Dear Sirs

Sanctions Guidelines – Consultation Paper, March 2019

KPMG appreciates the opportunity to comment on the proposed Sanctions Guidelines ("the Guidelines").

Overall, we welcome and support further independent oversight of auditors of Hong Kong listed entities. We believe this is in the public interest and will benefit investors, the audit profession, and Hong Kong’s standing as an international financial centre.

We also support the position that the Financial Reporting Council (FRC) should have powers to impose a wide range of possible sanctions.

We set out in the attached appendix our comments on the questions that the FRC has raised in its consultation paper on the Guidelines.

As further elaborated in the appendix, we believe that the FRC should provide additional clarity on how the Guidelines will be implemented.

We trust the Council will find our comments helpful.

If you require any clarification, please do not hesitate to contact us.

Yours faithfully

Enclosures
Responses to the Financial Reporting Council’s Consultation Paper on Sanctions Guidelines of March 2019

We set out our comments below in respect of the questions raised in the Consultation Paper.

Please also refer to our comments in our covering letter.

Q.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.

Yes, we agree with the FRC’s objectives of imposing sanctions as set out in paragraph 10 of the Guidelines. We also agree that, as set out in paragraph 11 of the Guidelines, the primary purpose of imposing sanctions is not to punish, but to protect the public and the wider public interest.

Therefore, we suggest that the focus should be on the non-financial sanctions that would help ensure regulated persons improve audit quality by remediating their audit procedures and system of quality control.

The use of financial sanctions should be imposed in exceptional circumstances and only for severe cases of wrongdoing by a regulated person.

Q.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.

We agree with the principles as set out in paragraph 19 of the Guidelines. However, as explained below, we have concerns about some of the subsequent paragraphs that are cross-referenced in paragraph 19.

We believe that the FRC should provide more clarity and transparency on how the Council will implement the Guidelines in practice and how the sanctions would be applied consistently in different disciplinary cases.

It would be helpful if the FRC were to provide examples of how and what sanctions may be applied to different regulated persons in a case of misconduct (i.e. the audit firm, engagement partner, engagement quality control reviewer and person(s) in charge of the firm’s system of quality control).
Q.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?

Yes, we agree that the FRC should generally take into account the factors set out in paragraphs 21 to 24 of the Guidelines, subject to our comments below.

i. We believe that the FRC should provide further guidance on how it would decide the relative weight to each of the relevant factors as set out in paragraphs 21 to 22.

ii. We are concerned that making reference to reduction in market value and loss to creditors in paragraph 22(d) may give an incorrect impression to the public that the auditor also owes a duty of care to third parties other than the listed entity’s shareholders as a whole, and those changes and loss may not be entirely, if at all, attributable to any audit failings.

iii. Any penalties for an audit failure should be proportionate to the nature and seriousness of audit failure itself, and should be consistently applied. We are concerned that the references to the size/financial resources and financial strength of a regulated person or insurance coverage in determining the level of penalties could lead to inconsistent penalties being applied for similar issues, which does not appear appropriate or fair. Such references can be found, for example, in paragraphs 22(e), 38(c), 38(d), 39 to 44.

We agree with the FRC’s position as set out in paragraph 45(d) that the pecuniary penalty should not cause financial jeopardy to the regulated person. Therefore, we believe that the Guidelines should make it clear that it is the FRC’s intention that the Council will consider first the level of penalty that should apply to the particular misconduct; and then secondly whether a reduction is needed to take account of the financial circumstances of the regulated person.

iv. The auditor performs the audit of the financial statements as a whole. Furthermore, an audit involves many different audit procedures and the exercise of judgement throughout the entire audit process. Accordingly, references to financial benefit derived or profit/loss gained/avoided from a misconduct as set out in paragraph 22(c) do not seem appropriate as it would be difficult to separately identify and quantify.
Q.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.

Yes, subject also to our comments on Q.1 and Q.3.

As stated in paragraph 9 of the Guidelines, sanctions should be proportionate to the misconduct. This would involve considerable judgement. Therefore, it is important for the FRC to include input from persons with sufficient professional experience and expertise in the sanctioning process. We elaborate further under Q.6 below.

Q.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.

We refer to our comments on Q.1, Q.3 and Q.4.

Q.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?

We refer to the Legislative Council Brief dated 17 January 2018 ("the LegCo Brief") and the Summary of Views of Submissions and the Government's Response dated 3 July 2018 ("the Summary of Views and Government's Response") prepared by the Financial Services and the Treasury Bureau ("FSTB"). These documents noted that the FRC will put in place checks and balances to ensure an independent and due process when exercising its sanctioning powers.

Such details are awaited. However these are needed in order to properly evaluate and provide informed comments on the Guidelines. For example:

i. Under item 16 of the Summary of Views and Government’s Response, the FSTB stated that “Finally, to ensure clarity and transparency in its operation, the FRC will formulate guidelines setting out the thresholds and circumstances under which misconduct identified during an inspection would be referred to the disciplinary department for follow-up.”

Accordingly, for any issue arising from an inspection, the FRC will need to determine the appropriate response. The appropriate response will depend on the severity of the issue and on the facts and circumstances. In some situations, disciplinary action may be appropriate and in others it may not be warranted.
Therefore, and as contemplated by the FSTB, for matters arising in an inspection, it is important for the FRC to set out the threshold and circumstances for triggering disciplinary action.

ii. Under paragraph 18 of the LegCo Brief, the FSTB stated that "In addition, there will be inputs from independent audit and legal experts in the [disciplinary] process. The FRC will establish a panel of audit experts who are independent of the FRC. Where the application of relevant auditing standards is a key factor in considering whether the regulatee concerned has committed misconduct in a disciplinary case, the FRC will invite a member of the panel to provide expert opinions. The FRC will also establish a panel of case advisers who are legal experts and independent of the FRC. In contentious cases (i.e. where the recommended sanction of the Disciplinary Department for consideration of the FRC is not accepted by the PIE auditor or responsible person concerned), the FRC will invite a case adviser to study all the relevant documents and information and give his views on whether the principles of due process and natural justice have been observed in the disciplinary process, as well as on the merits of the case including whether the recommended sanction is appropriate...."

Accordingly, it is imperative that the FRC will establish a panel of audit experts who are independent of the FRC and the regulated person to provide expert opinions and assistance to the FRC when the FRC is considering disciplinary action against a regulated person. It is also important for the FRC to establish a panel of legal experts who are independent of the FRC and the regulated person to provide expert opinions on whether the principles of due process and natural justice have been observed in the disciplinary process and whether the recommended sanction is appropriate.

iii. Under item 17 of the Summary of Views and Government's Response, the FSTB stated that "To address the audit profession's concerns over the FRC's disciplinary powers, we will put in place a series of administrative arrangements, including that the executives who have participated in the investigation/inspection or disciplinary processes of a case would not take part in making a disciplinary decision of the case (i.e. the so-called China Wall policy)."

Under paragraph 18 of the LegCo Brief, the FSTB stated that "Besides, the FRC will put in place administrative arrangements to ensure that the executives who have participated in the investigation/inspection or disciplinary processes of a case would not take part in making a disciplinary decision of the case."

Accordingly, the FRC will need to put in place administrative arrangements to address the above.
iv. Audit firms have many controls and different persons may be involved in the system of quality control in ensuring quality of audit services. Therefore, the FRC should give some clarity and transparency on what circumstances an audit firm would be regarded as having systemic failure in its system of quality control and in turn, the circumstance when the person(s) in charge of the system of quality control may be subject to disciplinary action.