

**Draft Proposed Framework for
Independent Regulation of Listed Company Auditors**

A. Broad Principles for the reform

1. Key principles

- Hong Kong’s auditor oversight regime should be benchmarked against international standards whilst being appropriate in the local context.

2. Objective

- To secure Hong Kong’s membership in the International Forum of Independent Audit Regulators (“IFIAR”) and to attain regulatory equivalence status with the European Commission (“EC”).
- To achieve this objective, there should be an independent auditor oversight body responsible for the oversight of auditors of “public interest entities” (“PIEs”) with regard to all of the following six key functions, viz. registration, inspection, investigation, enforcement/discipline, standard setting and continuing education.

B. Coverage of “public interest entities”

3. The intention is to cover auditors of listed entities in Hong Kong when the new regime is implemented. In the light of relevant rules of IFIAR, the legislation should stipulate that the new regime would apply to auditors of PIEs in Hong Kong, with PIEs to be defined to cover all listed entities in Hong Kong and the legislation should also provide for a mechanism to expand the list of PIEs if necessary in due course. In other words, PIEs should be defined in the legislation to cover –

(a) all listed entities in Hong Kong; and

(b) any other entities designated by the independent auditor oversight body

after a due process (e.g. prior consultation with the Government (FS) and HKICPA and negative vetting by LegCo).

C. Possible oversight arrangements for individual key functions

(i) Registration

4. Auditors of PIEs (“PIE auditors”), including both Hong Kong PIE auditors and recognised non-Hong Kong PIE audit firms (paragraph 9 refers), should be required to be registered under the new regime. Hong Kong PIE auditors should be defined to include –

(a) Hong Kong audit firms (viz. audit firms registered with HKICPA under section 28A/28E of the Professional Accountants Ordinance (Cap. 50) (“PAO”) under the present regime) which give opinions in respect of assurance engagements with PIEs; and

(Note: “Assurance engagements” in this context cover audit engagements as well as the engagements required to be undertaken by auditors under the Listing Rules (c.f. Rules 4.03 and 19.20).)

(b) the following relevant individuals in respect of each of such audit firms -

(i) individuals who are authorised by the relevant audit firm to issue opinions in respect of its assurance engagements with PIEs;

(ii) individuals who take responsibility for engagement quality control reviews in respect of the assurance engagements with PIEs within the audit firm; and

(Note: According to paragraph 12(d) of Hong Kong Standard on Quality Control 1, an engagement quality control review provides an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report and a review is required for all audits of financial statements of listed entities and other engagements meeting criteria established by the firm. Therefore, it is appropriate for the independent auditor oversight body to establish oversight over persons who take responsibility for engagement quality

control reviews in respect of assurance engagements with PIEs since they may need to be held accountable for irregularities concerning such engagements. It is understood that under the existing regime, the Institute has previously requested FRC to focus on engagement quality control reviews as well as engagement partners such that the Institute may take disciplinary action against the reviewers if necessary.)

- (iii) an individual/individuals who is/are ultimately responsible for the firm's system of audit quality control.

(Note: The system of quality control of an audit firm is defined in paragraph 16 of Hong Kong Standard on Quality Control 1 and paragraph 18 sets out the leadership responsibilities for quality within an audit firm. In case an audit firm's deficiencies extend beyond a single audit and are firm-wide and systemic as a result of inappropriate culture, strategy, policies or resources of the firm, such individuals (apart from the firm itself) may be held responsible by the independent auditor oversight body.)

- 5. Each registration should be subject to annual renewal.
- 6. The new regime would not introduce any material change to the existing registration / renewal criteria for Hong Kong PIE auditors viz. the specified statutory criteria (on education or other qualifications or experience, etc.) and the 'fit and proper' test. Such criteria would be subject to regular reviews in future.
- 7. HKICPA would exercise statutory powers and functions to receive and make decisions on applications for registration and renewal of registration, and to maintain a register of Hong Kong PIE auditors, subject to the oversight of the independent auditor oversight body. The Institute would derive its powers and functions in respect of registration of Hong Kong PIE auditors either –
 - (a) *Option A* – from delegation of such powers by the independent auditor oversight body as to be stipulated by law (which is similar to the model practised by SFC in delegating certain powers to HKEx); or
 - (b) *Option B* – from express assignment by law (which is expected to reduce the scope of changes to be made to the existing legislation).

8. The independent auditor oversight body would exercise oversight of the Institute’s registration powers and functions through –

- (a) receiving periodic reports from the Institute on the exercise / discharge of such powers and functions;
- (b) conducting quality review on the Institute in respect of the exercise / performance of such powers and functions by it; and
- (c) exercising reserve powers provided by law to give directions to the Institute as necessary and, where circumstances so warrant, act itself in respect of registration of Hong Kong PIE auditors.

(Note: The intention is that, for example, where the independent auditor oversight body is in a better position than the Institute to make a decision on an application for registration / renewal of registration (e.g. when the oversight body possesses additional information about the applicant), the Institute may be required by the oversight body to pass on the application and all relevant material for the latter to make the registration decision in such case. Any person whose registration is not renewed or is renewed with conditions imposed may appeal against the decision – please see paragraph 11.)

9. A non-Hong Kong audit firm (viz. an audit firm not registered with HKICPA under section 28A/28E of the “PAO” under the present regime) may enter into an engagement with a specific non-Hong Kong PIE to audit its financial statements (“audit engagement”) provided that it is recognized by the independent auditor oversight body and registered by the Institute under the new regime. *(Note: In the case of a listed entity, having regard to the existing Listing Rules 19.20 and 19A.31, the independent auditor oversight body would only recognize non-Hong Kong audit firms to enter into audit engagements with listed entities which are incorporated outside Hong Kong which fulfills the requirements as set out in paragraph 9(b) below, subject to the Convergence Scheme – see paragraph 10.)* The recognition and registration of non-Hong Kong PIE audit firms would be dealt with as follows –

- (a) the law would provide the independent auditor oversight body with the powers and functions to receive and make decisions on applications for registration / renewal of registration from non-Hong Kong PIE audit firms,

having regard to relevant registration / renewal criteria (see (b) below) and other relevant factors, including whether the firm has adequate resources or has demonstrated its capability to perform the audit in question, etc.;

(b) a non-Hong Kong PIE audit firm must meet the following basic qualifying requirements before it applies for registration –

(i) the audit firm is a member of a body of accountants recognized by the independent auditor oversight body; and

(ii) the domestic regulator of the audit firm is a member of an international body of independent auditor regulators (viz. IFIAR) with which there is in force an agreement of mutual or reciprocal cooperation arrangement between that regulator and the independent auditor oversight body;

(Note: The Listing Rules provide, inter alia, that non-Hong Kong audit firms approved by HKEx “must normally have an international name and reputation” and “be a member of a recognised body of accountants”. While the first limb of “must normally have an international name and reputation” would no longer be a basic qualifying requirement for recognition by the oversight body and registration by the Institute, there would be a new requirement (i.e. (ii)) that the applicant must be regulated by an overseas regulator which can be relied upon by the oversight body to provide regulatory assistance if necessary (through a cooperation arrangement between the overseas regulator and the oversight body). This new requirement represents an improvement over the present HKEx regime as it would ensure that the oversight body would be able to follow through on any issues concerning these registered non-Hong Kong audit firms by referring such cases to the respective overseas regulators.)

(c) registration of any non-Hong Kong PIE audit firm should be subject to a registration fee and confined to a specific non-Hong Kong PIE from the relevant jurisdiction. If the registered non-Hong Kong PIE audit firm wishes to enter into an audit engagement with any other non-Hong Kong incorporated PIEs in Hong Kong, it needs to make a separate application to the independent auditor oversight body, as the case may be, who will consider the application having regard to the relevant factors as mentioned

in (a);

- (d) there should be a mechanism for handling applications for new registration from a non-Hong Kong PIE audit firm in respect of a non-Hong Kong incorporated company which seeks to list in Hong Kong; and
- (e) the non-Hong Kong PIE audit firms recognized by the oversight body under (a) above would be registered by HKICPA, which should maintain a separate register or sub-register of such non-Hong Kong audit firms.

(Note: Following the approach of equivalent status of regulatory regimes adopted by the EC, it is envisaged that the independent auditor oversight body would enter into regulatory arrangement with the relevant home regulators of the non-Hong Kong PIE audit firms and rely on the latter to perform direct supervision and regulation of the audit firms concerned.)

- 10. The arrangement described in paragraph 9 would replace the existing scheme operated by HKEx for recognising non-Hong Kong audit firms as auditors of listed companies which are incorporated outside Hong Kong under the Listing Rules 19.20 and 19A.31. Non-Hong Kong audit firms which have been recognised by HKEx would be put onto the new register of non-Hong Kong PIE audit firms. They would be subject to the renewal requirement under the new regime (see paragraph 9(b) above). *(Note: There would be no change to the Convergence Scheme agreed between Hong Kong and the Mainland on the recognition of Mainland audit firms as auditor of H-share Mainland companies listed in Hong Kong, with the relevant Mainland audit firms to be put onto the separate register or sub-register of non-Hong Kong PIE audit firms.)*
- 11. Appeals against any registration decision should be handled by an independent appeals tribunal to be chaired by a person who is qualified to be appointed as a judge.

(ii) Inspection

- 12. The independent auditor oversight body should be responsible for conducting regular inspections on PIE auditors in respect of their PIE engagements. The oversight body may delegate such powers and functions to HKICPA.

13. The independent auditor oversight body and HKICPA (which would continue to be responsible for regular inspections on Hong Kong PIE auditors in respect of their non-PIE engagements) should maintain close liaison and coordination to ensure effective regulation and minimise any overlap / underlap in their respective regulatory work in respect of Hong Kong PIE auditors. There should be a mechanism for the oversight body and HKICPA to share their inspection results to enhance regulatory efficiency
14. The reporting mechanism on the findings of inspections should be a mixture of overall inspection results, firm by firm reporting and supplemental private report on individual audit engagement.

(iii) Investigation

15. The independent auditor oversight body should be responsible for the investigation of potential irregularities in respect of PIE auditors with regard to their PIE assurance engagements.

(iv) Enforcement/discipline and appeal mechanism

16. To ensure independence of the disciplinary process, the law would specify that the independent auditor oversight body would have the ultimate responsibility with respect to enforcement and discipline. There are three options for the disciplinary mechanism, as follows –

- (a) Under Option A, the independent auditor oversight body would be directly responsible for handling the disciplinary cases concerning Hong Kong PIE auditors in respect of their PIE engagements.

(Note: Option A is modelled on the established disciplinary system of SFC and HKMA in respect of their regulatees, under which the regulator has the powers to impose direct sanction on the regulatees.)

- (b) Under Option B,
 - (i) the independent auditor oversight body, in exercising its statutory disciplinary powers, would appoint a disciplinary committee (“DC”) chaired by a lay person and comprising another lay person and a non-practitioner with knowledge of the auditing profession to hear each

disciplinary case; and

- (ii) the oversight body would be empowered to appoint a panel of, say, no less than 5 lay persons and another panel of, say, no less than 5 non-practitioners with knowledge of the auditing profession, and to appoint the chairman and members of the DC for each case by drawing from members of these two panels.

(Note: Option B is modelled on the existing disciplinary system under PAO.)

(c) Option C is a hybrid of Option A and Option B. Under Option C,

- (i) the independent auditor oversight body, in exercising its statutory disciplinary powers, would appoint a DC chaired by a senior executive of the oversight body and comprising a lay person and a non-practitioner with knowledge of the auditing profession to hear each disciplinary case; and
- (ii) the oversight body would be empowered to appoint a panel of, say, no less than 5 lay persons and another panel of, say, no less than 5 non-practitioners with knowledge of the auditing profession, and to appoint members of the DC for each case by drawing from members of these two panels.

17. The law would provide for a due process to be followed by the independent auditor oversight body (or the DC, as the case may be) in exercising its disciplinary power, as follows –

- (a) it must not exercise any disciplinary power without first giving to the regulated person concerned a reasonable opportunity of being heard. In reaching a decision on whether to exercise a disciplinary power, it may have regard to any information or material in its possession which is relevant to the decision, regardless of how the information or material has come into its possession;
- (b) if it decides to exercise any disciplinary power, it must inform the regulated person concerned of its decision to do so by notice in writing;
- (c) it must not exercise its powers to impose a pecuniary penalty unless –
 - (i) it has published guidelines to indicate the manner in which it proposes

- to exercise such power; and
- (ii) in exercising such power, it has had regard to the guidelines so published;
- (d) a person who is aggrieved by a specified disciplinary decision in respect of the person may, by notice in writing apply for a review of the decision by an independent appeals tribunal (same tribunal as per paragraph 11 above). The law would stipulate the statutory time limit for the person to apply for the review; *(Note: For reference, the period in respect of cases handled by the Securities and Futures Appeals Tribunal is 21 days.)*
- (e) the independent appeals tribunal may by order extend the time within which an application for review of the specified decision may be made. However, the tribunal may only grant an extension after the applicant and the independent auditor oversight body (or the DC, as the case may be) have been given a reasonable opportunity to be heard on the proposed extension, and if it is satisfied that there is a good cause for granting the extension; and
- (f) in reviewing a specified disciplinary decision, the independent appeals tribunal must give the parties to the review a reasonable opportunity to be heard. If a party to a review is dissatisfied with the determination of the review, the party may appeal to the Court of Appeal against the determination. No appeal may be made unless leave to appeal has been granted by the Court of Appeal.

(Note: The principles of fairness and natural justice would apply to the independent auditor oversight body (or the DC, as the case may be) in exercising its disciplinary power.)

18. The law should provide for a range of disciplinary powers. By reference to the existing regimes of financial regulators, the disciplinary powers should include, for example –

- (a) to reprimand the regulated person publicly or privately;
- (b) to give directions to the regulated person on remedial actions;
- (c) to impose registration conditions on the regulated person;

(d) to order the regulated person to pay a pecuniary penalty, separately or in addition to any other sanctions, not exceeding the amount which is the greater of –

(i) \$10,000,000; or

(ii) three times of the profit gained or loss avoided by the regulated person as a result of his misconduct;

(Note: For reference, section 194(2) of the Securities and Futures Ordinance (Cap. 571) stipulates that SFC may order a regulated person to pay a pecuniary penalty not exceeding the amount which is the greater of (i) \$10,000,000 or (ii) three times the amount of the profit gained or loss avoided by the regulated person as a result of his misconduct, or of his other conduct which leads the Commission to form the opinion (as the case may be).)

(e) to suspend or revoke the registration of a Hong Kong PIE auditors (or the recognition of a non-Hong Kong PIE audit firm); and

(f) to prohibit the regulated person from applying to be registered for such period or until the occurrence of such event as the independent auditor oversight body (or the DC, as the case may be) may specify, etc.

19. The law should provide for flexibility for the independent auditor oversight body to settle a disciplinary matter with a regulated person before or during the disciplinary process.

20. Any pecuniary penalty paid to or recovered by the independent auditor oversight body, and any amount paid to or recovered by the independent auditor oversight body arising from any monetary settlement agreed between the body and the regulated person (other than the costs and expenses in relation to or incidental to the investigation/proceedings), would be paid by the body into the Government general revenue.

(v) *Standard setting*

21. HKICPA would exercise statutory powers and functions to specify the standards on professional ethics, auditing and assurance to be observed and

complied by PIE auditors, subject to the oversight of the independent auditor oversight body. The Institute would derive its powers and functions in standard setting in respect of PIE auditors either –

(a) *Option A* – from delegation of such powers by the independent auditor oversight body as to be stipulated by law (which is similar to the model practised by SFC in delegating certain powers to HKEx); or

(b) *Option B* – from express assignment by law (which is expected to reduce the scope of changes to be made to the existing legislation).

(Note: Irrespective of the oversight approach to be adopted, the independent auditor oversight body is to be represented on HKICPA's Auditing and Assurance Standards Committee and Ethics Committee, similar to the existing arrangement for FRC's participation in the relevant committees, so as to ensure that the independent auditor oversight body will play a prominent role in the process of specifying standards on auditing and assurance and professional ethics before they are finalised.)

22. The independent auditor oversight body would exercise oversight of the Institute's standard-setting functions in respect of PIE auditors through –

(a) receiving periodic reports from the Institute on the exercise / discharge of such powers and functions;

(b) conducting quality review on the Institute in respect of the exercise / performance of such powers and functions by it; and

(c) exercising reserve powers provided by law to give directions to the Institute as necessary and, where circumstances so warrant, act itself in respect of specifying standards to be observed and complied by PIE auditors.

23. The exercising of oversight of the Institute's standard-setting functions by the independent auditor oversight body should not affect the standing of both the Institute and the oversight body to participate in international standard-setting forum.

24. It is for consideration whether the standards specified by the Institute should be subject to endorsement or indication of no objection by the independent auditor

oversight body. (*Note: In practice, this would imply that HKICPA would continue to exercise its existing functions of specifying standards but the standards will only come into effect after the oversight body explicitly endorses or indicates no objection to their promulgation.*)

(vi) Continuing education

25. HKICPA would exercise statutory powers and functions in respect of the continuing professional development of PIE auditors, subject to the oversight of the independent auditor oversight body. The Institute would derive its powers and functions in respect of the continuing professional development of PIE auditors either –
- (a) *Option A* – from delegation of such powers by the independent auditor oversight body as to be stipulated by law (which is similar to the model practised by SFC in delegating certain powers to HKEx); or
 - (b) *Option B* – from express assignment by law (which is expected to reduce the scope of changes to be made to the existing legislation).
26. The independent auditor oversight body would exercise oversight of the Institute’s functions in respect of the continuing professional development of PIE auditors through –
- (a) receiving periodic reports from the Institute on the exercise / discharge of such powers and functions;
 - (b) conducting quality review on the Institute in respect of the exercise / performance of such powers and functions by it; and
 - (c) exercising reserve powers provided by law to give directions to the Institute as necessary and, where circumstances so warrant, act itself in respect of the continuing professional development of PIE auditors.

D. Funding mechanism

27. The operation of the independent auditor oversight body should be funded mainly from –

- (a) the PIEs (e.g. by way of a fixed levy on all PIEs); and
 - (b) investors (e.g. by way of a transaction levy).
28. With reference to the existing requirement for payment of a licence / registration fee by regulatees of SFC, HKMA and MPFA (and the future IIA) under their respective licensing / registration regimes, there should be a registration fee and a renewal fee to be payable by registered auditors (including audit firms and relevant individuals in respect of each of such audit firms). Having regard to the existing arrangement for payment by auditors of listed entities to HKICPA, the level of the registration/renewal fee payable by a registered audit firm would likely vary according to the number of PIE clients and the number of relevant individuals of the firm and should be pitched at a reasonable level (e.g. no more than what they pay to HKICPA now).
29. There should also be user fees for specific services, e.g. notification in relation to changes of particulars of a registrant.

E. Designation of the independent auditor oversight body

30. FRC to become the independent auditor oversight body. It would derive its powers from express assignment by law. Legislative amendments should be made to FRCO and PAO for implementing the reform proposals.
31. The existing checks and balances that apply to FRC to ensure its accountability should be maintained, e.g. the tabling of annual report before LegCo; annual budget to be subject to FS's approval; public disclosure of relevant disciplinary decisions; operation of an independent process review panel; and the scope of purview of the Ombudsman, Director of Audit and ICAC covering FRC; etc.