

8 October 2013

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# Regulatory Framework for Listed Company Audits

Information Paper and  
Request for Comment



## 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 ([Annex 2](#)) 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.

## Introduction and objectives

1. Regulation of auditors in Hong Kong has been the responsibility of the HKICPA since it was first formed with powers under the PAO. Over the last ten years there has internationally been significant movement of responsibility for auditor regulation from professional bodies to independent oversight organizations. Hong Kong is rightly proud of its status as an important and trusted international capital market. Having a system of auditor regulation that can be seen to be independent from the profession and benchmarked to other major jurisdictions is a key element in maintaining that status.
2. The HKICPA realised some years ago that the status quo was not an option if the Hong Kong system of auditor regulation was to be recognized as equal to systems in other jurisdictions. Reform is not being undertaken because of failings in the current practice review programme which is fully benchmarked to international best practices and there is no evidence to suggest that the HKICPA is not meeting public interest expectations in its standard setting, qualification or educational activities.
3. In 2008 and 2009 we researched the international scene and reached out to relevant bodies, including the International Forum of Independent Audit Regulators (IFIAR), to establish what would be necessary to develop an internationally accepted system. In early 2010 Council approved the establishment of a committee and working group to develop proposals for reform of the auditor regulatory system. This step was taken with the encouragement of Government and an initial proposal was submitted to Government at the end of 2011.
4. In the early part of 2012 a joint proposal for reform and timeline for action was developed with the Government and the FRC. In early June 2012 HKICPA and FRC representatives engaged with EC officials and the then IFIAR chairman to establish that the proposed reforms would be significant move to achieving reform objectives.
5. For much of 2012 and 2013 the HKICPA has been engaged in discussions with the Government and the FRC to develop more detailed plans for changes to the auditor regulation system that achieve a position that is relevant to the Hong Kong market and recognized internationally as an effective independent regulatory function.
6. Benchmarks used in assessing whether the proposed revised system would be acceptable internationally remain the same as we established when we began our work on reform in 2010, namely criteria for membership of IFIAR and requirements for recognition as an equivalent regulatory system by the European Commission (EC). The two common essential criteria are:
  - Inspection of Public Interest Entity (PIE) auditors must be the responsibility of and subject to oversight by an independent body; and

- Funding and governance of the oversight body must be independent of the profession.
7. The scope of reform remains as it has always been - Hong Kong listed company audits and auditors. However, legislation to give effect to reform will refer to PIEs as IFIAR membership criteria refer to PIE auditors. There is no internationally agreed definition of PIE and in Hong Kong the only definition of PIE, in the Code of Ethics for Professional Accountants, is listed companies. Under the revised system PIE will be defined as only listed companies. Any subsequent changes will be at the instigation of the independent regulator, subject to consultation with Government, the HKICPA and other stakeholders. Therefore, for clarity we use the term listed company rather than PIE throughout this paper.
  8. IFIAR is an increasingly influential organization. In 2011 IFIAR became a member of the Monitoring Group, the body that oversees the auditing and assurance related standard setting activities of International Federation of Accountants ("IFAC"), monitors the activities of the Public Interest Oversight Board (PIOB), which oversees the independent standard setting boards of IFAC, and convenes to discuss issues and share views relating to international audit quality and regulatory and market developments that have an impact on auditing. We believe that it would be in the interest of Hong Kong to have a voice and influence in this forum.
  9. In addition to the two main criteria in Paragraph 5, EC equivalence provisions, which are set out in the EU 2006 Statutory Audit Directive (SAD), require the independent body to have oversight of all elements of the regulatory system that it does not carry out itself. EC rules identify six elements of a regulatory system – registration, inspection, investigation, enforcement/discipline, standard setting and continuing professional development. Consequently all six elements have been addressed in the reform process.
  10. Attaining EC equivalence does not require non-EU jurisdictions to have an auditor regulation system that complies with all requirements of the SAD. The SAD sets out very detailed requirements for statutory auditor regulatory systems in EU member states and its provisions extend well beyond equivalence requirements, which are only a part of the SAD.
  11. Non-EU jurisdictions that cannot meet equivalence requirements have been given temporary transitional status to allow them to make appropriate changes to their auditor regulatory systems. As of 1 August 2013 Hong Kong lost its transitional status and the small number of Hong Kong audit firms registered with European Union (EU) member state regulators will be subject to regulation by those regulators, in respect of any audit clients listed in EU member states, unless and until Hong Kong is given equivalence status. If these firms cannot re-assign their audit appointments for EU listed clients to their local network firms they will be inconvenienced by more stringent registration requirements and potentially direct inspection.

12. However, the number of EU listed clients audited by Hong Kong audit firms is relatively few and the extent and impact of direct inspection would therefore be limited. We do not expect the number of Hong Kong audit firms with clients listed in the EU to increase as we have not seen any strong interest for companies from Hong Kong (and China) to list in the EU. Rather we expect the flow to be in the opposite direction, a matter we address later in the paper.
13. In our view membership of IFIAR will provide real opportunities for Hong Kong to participate in and influence the international development of auditor regulation as well as enhancing the reputation and standing of Hong Kong as an international capital market. The benefits of EC equivalence will be primarily reputational.
14. Our research has confirmed that among a number of key jurisdictions (UK, USA, Germany, Australia and Singapore) that are members of IFIAR, members of EU and non-EU countries recognized as equivalent by the EC the system of auditor regulation varies in certain features. It is clear that there is no one model that Hong Kong has to adopt to gain recognition. Therefore the new system of regulation, while being benchmarked against international standards should also be relevant and appropriate for the Hong Kong market.
15. In developing proposals for a revised system all three parties have taken into account the need to make the transition to a new system as smooth as possible and to minimize operational disruption and additional regulatory and compliance costs to firms.
16. The HKICPA realizes that changing the system of audit regulation could have significant and far-reaching effects on its responsibilities and activities and on the future of the audit profession as a whole. We recognize that members may feel uneasy with potential changes. As the representative of the audit profession in Hong Kong the Institute is committed to working in the public interest with other parties to ensure that the system of auditor regulation in Hong Kong supports the reputation and status of its capital market and is fair to the audit profession.
17. We are now seeking members' views on this important issue and have developed a comprehensive engagement plan to ensure that all members fully understand the background, the proposals and the HKICPA position. Following member engagement and consideration of the outcome we will work with the Government to draft proposed legislative changes for public consultation in 2014. The aim is to introduce amending legislation to the Legislative Council in 2015.



## **Regulation of the Hong Kong Capital Market**

18. Auditor regulation is only one part of the overall framework that builds and maintains confidence in the Hong Kong capital market. The current system of listed company regulation involves a number of bodies (the Securities and Futures Commission (SFC), Hong Kong Exchanges and Clearing Limited ("HKEx"), FRC and HKICPA) that have regulatory powers and responsibilities in respect of different activities of different market participants. We understand the concerns of some commentators who have said that the current regulatory system is fragmented and has a potential for inconsistent decisions and gaps and overlaps in enforcement.
19. The regulation of listed company auditors as significant service providers to listed companies should be considered in the overall context of listed company and market regulation. Audit is a significant, but only one, element of the financial reporting supply chain and public confidence in financial reporting. This reform process is only about auditor regulation but we take the opportunity to remind all market regulators that there should be equally robust regulation of all elements of the supply chain, including the preparers of financial information.

### **The proposed framework**

20. The Government has worked with the HKICPA and the FRC to develop a proposed framework for a new system of independent regulation of listed company auditors (**Annex 1**). All three parties consider that this document is suitable for the purpose of consultation with HKICPA members but it does not represent a final position of any of the parties.
21. In places the proposed framework contains options. In this paper we offer comments and views on our preferred options. Where we disagree with elements of the proposed framework we explain why and offer alternatives.
22. In the following pages the contents of the draft framework are addressed in the order in which they are presented and references are made to the appropriate section of the draft framework.

### ***Broad principles of reform***

23. The principles and objectives of the reform process (*Framework section A*) are set out in the above introduction. An independent oversight model is being proposed to ensure that the Hong Kong auditor regulatory system is benchmarked to international best practice and recognized internationally. The HKICPA fully supports the introduction of a regulatory model that meets internationally recognized criteria and enhances the standing and reputation of Hong Kong as an international capital market.

### ***Exercise of Oversight***

24. Aspects of regulation affecting listed company audits that are not carried out directly by the independent body but remain with the HKICPA will have to be subject to oversight by the independent body. This is necessary to demonstrate EC equivalence but is not in IFIAR membership criteria. Assuming that the independent body will directly perform inspections and investigations and will establish procedures to allow it to exercise sanctions, enforcement and disciplinary proceedings, the functions of continuing education, registration and standard setting carried out by the HKICPA will be subject to oversight. There is no evidence to suggest that the HKICPA is not meeting public interest expectations in its standard setting, qualification or educational activities.
25. Oversight can be applied in a range of ways, from controlling and mandating to collaborative and guiding. We accept that for oversight to be effective the independent body must be able to exert influence but believe that oversight should be of the processes carried out and not interfere with executive decision making.
26. The oversight models in the UK and Germany, two of the major economies in the EU do not involve the independent bodies in day to day executive decision making. The UK FRC oversees elements of regulation that it does not carry out directly, including delegated inspection, primarily through an annual review of the activities carried out by the professional bodies. An "on-site" review of process and samples of work carried out, concluded by discussion and agreement on any necessary action should be an effective and efficient use of resources of the HKICPA and the independent body. .
27. The description of the proposed oversight mechanism in the draft framework broadly reflects these models and we believe it would be workable subject to the comment below on reserve powers.
28. We accept that for oversight arrangements to be seen to be effective and to ensure the independent body is able to fulfill its own responsibilities the independent body must have reserve powers, accompanied by appropriate checks and balances, to direct the HKICPA to take specified action in the event that the HKICPA activities do not address the public interest. Such reserve powers should be exercised in the most exceptional circumstances and should not be interpreted to amount to ownership of the functions by the independent body. We believe that more details need to be incorporated into the draft framework to explicitly set out how the independent body will exercise oversight and in what circumstances it will seek to use its reserve powers.

### ***Definition of PIE***

29. In the proposed framework PIE are defined for the initial introduction of the reformed regulatory system as listed companies (*Framework section B*). The HKICPA supports this position, which is in line with the international code of ethics and there is no other definition currently available in Hong Kong; to extend beyond listed companies would require extensive and delaying consultation with other stakeholders. Subsequent extension of the definition of PIE may be proposed, subject to appropriate discussion and approval mechanisms.

### ***Registration***

30. The HKICPA will continue to maintain the register of all Hong Kong audit practices (firms, corporate practices and own name). Information on the nature of client base, including listed companies, will continue to be gathered through periodic submission of the practice review questionnaire and updates. We support Option B (*Framework paragraph 7*) where authority for the role is assigned directly to the HKICPA by law, as is currently the position under the PAO, and not delegated by the independent body.
31. Under the proposed framework the HKICPA, under oversight of the independent body, will maintain a sub-register of all Hong Kong based listed company auditors. For the sake of clarity we have confirmed that the remit of the independent body, and therefore registration requirements, will extend to all assurance engagements currently required under HKEx Listing Rules. The register will also record all practising certificate (PC) holders with responsibility for listed company audits, as advised by the firm (*Framework paragraphs 4(a) and 4(b)(i)*). Registration of firms and individuals responsible for listed company audits is common practice in other jurisdictions.
32. The HKICPA supports this proposal as two registers and sets of registration requirements would be onerous for firms and difficult for third parties to comprehend and it would be appropriate for the HKICPA to maintain and administer the register of listed company auditors.
33. The framework also proposes that the sub-register be extended to include nominated engagement quality control (EQC) reviewers (or PC holders with responsibility for EQC reviews) and the individual or individuals with ultimate responsibility for systems of quality control in each registered audit firm (*Framework paragraphs 4(b)(ii) and (iii)*). We recognize that EQC reviewers have a position of influence and authority in respect of audit opinions on listed companies. We agree that the definition of those responsible for EQC review included in the draft framework is necessary to capture all individuals that fulfill this role as they will not all be PC holders.

34. We accept the proposal insofar as it is founded on the requirements of HKSQC 1. In our initial engagement with member firms some expressed concern over this provision but most now seem less resistant with the additional explanations and linkage to HKSQC1 included in the draft framework. There will need to be guidelines developed to clarify that action would be taken against the named individual only in the event of a systemic and serious breakdown in the system of quality control of the firm that leads to serious audit failures.
35. The draft framework proposes that registration criteria for firms and individuals will initially be the same as are currently set out in the Professional Accountants Ordinance (PAO) but will be subject to regular reviews in the future. All registration criteria will be reconfirmed at the annual renewal of registration.
36. There is also a proposal that applicants for registration would have to meet "fit and proper" criteria (*Framework paragraph 6*). In principle the HKICPA supports extending fit and proper requirements to PC holders and applicants (currently it applies to general membership). In our view the "fit and proper" test for registration should be similar to the criteria we apply for admission to membership and should not be confused with additional competence requirements.
37. We are not aware that other significant jurisdictions have established additional knowledge or competency criteria for qualified auditors to be admitted to a register of listed company auditors. In most jurisdictions the eligibility criteria for statutory auditors are similar to our PC rules and are set out in regulations or legislation. Specific competencies relevant for auditors of listed companies e.g. knowledge of Listing Rules, are assessed by inspection.
38. To be comprehensive, the register of listed company auditors will have to include non-Hong Kong audit firms (i.e. firms not registered with HKICPA or from the Mainland and recognized under the H-share scheme referred to in paragraph 44) (*Framework paragraph 9*) that currently audit companies listed in Hong Kong. The current proposals are to "grandfather" currently recognized non-Hong Kong firms and to keep recognition criteria for new applicants substantially as they are under the current system.
39. Setting registration criteria for non-Hong Kong audit firms will be the responsibility of the independent body. The HKICPA role in maintaining the register, for non-Hong Kong audit firms, is a straightforward administrative task. However, as a key stakeholder and statutory licensing body, the new system should facilitate HKICPA participation in the development of appropriate criteria by sharing knowledge and experience about criteria for recognition of auditors.

40. Currently, recognition of non-Hong Kong auditors is governed by HKEx Listing Rules. Under these provisions HKEx has allowed some newly listed foreign companies to engage non-Hong Kong auditors (Main Board Listing Rule 19.20: "*the firm of accountants acceptable to the Exchange which has an international name and reputation and is a member of a recognised body of accountants*").
41. At the end of December 2012, the number of non-Hong Kong auditors accepted by the HKEx under Rule 19.20 was 17 firms auditing 24 companies. However, given the policy of HKEx to attract non-Hong Kong incorporated companies to list in Hong Kong the number of non-Hong Kong auditors of companies listed in Hong Kong is likely to increase.
42. The draft framework proposes to replace Listing Rule 19.20 with two specific criteria and "other relevant factors" relating to the capability of the non-Hong Kong auditor to carry out a satisfactory audit, to be assessed by the independent body (*Framework paragraph 9(b)*). In our view this does not give sufficient clarity about how the suitability of a non-Hong Kong firm will be addressed. We also believe that retaining the Listing Rule requirement for an audit firm to have an international name and reputation is appropriate.
43. The Hong Kong capital market is a very open market and has attracted a number of overseas companies to list in Hong Kong. As explained above there are existing provisions to allow non-Hong Kong auditors to audit these companies and this practice will continue. We have been assured by the other parties that there is no intention to accept more overseas auditors into the Hong Kong market without a stringent screening process and there will be no automatic jurisdictional recognition. Applications to retain their local auditor by overseas companies wishing to list in Hong Kong will continue to be dealt with on a case specific basis and an overseas auditor's registration will only relate to that company.
44. From 2010 the arrangements to allow H-share companies to file financial statements prepared under Chinese Accounting Standards for Business Enterprises (CASBE) and audited by Mainland auditors have also been effective (Main Board Listing Rule 19A.31: "*a firm of practising accountants which has been approved by the China Ministry of Finance and the China Securities Regulatory Commission as being suitable to act as an auditor or a reporting accountant for a PRC incorporated company listed in Hong Kong*"). The list of the 12 firms currently approved by MoF/CSRC is available on the HKEx website.
45. The current arrangements for H-share companies and their auditors will remain and will not be amended as part of the reform process (*Framework paragraph 10*). We recognize that the arrangements have only been introduced at the end of 2010 but we believe that the current audit regulation reform is an opportunity to address the situation where three different groups of auditors (Hong Kong, Mainland and non-Hong Kong) are recognized and regulated by different bodies under different criteria.

46. We suggest that at a minimum the independent body should commit to a positive and proactive role in ensuring transparency and sufficiency of regulation of all non-local audit firms.
47. The potential difficulties of a national regulator effectively exercising its powers over auditors who are active but not located in the same jurisdiction have been put in the spotlight in the last few years, internationally and within Hong Kong. These circumstances also give rise to potential investor protection issues that have yet to be fully explored, including how an investor or liquidator could pursue an action against an auditor outside of Hong Kong through the auditors own domestic legal system.
48. We believe that until further serious consideration has been given to ensuring the effectiveness of cross border regulation, confirming that local and non-local auditors are regulated in an equitable manner and maintaining appropriate levels of investor protection, no steps should be taken that potentially accept into the Hong Kong market even greater numbers of non-Hong Kong auditors.

### ***Inspection***

49. We accept that to meet international expectations and benchmarks the independent body will assume statutory responsibility for inspection of listed company auditors (*Framework paragraph 12*). The scope of inspection activities will include review of firm-wide quality control policies and procedures and completed listed company audit engagements. The HKICPA will continue to carry out practice review on all audit practices and engagements not covered by the independent body.
50. The HKICPA will continue to have responsibility for review of non-listed company engagements in a listed company auditor. To minimize duplication of work and ensure effective regulation the independent body and the HKICPA will share their inspection results (*Framework paragraph 13*).
51. IFIAR and EC criteria allow for a professional body to continue inspecting listed company auditors under supervision and direction of an independent oversight body. However, we recognize that in most significant jurisdictions the independent body takes all, or a significant, responsibility for direct inspection. The UK is a notable exception where the UK FRC has recently taken the step of delegating more inspection work back to the professional bodies. There needs to be full consideration of the extent of direct inspection by the independent body that would be most effective in Hong Kong.
52. We believe that delegation of some elements of inspection work by the independent body to the HKICPA would be an effective and efficient use of resources and a practical way to manage the transition to the new system and to build appropriate skills and experience in the independent body.

### ***Investigation***

53. HKICPA powers to investigate members and firms concerning audits of listed companies were transferred to the FRC on the establishment of the FRC in 2006. The reform process will have no impact on the HKICPA in respect of this element of regulation. (*Framework paragraph 15*)

### ***Sanctions / Discipline***

54. We recognize that the key objective in establishing an effective enforcement and disciplinary system is to achieve an appropriate balance between efficiency and procedural fairness. Discussions about enforcement powers for the independent body have covered many possible models with different balances of these key elements. The proposed framework includes three options (*Framework paragraph 16*).
55. Option A proposes direct sanctioning and enforcement powers for the independent body based on the models for other regulatory bodies in Hong Kong. Whilst we recognize the potential benefits in operational efficiency, introduction of this model would be a significant move away from the current system under the PAO where the disciplinary process is completely independent of the inspection (and investigation) processes. We believe that as a matter of principle there should be a fully transparent separation of responsibilities between inspection (and investigation) and discipline which will not be achieved if all activities are undertaken directly by the independent body.
56. Duplicating an enforcement and sanctions model from another Hong Kong regulatory body would not be entirely appropriate. Regulation of auditors, including the enforcement regime, should reflect that auditing standards are principles and not rules based and that the audit process requires significant exercise of judgment by the auditor. The audit process and expression of an audit opinion is a very different activity to the services provided by other regulatees within the financial market, which very frequently are subject to a more rule-based regime.
57. Option C proposes a disciplinary committee with an independent majority and the right of appeal to an independent tribunal. However, we are concerned that the proposal envisages the disciplinary committee being convened and chaired by the "senior executive" of the independent oversight body. In our view there is a serious conflict in the same individual leading the inspection and investigation functions and participating in the disciplinary committee that deliberates on cases based on inspection findings. Acting as chairman of the disciplinary committee will aggravate the conflict as in reality the chairman is in a position to exercise significant influence over the deliberations and decisions of the committee. .

58. We support Option B, which has very clear features that demonstrate that a disciplinary committee is completely independent of the inspection and investigation body. Our research indicates that Option B also reflects the disciplinary arrangements of the other main professions in Hong Kong (medical, legal and construction) which have a complete separation of investigation and disciplinary processes, a fair hearing at the disciplinary stage and a right of appeal.
59. We accept that there may be a process by which the independent audit oversight body can conclude a disciplinary matter with a regulated person by offering an appropriate sanction before a disciplinary committee is convened to deal with the case (*Framework section 19*). The regulated person should be free to accept or reject the proposal. In the event that the regulated person rejects the proposal, the matter should proceed to be heard before the disciplinary committee without reference being made to the rejection of the proposal. Any sanctions proposed and accepted would be publicized in the same way as a disciplinary committee decision.
60. Such arrangements are not inconsistent with our support of Option B and assists in achieving a balance between efficiency and procedural fairness. A case can only be concluded by offer and acceptance of a sanction as opposed to a decision by the independent body which the auditor may appeal against.
61. We understand there are concerns within the investment community that an entirely internal disciplinary process that is not transparent may be misused to manipulate caseload and results. Therefore we suggest that any disciplinary powers exercised directly by the independent body, whether initial decisions under Option A or settlement offers under Option B, are subject to oversight and annual review by the independent appeal tribunal to check consistency and appropriateness of the use of such powers. The disciplinary process should also be transparent and given adequate publicity.
62. The draft framework indicates that a disciplinary committee will consist of three persons, including the chair. We understand that requiring relatively few members to constitute a committee may be preferable for ease of administration. However, we suggest that increasing the size of a disciplinary committee to five members would increase the perception of a fair and open hearing. We also believe that, to ensure a disciplinary committee has the appropriate level of knowledge of professional standards and practice, any accountants appointed to the committee should be members of the HKICPA.



63. We suggest that to encourage participation of suitably skilled and experienced individuals in the disciplinary process and to address concerns about excessive delays in disciplinary proceedings when all participants in the process are providing their services free of charge, consideration should be given to introducing a scheme for remuneration of disciplinary panel members. This could be further strengthened by retention of committee chairmen on a more permanent basis. To maintain independence remuneration of committee members and chairmen should come from an independent fund.
64. We support the proposal that decisions of disciplinary committees and the independent body may be appealed to an independent tribunal (*Framework paragraph 17(d)*). We do not believe that there should be any restrictions on the right of a respondent to appeal a decision of the independent tribunal to the Court of Appeal or that such appeal can only be made with leave of the Court of Appeal (*Framework paragraph 17(f)*). This would significantly reduce the rights of appeal that are currently available to members and firms under the PAO.
65. We believe that there must be clear proceedings rules to govern disciplinary activities whether carried out directly by the regulator, by a disciplinary committee or an independent tribunal and there must be absolute clarity that a respondent has the right of a full hearing, in person, before all bodies. In our view the expression in the framework giving "a reasonable opportunity of being heard" does not provide such comfort. Given the nature of audit work and in particular the exercise of judgment in the audit process an auditor accused of a failure in audit work should be allowed sufficient time and a full hearing to adequately present a defence supported by such relevant materials as the auditor should think fit.
66. Our research on enforcement powers available to listed company auditor regulators in other jurisdictions indicates that there is a fairly common range of sanctions, most related to the registration or licence of an audit firm or individual. A typical range of sanctions available to an independent regulator is:
- Conditions placed on the continuing ability of the auditor to continue to undertake audits e.g. required to implement specific procedures or undertake specified training;
  - Restrictions placed on the continuing ability of the auditor to continue to undertake audits e.g. not allowed to undertake audits of a specified type of entity for a prescribed period of time;
  - Suspension of licence/registration for a period of time, often conditional on completing specified remedial action;
  - Withdrawal of licence/registration; and
  - Monetary fines.

The range of sanctions included in the draft framework (*Framework paragraph 18*) broadly follows this example and in principle we support the proposed range of sanctions.

67. The most serious sanctions (suspension or withdrawal of registration and fines) should only be applied when there is no other effective sanction available and to allow the auditor to continue to audit listed companies would not be in the public interest. In our view, the most serious sanctions should only be exercised by an independent disciplinary committee or tribunal.
68. Fines and financial penalties are of a punitive nature, as opposed to other types of sanction used by regulators which are clearly focused on remedial action and protecting the public. We disagree in principle with the use of financial penalties as a punishment as the reputational damage to an auditor, and the potential prompt of civil action as a result of any regulatory action, is in itself a sufficient deterrent..
69. We recognise that the proposed multiple of three times (*Framework paragraph 18(d)*) profit made or loss avoided as an alternative cap on the amount of fines reflects provisions for maximum fines in the powers of other Hing Kong regulators. However, profit or loss in an audit engagement may not be a fair reflection of the culpability of the auditor and may result in excessive monetary amounts.
70. If the range of sanctions available to the independent body does include monetary penalties the maximum amount should be set at a reasonable level. The provision of monetary penalties in the range of sanctions is designed to allow punishment and deterrence, not compensation for loss which will still be pursued by any parties incurring loss through civil actions.
71. For many audit firms in Hong Kong that audit listed companies the proposed cap of \$10,000,000 is an amount that if applied would threaten the continued existence of the firm. There needs to be clarity that the principle of proportionality would always be applied in determining the amount of a fine. Sanctions such as suspension or withdrawal of registration are the appropriate mechanism to curtail an auditor's ability to carry out listed company audits, not fines.
72. Given the variation in size among firms that audit listed companies, we have also been advised that the imposition of a penalty that is close to the maximum will seriously threaten the viability of even some sizable firms or that simply the threat of a maximum \$10,000,000 penalty may result in them withdrawing from the market for listed company audits due to a lack of confidence in how the power will be used. Reducing choice in the market for listed company auditors would not contribute to the healthy development of the audit market, which already shows a high degree of concentration.

73. We believe that guidance needs to be developed on sanctioning procedures and application similar to that published by other Hong Kong market regulators and overseas audit regulators. All fines should be proportionate and reasonable in relation to the audit failing and be calculated by reference to a number of factors including the financial resources of the auditor, previous record and admission of the failing.
74. We believe that a reasonable absolute monetary cap and reference to appropriate factors in determining the amount of a penalty would be acceptable and easy to understand and administer.
75. We support the proposal that financial penalties recovered will be paid to the Government rather than the independent body to enhance and emphasise the impartiality of the process (*Framework paragraph 20*).
76. The HKICPA recognizes that a regulator requires enforcement powers that create a regulatory environment in which, after consideration of all relevant factors (e.g. prejudicial effect on on going criminal or civil proceedings), timely, appropriate, proportionate and effective action can be taken in response to audit failings. However, we are of the view that all sanctions should be proportionate and reasonable, no sanction should be exercised without due process and there should be absolute transparency of process and clear separation of responsibility for inspection and sanction.
77. We believe that the reform exercise presents a good opportunity to also consider whether new sanctions should be introduced to complement existing HKICPA practice review committee powers and disciplinary processes. Any such changes should be benchmarked to enforcement powers of other leading professional bodies and should be largely consistent with the powers taken up by the independent body.

### ***Standard setting***

78. We believe that the HKICPA should continue in its role as the setter of auditing standards and the code of ethics in Hong Kong, subject to oversight by the independent body, and that it is neither appropriate nor necessary for the independent body to take over that responsibility.
79. Auditing standards in Hong Kong (HKSAs) have been fully converged with international standards (ISAs) since 2005. We see no need to move standard setting from the HKICPA where there is an established, efficient and broad based mechanism, funded by member subscriptions, for involvement in the whole international standard setting process and local adoption. Standard setting is a specialized and highly technical activity that would take a significant amount of time and resources to develop and maintain in another body.

80. The HKICPA has well established relations with the International Audit and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA) to ensure that Hong Kong has a real and influential involvement in international standard setting. The standard setting processes and procedures of the IAASB and IESBA are already subject to independent oversight by the PIOB and the Monitoring Group.
81. The standard setting process of the HKICPA is fully transparent and aligned with international procedures. Exposure and adoption of new or revised standards is carried out concurrently with IAASB and IESBA processes.
82. There is only one set of auditing standards in Hong Kong, applying to audits of non-listed and listed companies. The approximately one million Hong Kong companies that are not listed are completely outside the scope of this reform. It would not be appropriate for the independent regulator to take responsibility for setting standards for the audits of this group of companies.
83. We have sought to understand how oversight is exercised in EU countries where the independent body oversees, but does not directly carry out, standard setting. In Germany, auditing standards are set by the professional body subject to what seems to be a fairly "light touch" oversight by the independent regulator. A representative of the regulator sits on the standard setting committee. The HKICPA's Audit and Assurance Standards Committee has for a number of years included members representing the FRC, SFC and HKEx. The standards issued by the German professional body do not require endorsement or "no objection" by the oversight body.
84. We therefore support Option B (*Framework paragraph 21*) where authority for the role is assigned directly to the HKICPA by law, as is currently the position under the PAO, and not delegated by the independent body. We are of the view that the proposed oversight mechanism gives the independent body appropriate reserve powers and that there is no need for specific requirements for the independent body to endorse standards before they are issued (*Framework paragraph 24*). The independent body will also continue to have representatives on the HKICPA standard setting committees and will be involved in and able to influence the process by this means.
85. Option A and the proposal that the independent body should endorse standards effectively would give the independent body ownership of standard setting. This is more than is required to meet EC equivalence requirements.
86. The HKICPA standard setting process is well established, effective and efficient. There has been no suggestion that the existing process has failed to produce relevant and high quality standards. We see no reason to disturb the status quo other than introducing an appropriate mechanism of oversight by the independent body.

### ***Continuing professional development (CPD)***

87. The HKICPA will, subject to oversight by the independent body, continue its role of setting and monitoring compliance with CPD standards and requirements for its members. We support Option B in respect of the source of authority for the role and the proposed oversight arrangements (*Framework paragraph 25*).

### ***Funding***

88. Based on our research it is apparent that the source of funding of an independent regulator is less relevant in determining that the body is independent of the profession than the control of budgets and strategy. Many IFIAR member bodies obtain part of their funds from the profession.
89. We believe that, as the independent body will be concerned solely with audits and financial statements of listed companies, it would be reasonable to propose that the future operations of the independent body should be funded primarily by listed companies. We therefore support the proposed funding mechanism in the draft framework (*Framework paragraphs 27 to 29*). Levies on listed companies and transactions should be collected on behalf of the independent body by bodies with existing direct regulatory relationships with the relevant parties i.e. SFC and HKEx.

**This paper sets out the views of Council on the proposed framework of key reform proposals, including preferred options where options are provided in the framework, and explains the reasons why Council has reached these views. You are asked to comment on the framework and confirm if you support Council's views. We would be pleased to hear from you if you have any additional arguments to support Council's views. If there are any aspects of the views expressed, the reasoning behind them or the framework itself that you do not agree with please contact us with your thoughts.**

Your comments should be submitted by **10 January 2014** to the Hong Kong Institute of Certified Public Accountants:

37/F, Wu Chung House  
213 Queen's Road East, Wanchai  
Hong Kong  
Fax: (852) 2865-6603 or 2865-6776  
Email: [regulation@hkiipa.org.hk](mailto:regulation@hkiipa.org.hk)

Please mark the subject line: **Regulatory framework for listed company audits**

**We will publish responses on a named basis in the intended consultation conclusions. If you do not wish your name to be disclosed to members of the public, please state so when responding to this paper.** Our policy on handling personal data is available on the website [www.hkiipa.org.hk](http://www.hkiipa.org.hk).