularity is found) may be amended or omitted if our proposals are accepted) the committee should have access to the full range of sanctions set out in paragraph 7.27. Sanctions amounting to remedial or corrective actions i.e. directing a specific course of action e.g. undertake training on a particular audit procedure or on audit approach to a specific industry, and applying conditions to registration of firms or individuals e.g. not allowed to sign audit opinions for clients in a specified industry for a period of time or until training has been undertaken will have immediate effect. The auditor can appeal to the independent tribunal against the decision and if the appeal is upheld the sanction will be revoked. The auditor can apply to the tribunal for the effect of the sanction to be stayed for the duration of the appeal process. If the committee considers that more serious sanctions may be appropriate i.e. reprimands, fines or suspension/withdrawal of registration, this will become effective only when accepted by the audit firm or individual or confirmed by a hearing before the independent tribunal. **Annex 4** sets out our views on when regulatory decisions and sanctions should become effective and be publicized.

It is important to ensure that there is no premature disclosure of the consideration of serious sanctions against an audit firm. Firms consider reputational damage to be most serious and therefore proposed sanctions should not be disclosed to the public until finalized and approved through the appeal mechanism if appropriate.

As we have explained, we do not believe that the Council of the FRC should be the sole decision making body for all areas of activity, hence the suggestion that a committee is set up with the express responsibility for concluding on the outcome of inspections and determining appropriate sanctions if necessary. This could be a sub-committee of the Council and include a number of Council members. We suggest a total of 7 members with a non-practicing majority and at least three being experienced auditors. If it is decided to proceed with the proposal that the FRC Council takes on this role then it is vital that the Council includes sufficient numbers of experienced auditors and does not include the Chief Executive who will have led the inspection process.

We believe this is a practical and workable proposal. It is very similar to the mechanism established by the UK FRC to deal with the outcomes of inspections and similar committees exist within the structure of independent regulators in other jurisdictions (e.g. Singapore, South Africa and Japan). The benefits of such an arrangement are that there is an effective and transparent separation of functions, timely corrective actions, appropriate experience and skills are embedded in the

decision making bodies at all stages and that the workload is properly managed and distributed throughout the system.

Question 31
Do you agree that FRC should be empowered to exercise the range of disciplinary powers on a person subject to disciplinary action outlined in paragraph 7.27?

Subject to the comments below relating to pecuniary penalties we believe the proposed powers in paragraph 7.27 are appropriate powers to be available to the regulator of listed entity auditors.

We do not believe that "three times the amount of the profit gained or loss avoided" is an appropriate measure to use in calculating the potential maximum amount of a pecuniary penalty. The main justification seems to be that it is a measure used by other financial regulators in Hong Kong. We do not believe that this is a fair comparison because auditors are not market participants – they do not sell financial products or hold client assets, but rather provide a service to listed companies in the same way that lawyers provide legal services.

We also believe that the proposed alternative measure of a maximum penalty of $10,000,000 is lifted directly from other financial regulatory systems and is too high. The concerns of small and medium sized audit firms about the potential effects are summarized in the consultation paper.

In our view it would be sufficient to have a simple monetary cap of $5,000,000 with clear and strong guidance on how to determine the appropriate amount of a penalty.

Question 32
Do you agree that FRC should be required by law to issue guidelines to indicate the manner in which it exercises its power to order a person subject to disciplinary action to pay a pecuniary penalty, and to have regard to the issued guidelines when exercising such power?

We believe that guidelines on how to determine the appropriate amount of a pecuniary penalty are essential and support the indicative factors that are included as examples in paragraph 7.29. The scale or severity of the auditing irregularity should be a key consideration, more so that the size of the audit firm as included in paragraph 7.29(d). We believe such guidelines should be developed as soon as possible to start to develop an understanding and trust between the FRC and the auditing profession that will be necessary for an effective and efficient regulatory regime and to be presented to the Legislative Council for consideration with the main legislation.

An example of how such guidelines could be structured is attached at **Annex 2**.

Question 33
Do you agree that any pecuniary penalty paid to or recovered by FRC would be paid by FRC into the Government general revenue?

Yes. This arrangement would avoid any accusations that FRC disciplinary action is influenced by funding requirements.

Question 34
Do you agree that FRC may enter into a resolution with the person subject to disciplinary action at any time it is contemplating exercising its disciplinary power, and in exercising such power, FRC must consider it appropriate to do so in the interest of the investing public or in the public interest?

We agree that provision for settlement as an alternative resolution to potential or ongoing regulatory action should be allowed subject to suitable guidelines and policies to avoid any allegation that settlement is being used to short cut due process. The overriding principle must be resolution by settlement is in the public interest.

Question 35
Do you agree that any amount paid to or recovered by FRC arising from a resolution would be paid by FRC into the Government general revenue?

Yes. See our response to question 33.

Question 36
Do you agree that a new independent appeals tribunal should be set up for hearing appeals in respect of registration decisions made by the HKICPA Registrar and disciplinary decisions made by FRC?

Yes. We agree that an independent tribunal should be set up and that it should hear appeals from both sources. There may also be appeals against registration decisions made by the FRC which should also be heard by the tribunal. The tribunal should be supported by an independent secretariat. To make good use of existing and appropriately skilled resources such support could come from the Market Misconduct Tribunal secretariat.

Question 37
(a) Do you agree that a person who disagrees with a registration decision made in respect of him or is aggrieved by a disciplinary decision made in respect of him may apply to the new independent appeals tribunal for a review of the decision within 21 days after a notice of the relevant decision has been served upon him?

Yes. 21 days seems a sufficient length of time for an auditor to decide whether to apply for a review of a registration decision or sanction proposed by the FRC (subject to our proposals in Annex 1 on decision making structure and exercise of sanctions).

Decisions on registration of non-Hong Kong auditors are proposed to be made by the FRC not the HKICPA Registrar. Paragraphs 8.3 and 8.4 should recognize that the appeal mechanism will also cover appeals against an FRC registration decision. As explained in our response to Question 9 decisions to refuse registration should not be made public.

(b) If so, do you agree that the independent appeals tribunal may, upon application by the relevant person, grant an extension to application for review of a specified decision, and that such extension should only be granted after the applicant and FRC have been given a reasonable opportunity to be heard on the proposed extension and the independent appeals tribunal is satisfied that there is a good cause for granting the extension?

Yes there should be provision for extension of application for review of a decision provided there is good cause.

Question 38
Do you agree with the composition of the independent appeals tribunal as proposed in paragraph 8.6, i.e. a chairman who is a person qualified for appointment as a judge of the High Court and two members who are not public officers, all to be appointed by the Chief Executive?

We agree with the proposal for the qualification requirements for the chairman of the independent appeals tribunal. However, we believe that it is important that the composition of the tribunal ensures that the tribunal has sufficient understanding of professional standards and the audit profession. To achieve this, our preference would be for a five member tribunal with two having up to date auditing knowledge and experience.

Question 39
Do you agree that the independent appeals tribunal may exercise the proposed powers as outlined in paragraph 8.7 in the review proceedings?

We agree with the powers proposed for the independent appeals tribunal in paragraph 8.7.

Question 40
Do you agree that sittings of the independent appeals tribunal should be held in public unless in the interests of justice it determines otherwise?

Public sittings of the tribunal would be in line with existing HKICPA disciplinary proceedings rules. However, as we have stated in our response to Question 30 concerns over premature disclosure of regulatory action and potential consequential damage to an auditor's reputation need to be addressed. At the very least hearing of cases concerning registration and corrective sanctions should not be held in public and such decisions should not be made public until conclusion of tribunal hearings.

Question 41
(a) Do you agree that a party to the appeal who is dissatisfied with a determination of the independent appeals tribunal may further appeal to the Court of Appeal on a question of law, fact, or mixed law and fact?

Yes, we agree.

(b) If so, do you agree that no appeal to the Court of Appeal may be made unless leave to appeal has been granted by the same Court, and the leave may only be granted if the Court of Appeal is satisfied that the appeal has a reasonable prospect of success or there is some other reason in the interests of justice why the appeal should be heard?

We have some concern that this proposal limits an auditor's ability to appeal to the Court of Appeal and that such limitation does not currently exist under the HKICPA disciplinary process.

Question 42
Do you agree that under the new regulatory regime, FRC should be funded by way of introducing three new levies on (a) listed entities; (b) securities transactions; and (c) listed entity auditors such that they will each provide roughly equal contributions to FRC i.e. one third from listed entities, one third from securities investors and one third from listed entity auditors?

The re-introduction of listed entity auditors into the future FRC funding model came as a surprise as discussions at the tripartite meetings for the development of the Draft Framework had been made on the basis that listed entity auditors would not be a funding party. We believe that better justification should be given for including listed entity auditors as contributors of one third of future FRC funding.

As the change in the regulatory system is designed to enhance investor confidence and protection we believe that the most appropriate source of future funding for the FRC is through transaction levies. The actual amount paid by investors would vary based on market cap of the listed entities traded and volume of transactions and therefore more significant and active market participants would bear proportionally more of the costs of funding the enhanced regulatory system.

We also believe that for any proposed future funding party to be able to fully respond to the proposals there must be an indication of the quantum of costs that will be needed to establish and operate the new regime.

We have a concern that there is insufficient detail on checks and balances that will be in place to ensure that future operating cost of the FRC will be properly monitored and controlled and that funding parties are not being expected to write blank cheques. Without compromising the independence of the FRC there needs to be a degree of accountability to funding parties. Given that under the proposals the government will not be a future funding party and will not be represented on the council of the FRC we question whether, in these circumstances, approval of FRC annual budget by the Secretary for Financial Services and the Treasury will be a sufficient control mechanism.

In view that a major aim of changing the regime for regulating auditors of listed entities is to reinforce Hong Kong's status as an international financial centre we believe that it is entirely appropriate that the government continues, if not as a funding party of the FRC then at least with representation on the council of the FRC. This would provide all funding parties and market participants with confidence that there would be appropriate monitoring of governance and operations of the FRC.

Question 43
Do you agree that –
(a) the levy on listed entities should be based on the prevailing formula under which listed entities pay their annual listing fees to HKEx, and that the levy should be collected by HKEx on behalf of FRC;
(b) the levy on securities transactions should be based on the modus operandi for the existing levy charged by SFC under the Securities and Futures Ordinance, and that the levy should be collected by SFC on behalf of FRC; and
(c) the levy on listed entity auditors should be directly proportional to the number of listed entity audit engagements entered into by the listed entity auditors, and that the levy should be collected by the HKICPA Registrar on behalf of FRC?

Subject to our overall comment in response to question 42 we believe the proposed bases of charging and collection mechanisms are acceptable. We do not agree that the HKICPA Registrar should be responsible for collecting the levy from listed entity auditors. The HKICPA will not be a funding party and does not have the same sort of transactional relationship that HKEx and SFC have with listed entities and market participants respectively. There seems to be no good reason why the FRC could not collect the levy from listed entity auditors directly.

We also question how and by whom the levy will be collected from non-Hong Kong auditors.

Question 44
Do you agree that the three levies should be stipulated in subsidiary legislation subject to negative vetting by the Legislative Council?

Subject to our overall comment in response to question 43 and on the basis that this question is to do with setting or adjusting the quantum of levies we agree with this proposal.

Question 45
Do you agree that FRC should be required to review the levels of the three levies once its reserve has reached a level equivalent to 24 months of its operating expense, after deducting depreciation and all provisions?

In our view a reserve equivalent to 24 months of operating expenses, after deducting depreciation and provisions, is excessive and that 12 months would be acceptable. Therefore the level of all levies should be reviewed when a reserve of 12 months expenses has been reached.

Question 46
(a) Do you agree with the proposed new composition of FRC membership, i.e. not fewer than seven members appointed by the Chief Executive, together with the FRC Chief Executive Officer as an ex-officio member, and abolishing the existing arrangements for the nomination of FRC members and for the Registrar of Companies to be an ex-officio member as set out in paragraph 10.6?

We believe that the absolute number of FRC members is not the key issue but there seems to be no good reason for reducing the number of members from the existing level given that the significant increase in activities under the new regime will result in a far heavier workload for the FRC. We suggest the FRC should have no fewer than nine members with at least one third having appropriate knowledge and experience of listed entity auditing. There must be enough FRC members to ensure there are always sufficient numbers to reach reasoned decisions in the inevitable event that individual members are excluded by conflicts of interest.

We mention here and elsewhere in our response the critical importance of having appropriate skills, up to date auditing experience and knowledge and a full understanding of the audit process in any decision making organ within a regulator of auditors. We have suggested a dedicated committee is created to determine inspection outcomes but the consultation paper suggests that the FRC Council will become the decision making body in respect of all inspection and investigation work and sanctioning. As we have stated in our response to Question 30 we do not believe that such an arrangement is acceptable but if this is the model introduced then our comments above on requirements for skills, experience and knowledge should apply to the FRC Council.

It must be recognized that the depth of knowledge and breadth of understanding about auditing to successfully carry out all of the proposed roles of the FRC will be far greater than needed for the currently much more limited role of the FRC. There is a big difference between deciding that an investigation report shows reasonable suspicion of an irregularity, with the final decision on sanctions left to another body, and reaching a conclusion that evidence provided by an inspection is sufficient to prove an irregularity and determining a sanction that is reasonable and proportionate.

As we have noted in our response to Question 30, if the FRC Council does become the decision making body in respect of all inspection and investigation work and sanctioning then the inclusion of the CEO in the Council would give rise to unacceptable conflicts of interest.

(b) Do you agree that there should be at least two persons who possess knowledge of and experience in the auditing of Hong Kong listed entities out of the FRC members to be appointed by the Chief Executive?

We believe that it is critical that there should be sufficient FRC members with up to date knowledge and experience of auditing Hong Kong listed entities to ensure that the strategy and direction of the independent regulator and, if such powers do rest with the Council, decisions on outcome of inspections, investigation and disciplinary proceedings are appropriately informed. We suggest that at least one third of FRC members should have such knowledge and experience.

Question 47
Do you agree that FRC will be required to have a chairman and a majority of members who are non-practitioners, with a non-practitioner being defined as a person who (a) is not, or has not during the previous three years been, a CPA (practising); and (b) is not, or has not during the previous three years been, a partner, director, agent or employee of a practice unit?

We agree with the definition of non-practitioner and that the FRC should have a chairman and majority of members who are non-practitioners.

Annex 1

Proposed operational details for the new regulatory system

Enforcement procedures and sanctions based on inspection findings

Procedures – key features

1. Enforcement/disciplinary procedures and regulatory actions including sanctions available to the FRC under the new system will only apply to poor quality audit work (failure to comply with quality control, audit or ethics standards issued by the HKICPA) identified by inspection of listed company auditors that warrants regulatory action.

2. FRC enforcement procedures will not replace the HKICPA's disciplinary arrangements over members' professional conduct. The scope of the FRC enforcement procedures extends only to non-compliance with quality control, auditing or ethical standards in connection with the audits of listed entities. The FRC only has authority over firms and individuals named in the register of listed entity auditors.

3. Wider implications about e.g. professional conduct or integrity of HKICPA members will be assessed and dealt with under existing HKICPA disciplinary arrangements. As a general principle HKICPA will not take disciplinary action that duplicates FRC enforcement action.

4. Results of inspections by FRC staff will be reported to an appropriately constituted and skilled committee of the FRC (equivalent of the HKICPA practice review committee) which will consider whether poor quality audit work has been identified that warrants regulatory action. It is not intended that regulatory action will be taken against auditors for every technical failure (the results of most inspections will be dealt with by outcomes described paragraph 6.14 of the consultation paper).

5. Auditors will be provided with a copy of the inspection report and given the opportunity to respond. Auditors' responses to the report will be presented to the committee for consideration along with the report. Auditors should be given the same opportunity for representation before the committee as inspection staff.

6. The decision making committee of the FRC should be independent of the inspection teams (to maintain independence inspection teams should not provide secretarial support to the committee). The committee should include a sufficient number of individuals with up to date experience of auditing listed companies and appropriate competencies to ensure that conclusions on "adequacy" of audit are made on a fully informed basis. Any perceived need for "lay" committee members (and/or chairperson) should not outweigh the need for the committee to be appropriately skilled and experienced to achieve its objectives.

7. The committee will be able to take the actions set out in paragraph 6.14 of the consultation paper but in addition should have the ability to consider sanctions set out in paragraph 7.27 and referred to as disciplinary powers.

8. Procedures to apply sanctions should only be undertaken when the continued activity of a listed company auditor without conditions or restrictions could adversely affect a listed company audit client; and/or a sanction is necessary to ensure audit functions are undertaken, supervised and managed effectively.

9. The range of sanctions will be as set out in the consultation paper – reprimand, directions, conditions, monetary penalty, suspension or revocation of registration. The committee may accept written undertakings from an auditor as an alternative to sanctions if that is considered a more acceptable course of action.

10. If the committee decides that there are matters that warrant regulatory action it will determine and offer an appropriate sanction to the auditor. The basis of decision must be made known to the auditor and the auditor given an opportunity to make further representations (initial representations on the inspection findings will have been made to the committee at the same time as the findings are presented).

11. The committee should consider all sanctions available and determine which is appropriate. Sanctions that are of a corrective nature i.e. direct remedial actions and impose conditions on registration, will have immediate effect but may be revoked if not accepted and an appeal to the independent tribunal is upheld. The auditor can apply to the tribunal for the effect of the sanction to be stayed for the duration of the appeal process. More serious sanctions i.e. reprimand, fines and suspension/withdrawal of registration, will take effect only when accepted by the auditor or confirmed by a hearing before the independent tribunal.

12. The committee may vary its proposed sanction after receiving further representations from the auditor.

13. If the auditor accepts the sanction the matter is concluded on that basis. The basis of conclusion, including the sanctions accepted, will be made public.

14. If the auditor does not accept the sanction the matter will be referred to the independent (external to the FRC) tribunal. Cases involving corrective sanctions will be heard as an appeal against the committee decision. In cases where punitive sanctions are proposed the tribunal will not be advised of the sanction offered by the committee and refused by the auditor and will deal with the case as a first hearing.

15. The tribunal (at least five members) will have a lay majority and chair and include members with sufficient audit experience to give the matter a full and fair hearing. Consideration should be given to remunerating tribunal members to encourage timely proceedings and decisions.

16. Tribunal hearings will consider the case again, as if it was the committee. Tribunal consideration and determination of sanctions will follow the same principles that apply to the committee.

17. Tribunal hearings will be public, unless not in the public interest. Auditors have the right to be present and be heard and witnesses may be called.

18. Tribunal findings and decisions on sanctions will be made public. Tribunal decisions may be appealed to the Court of Appeal.

Sanctions - principles

19. Sanctions guidance and application should be consistent with the five principles of good regulation – proportionality, accountability, consistency, transparency and targeting – and the overarching principles of fairness and natural justice.

20. Sanctions should be determined by reference to the general regulatory objectives of the inspection programme. The purpose of using sanctions to deal with a failure to comply with professional standards is as a deterrent against future non-compliance to protect the public and the wider public interest.

21. Determination of sanctions should involve consideration of the whole circumstances and seriousness of the failure. A wide range of factors should be considered including financial benefit or loss, number of people affected, whether the failure involved ethical issues and previous record of the auditor on complying with standards.

22. There are a wide range of factors to consider in deciding what type of sanction is most appropriate – a brief summary is provided below. Sanctions can be used in combination but the appropriateness of each should be considered separately. (see **Annex 2** for more detailed guidance on determination of sanctions.)

23. Directions and/or conditions might be appropriate when there are shortcomings in a particular area of practice or to address a repeated but relatively minor breach of standards. (Directions and/or conditions do not extend to suspension of registration.)

24. Suspension of registration may be appropriate when directions, conditions or penalties are not sufficient to address concerns that shortcomings in competence or failure to comply with standards are so serious that the auditor should not be permitted to undertake audits for a period, or when the failure is so serious that public confidence in the quality of auditors is damaged.

25. Withdrawal of registration is the most serious sanction that should be reserved for fundamental failings in compliance and where continuing practice would be so damaging to public and market interest that withdrawal is the only appropriate and proportionate sanction.

Annex 2

Determination of sanctions

Summary of approach

1. Committee or tribunal will make a decision whether a listed company auditor has failed to comply with professional standards, and if so whether:

    a. Their continued registration or continued registration without direction or condition would adversely affect a listed company audit client or any other person; and/or
    b. A sanction is necessary to ensure that their audit functions are undertaken, supervised or managed effectively.

2. When the committee or tribunal is satisfied that these tests have been met and that a sanction is therefore appropriate or necessary the normal approach to determining the sanction should be to:

    a. Assess the nature and seriousness of the failure;
    b. Identify sanctions that are potentially appropriate or necessary;
    c. Consider any relevant aggravating or mitigating circumstances and how these affect the level of sanction;
    d. Consider any further adjustment necessary to achieve the appropriate deterrent effect;
    e. Consider whether a discount for admission or settlement is appropriate; and
    f. Decide which sanction to apply and the level/duration of the sanction where appropriate.

Determination of sanctions

3. The full circumstances of each case should be considered to determine which sanction should be imposed. The following factors may be relevant to the committee or tribunal's consideration but there may be other factors and not all listed factors will apply to all cases. The relative weight of factors must also be considered by the committee or tribunal.

4. Nature and seriousness of the failure will be determined by a number of factors. The extent to which intent, recklessness, knowledge of risk or consequences, negligence or incompetence will vary from case to case. Factors which are likely to be relevant, but are not necessarily exhaustive, are:

    a. Whether the failure was intentional or deliberate;
    b. Whether the failure occurred as a result of recklessness;
    c. Nature, extent or importance of the standards or regulations breached;
    d. How far short of the standards the auditor fell;
    e. Whether the failure adversely affected or potentially adversely affected a number of people (the client, the public, investors, consumers, employees, pensioners etc.);

f. Whether the failure could undermine confidence in the standards of auditors generally;
g. Whether the failure involved ethical issues;
h. Whether the failure was isolated, repeated or ongoing and if repeated or ongoing the length of time over which the failures occurred;
i. Whether similar failures have been identified in previous inspections and if so what steps had been taken to address them;
j. Whether the auditor had failed to comply with a previous written undertaking that is relevant to the failure;
k. Whether senior management foresaw that a failure would occur or allowed it to occur;
l. Whether senior management took or allowed action knowing that they or others were acting outside their field of competence;
m. Effectiveness of internal procedures, systems and guidance;
n. Whether it is likely the same type of failing will recur;
o. Arrangements for supervision and management of the performance of audits;
p. Financial benefit derived or loss avoided, for or by the auditor or others, as a result of the failure; and
q. Whether the failure caused actual or potential loss of significant sums of money.

5. Having assessed the nature and seriousness of the failure and determined an appropriate sanction the committee or tribunal will consider whether to adjust the sanction to reflect any aggravating or mitigating factors.

6. Events or behavior that could be considered aggravating factors may include:

a. The auditor failed to co-operate with or hindered the inspection;
b. Senior management were aware of the failure or that failure was likely but took no steps to prevent it;
c. Senior management or an engagement partner sought to conceal or reduce the risk that the failure would be discovered;
d. Similar findings were identified in a previous inspection;
e. No remedial steps taken to address previous inspection findings;
f. Failings repeated and/or occurred over an extended period of time;
g. The auditor has failed to comply with previous written undertakings; and
h. The auditor has previously been sanctioned.

7. Events or behavior that could be considered mitigating factors may include:

a. Co-operation during the inspection and with the committee or tribunal considering the report;
b. The auditor had taken steps to stop or prevent the failing;
c. The auditor has proper policies and structures in place;
d. The auditor has shown awareness of relevant standards;

e. Appropriate remedial action was taken promptly when the failing was identified;
f. The auditor brought the failure to the attention of the regulator;
g. The auditor was misled by a third party;
h. The failing was an isolated event that is unlikely to be repeated;
i. The auditor did not stand to profit or gain any benefit from the failure;
j. The auditor has a good compliance history; and
k. The auditor has shown contrition.

8. If the committee or tribunal, after determining the sanction and adjusting for any aggravating or mitigating factors, consider that the sanction is insufficient to deter the auditor from making similar or further failings it may adjust the sanction to achieve the intended deterrent effect.

9. In the event of a settlement or admission the committee or tribunal may consider discounting the determined sanction.

Specific sanctions

10. **Directions and/or conditions** might be the most appropriate sanctions when the shortcoming is identified in a particular area of the practice or there have been relatively minor or inadvertent breaches of standards. Directions and/or conditions should be appropriate, proportionate, workable and measurable and not amount to an inability to practice.

11. An order imposing directions and/or conditions will be accompanied by provisions addressing:

    a. The period for which a direction not to undertake a specified type of engagements remains in effect;
    b. The period for which a condition remains in effect;
    c. Any timescale within which a condition must be fulfilled; and
    d. Procedures to apply for variation or discharge of an order.

12. **Monetary penalties** can be used alone or in combination with other sanctions but only used alone if there are no concerns that continued registration without directions or conditions could adversely affect an audit client or other person and it is sufficient to ensure that audits are undertaken, supervised and managed effectively.

13. Determination of whether a monetary penalty is an appropriate sanction would normally involve considering whether:

    a. Other sanctions (directions, conditions, suspension or withdrawal of registration) alone would not be sufficient to address the concerns of the committee or tribunal;
    b. The auditor has derived financial gain or benefit;

c. The shortcoming identified involved or caused or put at risk the loss of substantial amounts of money; and
d. A monetary penalty was imposed in similar cases.

14. Having arrived at a figure for the penalty based on the nature and seriousness of the case the committee or tribunal should consider the financial circumstances of the auditor and whether it should be adjusted with reference to the factors in paragraphs 3 to 9 above.

15. **Suspension of registration** would be considered only when directions and /or conditions or monetary penalty or both are not sufficient to address the committee or tribunal's concerns. It is a far reaching and serious sanction that should be reserved for cases where concerns about the about the auditors competence and/or ability to comply with standards are so serious that the auditor should be prevented from carrying out audits for a period of time. It may also be used where the failure was so serious that it undermines public confidence in listed company auditors in general. The committee or tribunal must also be satisfied that the failures are capable of being rectified within a reasonable period of time.

16. The period of suspension must be necessary and proportionate and should be determined by considering the nature and seriousness of the failure.

17. **Withdrawal of registration** is the most serious sanction and should be reserved for fundamental breaches of standards and regulations where continued registration would be so damaging to the public, the public interest and market confidence that withdrawal of registration is the only appropriate sanction.

18. Withdrawal of registration may be appropriate where the tribunal considers that there is a lack of willingness to comply with standards and regulation such that the auditor is unlikely to improve and serious failings are likely to continue. Considerations that may be taken into account include:

    a. Previous sanctions in relation to similar failings have not resulted in improvements;
    b. Failings took place over a long period of time with the knowledge or complicity of senior management; or
    c. Conduct that was fundamentally incompatible with continued registration.

19. All other available sanctions must be considered before withdrawing registration to ensure it is the only appropriate sanction and it is proportionate in the circumstances of the case.

Other matters to be considered by committee or tribunal

20. Having regard to further information or representations received from the auditor or inspection team the committee may decide that an **amended or lesser sanction** is appropriate, provided it is still proportionate to the failings and the reasons for imposing the sanction and is sufficient to protect the public and the public interest.

21. Factors which may be relevant to a decision to agree a lesser penalty include:

    a. Further mitigation provided by the auditor;
    b. More detailed explanation about how the failings occurred; and
    c. Other information received after the sanction was initially determined that lessens the seriousness of the failing.

22. **Written undertakings from an auditor** may be accepted by the committee or tribunal when this is sufficient to address the concerns of the committee or tribunal, to prevent an adverse effect on a listed company audit client and to ensure that audits are undertaken, supervised and managed effectively.

23. If written undertakings are accepted the regulator will monitor compliance with the undertakings. Failure to comply will result in the case being re-opened and reconsidered by the committee.

24. By way of example written undertakings may include:

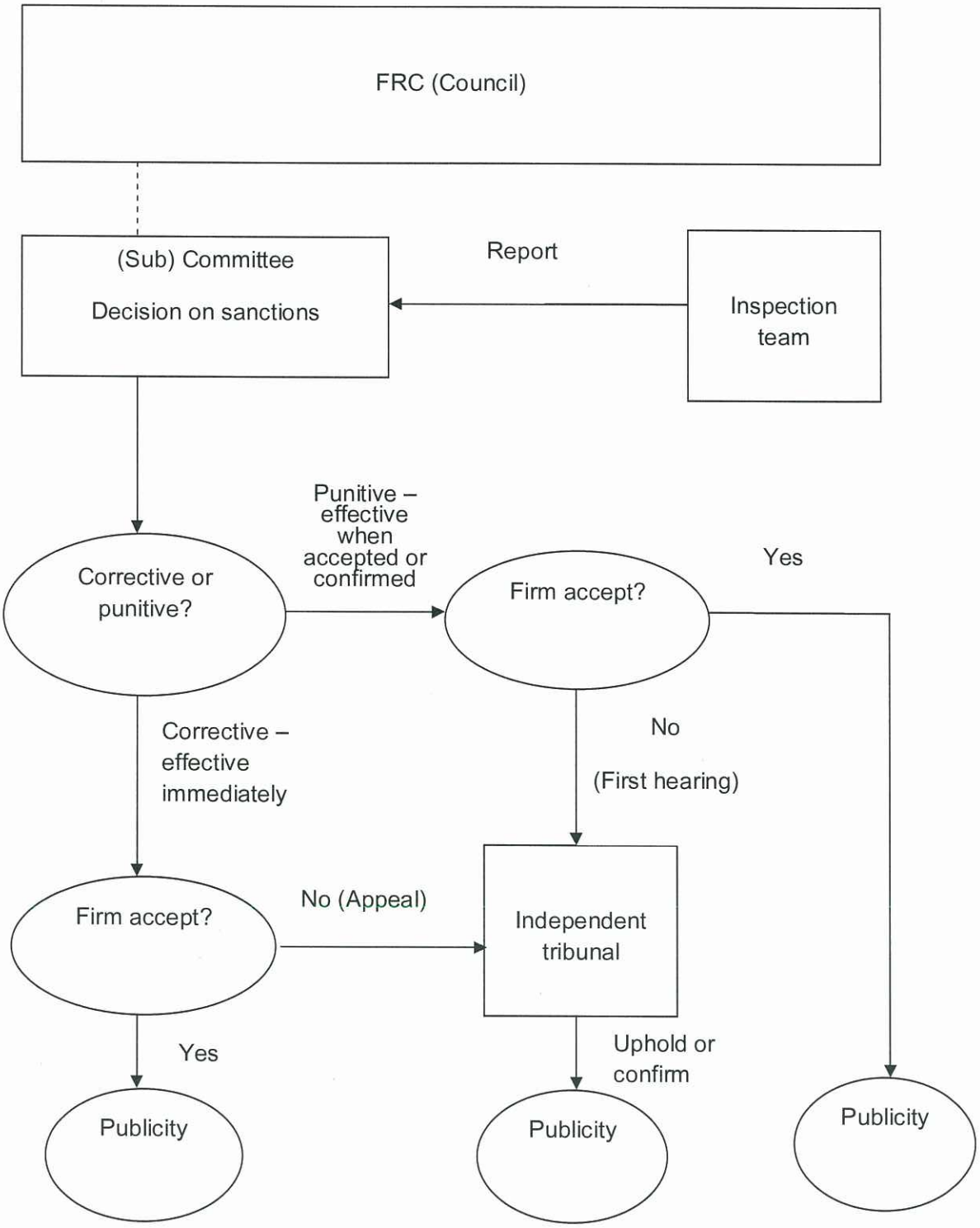
    a. A commitment to impose mandatory audit training on staff;
    b. An agreement not to undertake certain types of audit work; or
    c. A proposal to introduce new policies and procedures to address and prevent further or future failings.

25. The committee may at any time, with the agreement of the auditor vary or revoke a direction, condition or period of suspension. **Variation or revocation of a sanction** will only happen after considering whether:

    a. The auditor has taken steps to ensure the failure will not be repeated;
    b. The auditor has complied with directions, conditions or suggestions made by the committee in connection with a period of suspension;
    c. The sanction in the case of variation or any sanction in the case of revocation, is no longer required; and
    d. The varied sanction is sufficient to protect the public and the public interest.

Annex 3

Sanctioning process flowchart



Annex 4

Regulatory decisions and actions

Decision/action	When effective	Publicity
Initial registration refused	Immediate, may be reversed on appeal to independent tribunal.	None. No public interest element until registration achieved. Publicity may affect future applications.
Regulatory decision – corrective action	Immediate, may be reversed on appeal to independent tribunal. The auditor can apply to the tribunal for sanctions to be stayed for the duration of the appeal process.	Publicity through normal channels immediately after acceptance by the audit firm or decision is upheld by the independent tribunal.
Regulatory decision – punitive action	When accepted by the audit firm or confirmed by decision of the independent tribunal	Publicity through normal channels immediately after acceptance by the audit firm or confirmation by the independent tribunal.