

15 January 2014

By email <regulation@hkicpa.org.hk> and by post

Mr. Raphael Ding
Chief Executive and Registrar
The Hong Kong Institute of Certified Public Accountants
37/F, Wu Chung House
213 Queen's Road East
Wanchai
Hong Kong

Dear Mr. Ding,

I refer to your Institute's survey and information paper dated 8 October 2013 in relation to the regulatory framework reform proposed by the HKSAR Government (copy attached). I would like to share my view and express my serious concern as follows:

To my understanding, in the proposed future reform, an independent body should be responsible for (i) inspection of audits of listed companies and quality control systems of listed company auditors i.e. conducting practice review for listed company audits; and (ii) disciplinary action against auditors of listed companies where the audit was poorly conducted and to offer sanction against the regulated person for misconduct. However, these will only apply to Hong Kong auditors but not Mainland auditors who are authorised by the Hong Kong Exchanges and Clearing Limited ("HKEx") to sign annual audit reports of H share listed companies.

I understand that HKEx has licensed and authorized 12 accredited PRC audit firms in Mainland China to prepare and sign off audit reports for PRC companies listed in Hong Kong by issuing "H-shares". As you can appreciate, any materially inaccurate financial statements of "H-shares" companies audited by these Mainland audit firms will misguide investors, both in Hong Kong and overseas. As the above licensing regime of HKEx is not subject to any review by the HKICPA, my major concern is whether the current system provide adequate protection for investors in these cases where there are clear negligent or wrongful misstatement in financial statements audited by these 12 PRC audit firms in the Mainland given H-shares are an important component of the capital markets in Hong Kong.

As I see it, the problem stems from the fact that HKICPA currently has no say in reviewing, inspecting or investigating the process of audit of H shares PRC companies listed in Hong Kong, as conducted by these 12 PRC audit firms. The HKICPA also cannot take any disciplinary action against auditors of H shares listed companies who are stationed in Mainland China. Hence, the question for most investors is: **what recourse and protection would they have against negligent or wrongful misstatement in audit reports issued by the PRC audit firms in Mainland China re H shares of PRC company?**

This problem is further aggravated when overseas investors think HKICPA has the authority to monitor the quality of all audited accounts issued by companies listed in Hong Kong. Such public perception may constitute legitimate expectation at common law and HKICPA may not have reasonably discharged of its perceived duty if HKICPA does not take any positive step to highlight this loophole to the public.

Mr. Raphael Ding

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It would be highly appreciated if HKICPA can explore this area in great detail and address this matter in the abovesaid proposed regulatory reform by the HKSAR Government.

Yours faithfully,

A handwritten signature in black ink, consisting of a large, stylized 'J' followed by a smaller 'L' and a horizontal line.

Joseph Lam
B.Com (UNSW), LL.B (Hons) (Lond)

HKICPA Membership No.: A07905

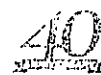
8 October 2013

Regulatory Framework for Listed Company Audits

Information Paper and
Request for Comment



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



40th Anniversary
of Accountants
in Hong Kong 1973-2013



Executive summary

Regulation of listed company auditors is an important, but only one, part of the overall system of regulation of the Hong Kong capital market. Under the existing system the responsibility for auditor regulation rests primarily with the Hong Kong Institute of CPAs (HKICPA). Internationally, over the last ten years there has been a trend of establishing independent auditor regulatory and oversight bodies. In two key respects that are explained in detail in the paper the Hong Kong auditor regulation system no longer meets international benchmarks or expectation. It is important that this situation is addressed to maintain the standing and reputation of Hong Kong's capital market and auditing profession. The HKICPA is committed to playing its part in achieving this.

The HKICPA took an early lead in identifying necessary reform by research and outreach activities in 2008 and 2009. In early 2010 a committee and a working group were set up to develop proposals for reform of the auditor regulatory system and an initial proposal was submitted to The HKSAR Government (Government) at the end of 2011. In early 2012 a joint proposal and timeline was developed with the Government and the Financial Reporting Council (FRC).

The overall aim of reform is to establish an independent body to exercise oversight over or assume direct responsibility for certain auditor regulation functions so that the regulatory system in Hong Kong meets international benchmarks for regulation of listed company auditors.

The HKICPA, the Government and the FRC have been involved in extensive dialogue to develop a proposed draft framework (framework) for a revised regulatory system (**Annex 1**) that meets international benchmarks and is suitable for the purposes of consultation with HKICPA members. The Government will conduct a public consultation subsequent to HKICPA's member consultation.

The framework addresses the objectives of the reform exercise, key principles of independent regulation and oversight and six recognized elements of auditor regulation. In places, options for proposed changes are provided.

In this paper the HKICPA explains the key proposals in the framework and, where appropriate, which options it prefers and why. The following summary highlights the important proposals and explanations. Please also refer to the table on pages 6 to 10 for summary of key issues on regulatory functions under the proposed framework.

Oversight

- To meet one of the key international benchmarks, any of the six elements of regulation (registration, inspection, investigation, discipline, continuing professional

development and standard setting) that are not carried out directly by the independent body will be subject to oversight by the independent body.

- In respect of functions that continue to be carried out by the HKICPA under the direct authority of the Professional Accountants Ordinance (PAO) and subject to oversight by the independent body, the independent body will have reserved powers to direct the HKICPA to take certain action if the HKICPA fails to act in the public interest. Such powers should not be framed so as to give the independent body operational control or "ownership" of the functions it oversees.

Registration

- The HKICPA will remain responsible for registration of members and member firms. The HKICPA will, subject to oversight by the independent body, maintain a separate register of firms that audit listed companies and specified individuals in those firms.
- Firms will not have to meet new criteria for registration although the "fit and proper" tests for admission to membership will also be applied to listed company auditors. Registration criteria will have to be re-confirmed as part of the annual renewal of registration.
- In certain circumstances Mainland and non-Hong Kong auditors have been and will continue to be allowed to audit Hong Kong listed companies. These auditors will also be included in the register. HKICPA's role as keeper of the register will be purely administrative in relation to Mainland and non-Hong Kong auditors.
- The HKICPA is of the view that under the new system attention must be paid to ensuring that issues around effective regulation of Mainland and non-Hong Kong auditors of companies listed in Hong Kong are addressed.

Inspection

- The independent body will take over responsibility for inspection of audits of listed companies and quality control systems of listed company auditors.
- The independent body may delegate any of its inspection responsibilities to the HKICPA, subject to direction and oversight.

Investigation

- Power to investigate listed company auditors was moved from the HKICPA and taken up by the FRC on its formation in 2006. No further action will be required by the HKICPA.

Discipline and sanctions

- The independent body will need to have sanctions available that allow it to take timely and proportionate action to address poor quality audit work that could damage public confidence in audit.

- Notwithstanding the need to ensure an effective and efficient disciplinary mechanism the fundamental principle of natural justice and fairness must always guide its development.
- To better assist the efficient administration of the disciplinary mechanism, there should be an opportunity for the independent body to offer a sanction to the regulated person to conclude the disciplinary matter without the need to convene a disciplinary committee.
- If no offer is made or an offer is rejected the matter should proceed to be heard before a fully independent disciplinary committee or tribunal that should strictly abide by the principles of natural justice and fairness:
 - No sanction should be exercised without due process;
 - There should be absolute transparency of process; and
 - Those responsible for the inspection or investigation of the matter should not be part of the independent disciplinary committee or tribunal.
- In respect of sanctions:
 - Clear guidance should be developed on sanctioning procedures;
 - We do not believe that a financial penalty, particularly one based upon a multiple of profit or loss in an audit engagement, would be appropriate ; and
 - Where a fine is to be imposed, it should be proportionate and reasonable in relation to the audit failing and should take into account any relevant factors including the financial resources of the auditor, previous record and admission of the failing and there should be a reasonable absolute monetary cap.
- There should be a right to have the decision of the disciplinary committee reviewed by an independent appeals tribunal and, if a party to a review is dissatisfied with the determination of the review, it should have the unrestricted right to appeal to the Court of Appeal against the determination.

Standard setting

- Setting auditing standards should remain the responsibility of the HKICPA, subject to oversight by the independent body. The HKICPA has the experience, skills, resources and international contacts necessary to carry out this function and a very good track record of introducing high quality auditing standards.
- The exercise of oversight should be no different from that on the areas of registration and continuing professional development. There is no need for standards to be endorsed by the independent body before introduction.

Continuing professional development (CPD)

- The HKICPA will continue to mandate CPD requirements for its members and monitor compliance, subject to oversight by the independent body.

Funding

- The HKICPA supports that funding should primarily be by listed companies and investors. A registration fee should be charged to listed company auditors to cover administration costs of maintaining the register.