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

By e-mail < Edcomments@ifac.org > and by fax (0062 1 212 286 9570)

2 May 2007

Our Ref.: C/AASC

Senior Technical Manager,
International Ethics Standards Board for Accountants,
International Federation of Accountants,
545 Fifth Avenue, 14th Floor,
New York,
New York 10017,
USA.

Dear Sir,

IESBA Exposure Draft of Sections 290 and 291 of the Code of Ethics on Independence - Audit and Review Engagements, and Other Assurance Engagements

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 provide you with our comments on the captioned IESBA Exposure Draft.

As the statutory licensing body of accountants that leads and serves businesses and the public interest of Hong Kong, we are supportive of the current work of the IESBA which seeks to consider what revisions to auditor independence requirements might be needed given the changing environment in the past few years.

However, having considered the proposals as drafted, our principle concern is that we are determining the independence requirements relating to "Entities of Significant Public Interest" (ESPIs) before we fully understand what is meant by ESPIs. Entities that might be classified as ESPIs can range from entities that are clearly of significant public interest such as listed companies to entities where the public has an interest, such as charities and schools, but the public interest may not be classified as significant.

If ESPIs are limited to listed entities and regulated financial institutions such as banks and insurance companies, the proposals as drafted appear acceptable. At the other end of the spectrum, if ESPIs are extended to include all regulated entities such as charities, schools and accounts of owners' corporation of buildings, there are concerns as to whether the proposals as drafted would be in the public interest and provide benefits to the public when compared with the additional costs to such entities.

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By way of background, all companies incorporated in Hong Kong are subject to a statutory audit and there are currently approximately 600,000 such companies with approximately 1000 being listed companies and the rest primarily private SMEs. Furthermore, approximately 83% of the accounting firms in Hong Kong are sole practitioners with another 13% having only two partners.

The process in the present Exposure Draft requires that we should consider the independence requirements first without clarifying the application of the proposed definition of ESPIs. The consequence of this is that the HKICPA will need to develop a consultation paper (which will take at least twelve months to complete the due process) to identify those entities that should be classified as ESPIs in Hong Kong. We are of the view that determining independence requirements first may distort the later determination of ESPIs. For example, extensive requirements imposed on ESPIs may encourage misclassification of “real” ESPIs as non-ESPIs.

We understand that the significant modifications to the Code in the proposed Exposure Draft that are expected to affect accountants in Hong Kong include:

- Introducing a new term - "key audit partner" which is to include lead partners on significant subsidiaries or divisions who are responsible for key decisions or judgements on the financial statements on which the firm will express an opinion;
- Extending the partner rotation requirements to all key audit partners on an audit of an ESPI; and
- Updating requirements related to the provision of non-assurance services, including setting out additional guidance on the provision of tax services to audit clients.

Without a clear understanding of which entities are ESPIs, it is difficult to determine all the practical consequences of the proposals. Concerns have been raised as to the ongoing divergence from a principles-based system towards a more rules-based approach by the impact of forced rotation of key audit partner (which would lead to firm rotation for smaller firms), and also the delineation of tax and audit services, in areas where this may substantially raise the costs to the entity receiving such services.

We would also, without prejudging the outcome of our consultation paper on what should be an ESPIs, request IESBA to consider carefully the practical business and economic consequences of a more rules-based regime on small businesses and not-for-profit enterprises if a strict definition of ESPIs is to be applied to entities such as charities and schools. We are reluctant to support increases in the costs to such entities unless the benefits can be clearly seen to outweigh the costs.

Finally, we note that the IESBA appears to be emphasizing independence beyond the 5 fundamental principles. Independence is a component of objectivity. Independence cannot guarantee a high quality audit without integrity, objectivity, professional competence and due care, confidentiality and professional behavior. We recommend that the revised Section 290 note that independence contributes to objectivity and the threat and safeguards approach should be interpreted in this light. That is, it should be clearly stated that, despite the high proportion of the Code being devoted to independence, the aim of being independent is to enhance objectivity. Independence is not an aim in isolation.

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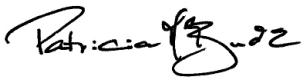
The attachment contains comments on the “Request for Specific Comments” for your consideration.

We trust that our comments are of assistance to you. If you require any clarifications on our comments, please do not hesitate to contact me or Steve Ong, Deputy Director, Standard Setting (ong@hkicpa.org.hk).

Yours faithfully,



Patricia McBride
Executive Director

PM/SO/jc
Encl.

ATTACHMENT

HONG KONG INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS' COMMENTS ON THE IESBA EXPOSURE DRAFT OF SECTIONS 290 AND 291 OF THE CODE OF ETHICS ON INDEPENDENCE - AUDIT AND REVIEW ENGAGEMENTS, AND OTHER ASSURANCE ENGAGEMENTS

Request for Specific Comments in the Exposure Draft

1. **Is it appropriate to extend all of the listed entity provisions to entities of significant public interest? If not why not and which specific provisions should not be extended? Is it appropriate that, depending on the facts and circumstances, regulated financial institutions would normally be entities of significant public interest and pension funds, government-agencies, government owned entities and not-for-profit entities may be entities of significant public interest?**

   HKICPA Comments

   Yes, generally in principle it is appropriate to extend all of the listed entity provisions to regulated financial institutions such as banks and insurance companies. However, we consider that it is premature to comment on extending the listed entity provisions to ESPIs until ESPIs are clearly defined.

   Whilst we understand that each jurisdiction will decide on what it considers to be an ESPI, we find it difficult and impractical to fully consider the proposals in the Exposure Draft and determine all the practical consequences without an agreed understanding of what is an ESPI. The HKICPA will need to develop a consultation paper (which will take at least twelve months to complete the due process) to identify those entities that should be classified as ESPIs in Hong Kong.

   Furthermore, we note that the International Accounting Standards Board (IASB) has recently introduced a term "public accountability" in its Exposure Draft of IFRS for Small and Medium-sized Entities (SMEs). An entity has public accountability if:

   - It has issued debt or equity securities in a public market; or
   - It holds assets in a fiduciary capacity for a broad group of outsiders, such as bank, insurance company, securities broker/dealer, pension fund, mutual fund, or investment bank.

   We would strongly recommend that all international standard setters – IESBA, International Auditing and Assurance Standards Board and IASB work closely together and develop a consistent definition of what is an ESPI and what is an entity with public accountability. In the basis of conclusions in IFRS 8 *Operating Segments,* the IASB indicated that it was premature to adopt the proposed definition of public accountability that is being considered in the exposure draft of IFRS for SMEs.

   Rather than introducing the notion of ESPI at this time, we recommend that the IASB align the "significant public interest" notion with the "public accountability" notion of

IASB. Once the appropriate term and its scope have been developed, it can then be promulgated consistently through all the standard-setting literature. It is extremely hard to comment on the term ESPI, and its implications, before there is a common and well-understood term in place.

In addition, we would recommend that IESBA makes some positive statements as to which entities are not ESPIs so that regulators can more clearly distinguish ESPIs and other entities. This could be achieved by providing some guiding principles for the development of more specific criteria. Central to this is deriving a suitable "public interest" test to be applied when considering the requirements. We are particularly concerned that the ESPI concept risks embracing many smaller not-for-profit entities and burdening them with inappropriate compliance costs.

2. Is it appropriate to eliminate the flexibility for small firms to apply alternative safeguards to partner rotation? If such flexibility is appropriate, what alternative safeguards will eliminate the familiarity threat or reduce it to an acceptable level?

HKICPA comments

We consider it appropriate to eliminate the flexibility for small firms to apply alternative safeguards to partner rotation for listed companies and regulated financial institutions such as banks and insurance companies. However, we are of the view that it is not appropriate to eliminate the flexibility for other entities of significant public interest at this stage. Until the term ESPI is properly considered and defined, it would be premature to propose a total elimination.

We are concerned that if no flexibility is provided to smaller firms, including safeguards which may be applicable such as monitoring by external assessors or employing another firm of certified public accountants to carry out certain procedures, smaller firms will need to rotate off an audit. That will impair the quality of the service that smaller firms can provide to SMEs, while doing little to improve audit quality or public confidence. Therefore IESBA should consider the practical challenges if this is applied to enterprises such as charities and schools.

The mandatory partner rotation combined with the expanded definition of the audit partners will, in many circumstances in Hong Kong, effectively amount to firm rotation. Smaller firms will lose ESPI audit clients while larger firms will retain such clients by way of rotating audit partners. Over time many smaller firms will be driven out of the ESPI audit market and ESPI audit will slowly concentrate in the hands of larger firms. It is generally agreed that increased auditor concentration is not in the public interest.

In this regard, we would prefer a principles-based approach to be developed rather than moving from a rules-based system that permits flexibility to a rules-based system that mandates rotation of key audit partners.

3. Is the revised guidance related to the provision of non-audit services appropriate?

Generally, the revised guidance related to the provision of non-audit services is appropriate for listed companies and regulated financial institutions such as banks and insurance companies. However, as mentioned above, given that the definition of the term "ESPI" has not yet been defined, it would be premature to introduce the revised guidelines for non-audit services affecting other potential ESPIs.

In Hong Kong, we are especially concerned about the revised guidance related to the provision of taxation services. We are of the view that smaller firms will be put in a disadvantaged position as compared to the larger firms. An example is the provision of services relating to (a) tax planning and other tax advisory services and (b) assistance in the resolution of tax disputes.

We note that smaller firms may not be able to implement the safeguards mentioned in the Exposure Draft such as:

- Using professionals who are not members of the audit team to perform the service;
- Having an additional tax partner or senior tax employee who is not involved in the provision of the tax services to the client, advise the audit team on the service and review of the financial statement treatment; or
- Obtaining advice on the service from an external tax professional.

Accordingly, we urge the IESBA to identify safeguards that are appropriate to firms of all sizes, rather than limiting the identified safeguards to those relevant to larger firms. For example, unlike other major jurisdictions, the Hong Kong taxation system is not a full "self assessment" system and the tax system is significantly simpler than in many other major jurisdictions. The Hong Kong Inland Revenue Department plays an active role in vetting all tax returns and tax disputes. Accordingly, consideration of such a system should be taken into account, and could be identified in the Code as an acceptable safeguard.

SMEs often prefer to have many of the abovementioned services provided by a known and trusted service provider. They place great value on having a close business relationship with a practitioner who develops a deep understanding of their business. The relationship is one that is mutually beneficial, has stood the test of time, and serves the public interest by making for a vibrant SME sector. Some aspects of the proposals in the Exposure Draft, while well intended, threaten this relationship while offering little enhancement to audit or service quality.

4. **The primary objective of the strengthening of the independence provisions of the Code is to enhance both the perceived and actual objectivity of those performing assurance engagements, thereby enhancing audit quality. Implementation of the new provisions will likely entail some additional costs to stakeholders which are particularly difficult to measure in the context of a global standard. The IESBA is, however, of the view that the benefits of the proposals are proportionate to the costs and therefore the proposals strike the appropriate balance between the differing perspectives of stakeholders. Do you agree?**

   Generally, there is agreement that for entities such as listed companies and regulated financial institutions such as banks and insurance companies, the public interest benefits of the proposals outweigh the costs borne by the entity.

   However, for SMEs, stakeholders would generally be worse off because of the disproportionate costs imposed on the entity are significantly greater than benefits received by users of their reports. We are especially concerned about the potential costs imposed on charities, schools and other not-for-profit entities that are already heavily dependent on the support of their service providers.

5. **Other Comments – Transition to the Proposed Requirements**

   The current proposed transition provisions are set for three areas, namely partner rotation, ESPIs and provision of non-assurance services.

   We are of the view that on partner rotation and ESPIs, the proposed two-year transitional period after the approval of the proposed standard is insufficient. We consider that a four-year transitional period after the approval of the proposed standard should be the minimum time for transition. This is because, it is envisaged that recruiting new partners or arranging another firm for rotation would need to be carefully considered and this is time consuming.

   In relation to the provision of non-assurance services, the proposed six-month transitional period is insufficient for handing over such services. Responsible professional accountants are likely to require longer to manage a smooth and clear hand-over arrangement without unnecessarily inconveniencing their clients. With this in mind, it was considered that a three-year transitional period would be more appropriate.

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