Dear Sirs,

Sanctions Guidelines Consultation Paper

Thank you for inviting us to comment on the captioned paper as proposed for publishing guidelines on how the Financial Reporting Council ("FRC") would exercise the power to impose the penalty.

We appreciate very much that the FRC prepared the consultation paper and organized the briefing sessions for the representatives of our firm to have more knowledge about the consultation.

Our views are expressed in response to the questions for consultation as below. Each paragraph is numbered for reference purpose.

1. Do you agree with the FRC’s objectives of imposing sanctions as set out in paragraph 10? If not, please state the particular objective(s) that you do not agree with and the reasons for your disagreement.

1.1 We generally agree with the FRC’s objectives of imposing sanctions as set out in paragraphs 10 to 12, and would like to put the most emphasis on the primary purpose ("not to punish, but to protect the public and the wider public interest") in paragraph 11 and the sanctions which improve the behaviour or performance of the regulated persons concerned in paragraph 12(a).

1.2 We support these objectives as they are mainly to protect the public and deter the misconduct rather than to punish the regulated persons. The sanctioning aims to enhance the audit quality but not to make the auditor unable to have an opportunity to improve its quality control system. The word "defer" in paragraph 10(a) may be replaced by "deter or discourage" because there is no need to instill fear, doubt or anxiety in some sanctioning cases.
2. Do you agree with the FRC's approach to determining sanctions summarised in paragraph 19? If not, please explain any alternatives you would propose and the reasons therefor.

2.1 In general, we agree with the FRC's approach to determining sanctions summarised in paragraph 19 subject to our specific comments below:

2.2 The approach is principle-based. The extent of judgement required in assessing the nature and seriousness of the misconduct is great, so sometimes injustice may ensue. The considerations as mentioned in paragraphs 19(c)-(e) of the consultation paper may also have similar issues. Provision of certain application examples is essential in these respects. Also, it is helpful to refer to paragraph 6.1 of the Guideline to Disciplinary Committee for Determining Disciplinary Orders issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") for more specific guidance.

2.3 As the determination of sanction necessitates a number of judgements, it is better to provide more information and application examples in the guidelines about how such judgements will be reviewed for appropriateness. In doing so, it can help to alleviate the panic and anxiety of the regulated persons especially when the starting points for sanctions are unknown.

2.4 In paragraph 19(a), the words "seriousness" and "gravity" are similar in meaning. It is advised to delete one to simplify the application or to combine them as "seriousness or gravity".

3. Have we included the sorts of factors (paragraphs 21 to 24) in the Sanctions Guidelines that you would expect the FRC to consider in assessing the nature and seriousness of the misconduct and determining the sanctions to be imposed? Are there any other factors you believe the FRC should take into account when determining the sanctions to be imposed?

3.1 Subject to paragraphs 3.2 to 3.5 of this letter, we concur with the FRC's inclusion of the sorts of factors as listed in paragraphs 21 to 24 of the consultation paper.

3.2 Paragraph 22(a): Should the nature of breaches (e.g. technical breaches vs. ethical non-compliances) be further elaborated in a separate paragraph? In view of increasing complexity of the professional standards, more technical judgements are to be made by the registered persons. What are the guidelines and application examples on sanctioning, if necessary, in the case where there is a disagreement over technical judgements between the FRC and the registered persons?

3.3 Paragraph 22(c): The examples mentioned in this paragraph, e.g. bonuses and share options, seem not to be applicable in the case of PIE auditor. We propose to remove these examples.
3.4  Paragraph 22(d): It is not advisable to include the loss of money as a factor in sanctioning. The auditor's report is addressed to the shareholders, but not the creditors. There should not be a linkage between the loss to creditors and the level of penalty. In most cases, the regulated persons cannot quantify the reduction in market value or loss to creditors when the audit firm enters into engagement with its client. It is quite unfair to use these amounts as reference factors for imposing sanctions.

3.5  Paragraph 22(o): It is advisable to avoid the use of "forward looking" factors, e.g., "likely ... will occur" as there will be no sufficient facts to support. The word "foresaw" in paragraph 53(a) also poses similar problems.

4.  Do you agree that the sanctions, including a pecuniary penalty, to be imposed by the FRC should act as an effective deterrent and be proportionate to the misconduct and have regard to all the circumstances of the case, including the financial resources of the regulated persons? If not, what would you propose? Please explain your rationale.

4.1  Sometimes non-pecuniary sanctions (e.g., sanctioning requirements on education and training) can much more effectively act as a deterrent, particularly in cases where the misconduct relates to the competency of the regulated persons.

4.2  We agree the sanctions should be proportionate to the misconduct.

4.3  The sanction purposes include deterring the regulated persons from committing misconduct but not prohibiting them from performing PIE audits, so it is reasonable to have regard to their financial resources in imposing penalty.

4.4  Paragraph 22(e) of the consultation paper: We were explained in the briefing session that the regulated persons having more financial strength would likely have higher pecuniary sanction amount and the $10 million cap could apply to each of the regulated persons. We therefore advise that non-pecuniary penalty should be the standard type of sanctions which apply to the regulated persons who have less annual income. One more important point to consider is that the professional indemnity insurance ("PIL") normally does not cover penalty.

4.5  Paragraph 40 of the consultation paper: we do not agree with the proposal to use certain indicators of financial means in this paragraph such as level of profitability per partner and market share as they are not readily measurable. In addition, the penalty should not refer to revenue from services other than PIE audits. These services and their information system (e.g., in capturing data on revenue) are normally not subject to FRC regulation. Certain partners in providing such services are not accountants registered with the HKICPA or under the FRC Ordinance.
4.6 Consistency in measuring the penalty should be considered. So the formula must be clear and beyond doubt. It is not considered justifiable to have different penalties due to different methods used in the measurement of the parameters. More importantly, it is also not acceptable to take into account these parameters in some, but not other, cases if the facts of the cases are comparable. Accordingly, the best way to deal with this is to provide application examples as mentioned in paragraphs 2.2 and 2.3 above.

5. Do you agree with the factors set out in paragraphs 37 to 43 that the FRC will normally take into consideration when determining the amount of a pecuniary penalty? If not, please explain any alternatives you would propose and the reasons therefor.

5.1 It appears to be more appropriate to refer to the amount of revenue or income (gross or net) from the audit engagement as a result of the misconduct rather than to the total turnover of the PIE auditor or annual income of the registered responsible person.

5.2 The rationale is weak if the penalty amount is related to the revenue or income generated from non-audit sources, which are irrelevant to the audit engagement.

5.3 It may be more reasonable to impose penalty by reference to the fee revenue (gross or net) from the audit engagement in which the misconduct is found.

5.4 The guidelines on determination of penalty amount are unclear in cases where there are multiple responsible persons (e.g. a registered PIE auditor includes registered engagement partner, registered engagement quality control reviewer and registered quality control system responsible person). There are also no guidelines on multiple penalty claims in excess of the financial resources of the regulated persons. Application examples should be provided in the guidelines as they are absolutely necessary in these aspects.

6. Do you have any other comments on the Sanctions Guidelines that would help the FRC as an independent auditor regulator to protect the investing public and the public interest?

6.1 Overall speaking, the Guidelines are principle-based. Two different experienced persons may often reach sanctioning conclusions quite differently (resulting in injustice) based on these guidelines only (in particular, there are no clear guidelines on how to arrive at the relative weight of factors). We suggest the FRC to research and then to revise the consultation paper so as to lessen the aforesaid differences in conclusions.

6.2 We also suggest that unless a technical misconduct or an inadvertent breach of technical standards has been repeated (or committed without any ground; which is indeed an ethics issue) by the regulated persons, the sanction should initially be educational in nature.
Financial Reporting Council  
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We as accountants in Hong Kong have both responsibility of and contribution to enhancing the audit quality in the PIE audit market. Our firm, being a member firm of Crowe Global, would like to express our appreciation for the efforts made by the Council and its working team members towards the drafting of the sanctions guidelines.

Yours faithfully,
For and on behalf of
Crowe (HK) CPA Limited

Charles Chan  
Chairman and Chief Executive Officer