From: KC Wong
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To: Regulation
Subject: Regulatory framework for listed company audits

Regulatory framework for listed company audits
Comments and views on the information paper prepared by the Institute

My responses on the key issues under the proposed framework (as set out, and as they are numbered, in Annex 2):

1. I am clear on the objectives of the reform exercise.

2. I agree strongly that changes should be made.

3. I understand that EC equivalence requirements are wider than IFIAR membership criteria.

4. I do not think that obtaining EC equivalence should be an objective of the reform. I agree with the view stated in paragraph 13 of the Information Paper that attaining EC equivalence is mainly for reputational purpose rather than having any real benefit.

5. I understand that there are different ways for the IOB to exercise oversight. At this moment, there are no indications whatsoever which suggest that the Institute is failing in these 3 functions (namely registration, CPD and standard setting). I agree that express assignment in law is the preferred option. The oversight function of the IOB should be limited to whether due process has been carried out.

6. I am not strongly opposed to the IOB having some form of explicit veto power on the registration of listed company auditors, but the power must be restricted by setting out clear criteria, and the refusal is subject to appeal to an independent body.

7. I support the view that there should only be one single set of “fit and proper” criteria. Otherwise we are running into the danger of creating 2 classes of Institute members. In reality we have to admit that the resources and technical capabilities to audit large and complex listed

entities are not possessed by all of our member firms. The listed companies (particularly their respective Audit Committees) must be responsible for selecting and engaging suitably competent audit firms.

It is worth noting that the category of Mainland auditors is likely to increase in size and importance, given the trend of Mainland companies listing in HK. The Institute and the IOB may have to conduct a separate study on the registration criteria on Mainland auditors, especially in view of the fact that Mainland auditing standards may not converge with international ones at the same pace as most others.

8. I support the clear separation of responsibilities between inspection and investigation and subsequent disciplinary action. There is always a natural tendency, and possibly bias, for the investigating party to press for disciplinary action.

9. I also support option (b), which represent total independence between investigation and disciplinary action.

   On the composition of the DC, I have no strong view on whether the size should be 3 or 5, as long as the majority are lay members. I can see clearly the advantage of having one non-practitioner with audit knowledge, but fail to understand the logic of restricting it to members of the Institute (as proposed in paragraph 62 of the Information Paper).

10. While I recognize that a settlement arrangement may have the benefits of speeding up proceedings and cost savings, such arrangement may not be in the best interest of the victims (the shareholders, lenders, market participants, etc.) of the audit failings. There is a danger that the regulated person may abuse the arrangement to reduce its risk of subsequent civil claims, if it can “buy its way out” of a potential admission of major audit fault. The objectives of the IOB and those of the victims may not be completely aligned. Accordingly I have reservation endorsing such an arrangement.

11. If the objectives of the disciplinary action are primarily punishment and deterrence, there is no reason why pecuniary penalty should not be included in the range of actions. In recent years, we have witnessed multiple reprimands and lawsuits against the major international audit

giants. Pathetically it is difficult to imagine how reprimands can cause additional reputational damages to these giant firms. Monetary fines can be an effective deterrence, if they are material enough.

Surprisingly little has been mentioned on the disciplinary actions of suspension and withdrawal of registration. These actions may have far greater financial impact on the regulated firms and/or persons.

12. I do not quite understand the concept of multiple of “profit”. Does it mean that the costs of an audit has to be deducted from the fee received to arrive at the “profit”? If this is so, it will open up a whole series of argument on how much profit the regulated person has made on the assignment. It is much simpler to use the fee as a base for the calculation.

    The range of factors to determine the level of penalty should be extensive. They should include, but not be limited to, the nature of the audit failure, the human or systemic causes involved, the degree of negligence, proportional responsibility, prior records, etc. I do not see why the regulated person’s financial resources should be a relevant factor.

    I am not convinced that the presence of monetary penalty will threaten the viability of many member firms. There may be an impact on insurance premium, which reflect the price to be paid for deterring reckless and negligent behavior. There may be an argument that smaller size firms may be more severely affected as they are not as financially strong as the big firms to withstand the penalties. However, there are sufficient safeguard in the proposed framework to avoid the risk of innocent accusations. If there is a serious financial threat, it will probably come from the civil actions rather than the IOB’s fine, as the Institute has correctly pointed out in its Information Paper.

13. I agree that the endorsement of standards by the IOB is unnecessary.

14. I see no harm in granting the right to the IOB to participate in international standard setting forum. This is indeed and simple and effective way to achieve the oversight function of the IOB in this respect.

Other comments and views which are not responding directly to those set out in Annex 2:

1. It has been suggested that the DC and independent tribunal should operate with “absolute transparency”. There should be mechanism in place to protect the unnecessary disclosure of confidential information of the auditee, especially when it may be an innocent party in the incident. In this respect, the framework may need to be more specific on whether the disciplinary hearings and appeal are open to the public, and whether the results and reports of such hearings can be censored to protect confidential information.

2. On the issue of funding of the IOB, if we view it as an insurance premium to guard against poor quality audit, the principle of “user pays” would apply and that the funding should be tied closely to the audit fees. The argument that the IOB should not be funded by its regulatee (impairment of its independence!) does not make sense as long as the funding is not voluntary. The question of whether the regulated firms or the PIE should pay is academic, as elementary economics would tell us that the additional costs will be shared by them in proportion dictated by market force.

   There is a mention on partly funding the costs by a “transaction levy”. I am not sure if it means an additional levy on the securities transactions of listed companies. If it is, I find it absurd. Why should a more actively traded company be charged more? Audit reports are used and relied on by those who decide not to trade in the auditee’s securities, as well as those who choose to trade. Why should the latter bear the costs alone?

3. On the definition of PIE, the framework should include public but unlisted companies and government owned or controlled, quasi-government (and possibly corporations under special operating licenses, eg. utilities, strategically important industries, large charitable organizations, etc.) which involve public interests.

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