



Dear Assignment/News/Business Editor

For a Better Future of Audit Regulation *HKICPA comments on public consultation paper*

(HONG KONG, 16 September 2014) — The Hong Kong Institute of CPAs ("HKICPA"), the only statutory body for the accountancy profession in Hong Kong, today announced its comments on "Improve the Regulatory Regime for Listed Entity Auditors" consultation paper.

Regulation of listed entity auditors is an important part of the overall regulatory system of Hong Kong capital market. The Institute began its work on audit reform in 2008. It set up a committee and working group and began research and outreach work to propose changes that would meet international best expectations and maintain the standing and reputation of Hong Kong's capital market and auditing profession.

Since 2012, the HKICPA has been working with the Government's Financial Services and the Treasury Bureau ("FSTB") and the Financial Reporting Council ("FRC") to develop a proposed framework that was the basis of a member consultation which concluded in January 2014. The member consultation was a major element of extensive engagement with members and other stakeholders over this very significant initiative. The resulting member consultation indicated strong support for the HKICPA Council's position. There were 42 written responses to the consultation paper and around 4,500 members completed an online questionnaire.

Clement Chan, president of the Institute said, "The current public consultation is a key stage in a very significant regulatory change in the listed entity market that will affect a number of stakeholders. It would be for the benefit of all stakeholders to be provided with full details on how a number of proposed operations and processes are expected to work."

Detail of operations and processes

The Institute believes further examples and details on five areas should be available when draft legislation is presented to the Legislative Council. They are: circumstances that would result in the FRC giving directions to HKICPA while exercising oversight of HKICPA activities; circumstances where a systemic failure in quality control would be considered to have occurred; FRC vetting procedures and criteria about registration of non-Hong Kong auditors; checks and balances to confirm separation of inspection and disciplinary processes and exercise of fairness in regulatory actions against auditors; as well as guidance on determination of regulatory action or sanctions.

Enforcement and disciplinary mechanism

According to the Institute, it is critical to have clear separation of inspection/investigation and disciplinary responsibilities and activities within the regulatory body.

"Introducing a model where all power and decision making is concentrated in a single entity within the FRC is totally unacceptable and not supported by models of auditor regulation operated in other significant jurisdictions," said Chan.

"You don't ask the policemen to also act as judges simply because it takes time to process a case in court," added Raphael Ding, chief executive of the Institute.

The Institute recognizes the need for a regulatory body to have appropriate enforcement powers to ensure effectiveness and efficiency of the regulatory system. However, the Institute believes that fairness and due process should not be compromised in the interest of efficiency. The consultation proposals give some assurance that the FRC will be required to put in place arrangements to achieve this separation despite there is 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 FRC.

Type and application of sanctions

The Institute has 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 gain 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," said Chan, "they do not sell financial products or hold client's assets, but rather provide a service to listed companies in the same way that lawyers provide legal services."

The Institute also believes that the figure of \$10,000,000 is a direct lift from financial market regulation systems. Many small and medium sized firms have expressed their view that the figure is too high and may drive firms out of the listed entity audit market.

The Institute is 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.

Composition of decision making bodies

It is of 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 suggest a dedicated committee to be created to determine inspection outcomes. 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," said Chan.

However, if FRC is designated to be making regulatory decisions on technical and professional matters, the Institute believes all the requirements on skills, experience and knowledge will have to apply to the FRC Council. There is a very big difference on the capability requirement on the current FRC, which only needs to establish whether there is a reasonable suspicion or belief of audit failure for referral to the HKICPA for the latter to decide whether there is sufficient evidence to successfully prove an audit failure before an independent disciplinary committee and act as the complainant.

“Unless the FRC has sufficient number of members who have the necessary experience in auditing and therefore know how to correct deficiencies in audit practices, there is a risk that they may simply rubber stamp the findings of the investigators and inspectors,” added Chan.

“It is also strange that the consultation paper suggests Hong Kong Government to pull out of FRC but retains the power to approve the annual budget of the FRC. The Hong Kong Government has two ex-officio members on the HKICPA Council since the establishment of HKICPA as a self-regulatory body 41 years ago. It is inconceivable why the Hong Kong Government should play no part in an independent regulatory body set up to serve a significant public interest,” said Chan.

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.

The Institute's response is 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.

In respect of an unregistered auditor there are already criminal sanctions under section 42 of the PAO that apply to non-members of HKICPA. Any offender who is a member of HKICPA will be subject to the Institute's disciplinary process.

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 practising certificate 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.

Definition of "irregularity"

The definition in the consultation proposals 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.

Funding

The consultation paper proposes a three party (investors, listed entities and listed entity auditors) funding system for the future operations of the FRC. In the Institute's views, investors, through a transaction levy, should be the main if not only funding party and there

should be an attempt to quantify future operating costs.

“The independent regulatory system is meant to enhance protection to the investors. It is like a taxpayer paying for the service of the police,” said Ding.

The Institute believes 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 having FRC's annual budget approved by the Secretary for FSTB.

"The HKICPA is committed to helping to scope, develop and implement a system of listed entity auditor regulation that will be internationally recognized and effective in maintaining confidence in the audit quality of the Hong Kong market. There should be no need for the system to include features not necessary to achieve such objectives," concluded Chan.

The HKICPA's full submission and comments is available from the Institute website <http://www.hkicpa.org.hk/en/communications/regulatory-framework/>.

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Editor's Note

About the Hong Kong Institute of CPAs

The Hong Kong Institute of CPAs is the only body authorized by law to register and grant practising certificates to Certified Public Accountants in Hong Kong. The Institute has more than 37,000 members and 18,000 registered students. Members of the Institute are entitled to the description *certified public accountant* and to the designation *CPA*.

The Hong Kong Institute of CPAs evolved from the Hong Kong Society of Accountants, which was established on 1 January 1973.

The Institute operates under the Professional Accountants Ordinance and works in the public interest. The Institute has wide-ranging responsibilities, including assuring the quality of entry into the profession through its postgraduate qualification programme and promulgating financial reporting, auditing and ethical standards in Hong Kong. The Institute has responsibility for regulating and promoting efficient accounting practices in Hong Kong to safeguard its leadership as an international financial centre.

The Hong Kong Institute of CPAs is a member of the Global Accounting Alliance - an alliance of the world's leading professional accountancy bodies, which was formed in 2005. The GAA promotes quality services, collaborates on important international issues and works with national regulators, governments and stakeholders.

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