Dear Ms Lam


On behalf of Mid-Tier Firm Alliance, I would like to express our gratitude for your time in meeting with us on 4 April 2019. The meeting has provided us with an opportunity to discuss with you and express our views and thoughts on the Financial Reporting Council ("FRC") Consultation Paper on Sanctions Guidelines. We are pleased to set out below detailed comments on the Consultation Paper.

1. We agree with the FRC’s objectives of imposing sanctions as set out in paragraph 10 of the consultation paper. We also agree with paragraph 11 that the primary purpose of imposing sanctions for misconduct is not to punish, but to protect the public and the wider public interest. Auditing involves a lot of professional judgement and auditing procedures include obtaining evidence from management and third parties. There are many cases and incidents whereby PIE auditors or regulated persons are deliberately misled by the management of the PIE or a third party. We agree with paragraph 57(e) and we consider FRC should place more emphasis in this when carrying out its regulatory function and/or imposing its sanctioning power. We accept that financial penalties have a role in encouraging improvements, but we suggest that the focus should be on sanctions which help to change and improve behaviours of audit industry, and to improve the system, controls and procedures of auditing. This would require a shift towards non-financial penalties which require audit practice firms and members to take positive steps and actions which are aimed at maintaining and enhancing the audit quality.

2. After determining preliminary sanctions, the FRC should consider if adjustments are needed before finalising the sanctions. Factors that may warrant a change to the sanctions include past similar cases as well as aggravating and mitigating circumstances. FRC should consider past sanction orders with similar case features to assist them in exercising their discretion on sanctions, including the disciplinary cases of the Hong Kong Institute of Certified Public Accountants ("HKICPA") in the past 46 years, in particular the recent years’ cases referred by the FRC.
3. Paragraph 8 of the consultation paper states that “These guidelines have been developed to ensure that there is an effective system of sanctions to complement investigations and inspections.” We believe that it is important to have clear distinctions between the sanctions imposed arising from investigations and inspections. We propose that the FRC should consider to adopt a separate sanctions guidelines for investigations and inspections. We consider that the FRC should make greater use of non-financial sanctions, such as imposing conditions that training or education be provided, for those breaches or weakness found in less severe or material inspection cases and that would be more effective for achieving the primary aim of protecting the public. Inspection should be considered as a system improving exercise with education elements therefore sanctions should only be imposed in extreme circumstances when the practice unit is not cooperative. In addition, for engagement partner/director, engagement quality control reviewer and registered quality control system responsible person of the auditor, they carry out different activities and have different roles, duties and responsibilities for the audit engagement. We propose that the FRC should consider to adopt a separate sanctions guidelines for registered persons of the engagement team and the registered quality control system responsible person of the PIE auditor. We consider that more emphasis should be placed on sanctions which bring improvements in audit quality and corporate governance, rather than imposing sanctions for punishments.

4. Paragraph 21 states that “In assessing the nature and seriousness of the misconduct and in determining which sanction(s) might be appropriate, the FRC will normally consider the factors summarised in the next paragraph….,. Having identified the factors that it regards as relevant, the FRC should decide the relative weight to ascribe to each relevant factor.” We are concerned that the proposed guidelines do not give sufficient explanation and guidance on how to decide the relative weight to each relevant factor. We consider that additional guidelines and Q&A examples should be included to illustrate that the level of penalty may be imposed based on the seriousness of the misconduct. We recommend that the FRC should consider paragraph 6.1 of the Guideline to Disciplinary Committee for Determining Disciplinary Order issued by the HKICPA and include a table for suggested sanctions based on the seriousness of offence so as to give the PIE auditor and the regulated persons a clarity of outcome of offence. Providing high level guidance, such as indicative ranges for the size of pecuniary penalties, would help further by reducing uncertainties and inconsistencies across cases. In addition, for sections 37D and 37E of the Financial Reporting Council Ordinance regarding the pecuniary sanctions for misconduct by PIE auditors and registered responsible persons, there is unclear on the basis for the determination the amount of pecuniary penalty. The maximum pecuniary amount for each case should not exceed the amount which is the greater of (A) $10,000,000; or (B) 3 times the amount of the profit gained or loss avoided by the person as a result of the misconduct. There should not be multiple charges on one offense and application of pecuniary penalty to each charge (which would result in a pecuniary penalty of multiple of $10,000,000 for one case).
5. Paragraph 22 states that “Factors which may be considered include: (d) whether the misconduct caused or risked the loss of significant sums of money (for example, this could be quantified in appropriate cases by reference to the reduction in market value or loss to creditors).” We do not consider that it is appropriate to determine sanctions based on the reduction in market value or loss to creditors. The auditors’ opinion in their audit report is made solely to the members of the PIE, as a body, and for no other purpose. It is clear that auditors assume responsibility for the audit report to the shareholders as a body. They do not assume responsibility towards or accept liability to any other person for the contents of their report. They do not have a duty of care to third parties, including the creditors of the PIE. Determining pecuniary sanctions by reference to financial measure, such as the reduction in market value or loss to creditors, would cause a risk of giving market the wrong impression on auditors’ liabilities. Secondly, the audit fee of the auditor is determined on the basis of the audit complexity involved and the time for the work spent for the engagement. There is no correlation between the audit fee received from the PIE and the market value of the PIE. Further, it is difficult to determine the basis for calculating the reduction in market value.

6. Paragraph 30 states that “In addition, where there is a reason to believe there may be a risk of recurrence of the misconduct, the FRC may identify steps that could be ordered to prevent the recurrence or reduce the likelihood of recurrence of the misconduct and may order the regulated person(s) to take such steps.” The FRC should only consider aggravating factor on recurrence of similar breaches of the PIE auditor in the past. It is inappropriate to assume and predict without reasonable ground that there will be a risk of recurrence of the misconduct in the future.

7. We agree with the paragraph 39 of the consultation paper that the amount of revenue generated by the PIE auditor involved in the misconduct will be a factor to be taken into account when assessing the size of the pecuniary penalty. A more equitable basis would be a measure of the revenue or profit generated from the audit that gave rise to the misconduct, such the audit fee received from the PIE or a multiple thereof. In respect of paragraph 40, we do not consider that it is appropriate to determine the pecuniary penalty based on the market share and the number of non-audit clients of the PIE auditor. Market share is a subjective measure and it is not a fair and appropriate indictor of financial means. We do not believe that such a measure of the pecuniary penalty is proportionate to the misconduct. In addition, determining the pecuniary penalty based on the number of non-audit clients of the practice unit has the effect of punishing a non-audit business which for a failure in the audit practice. The consequence of the proposal is that the greater the size of the non-audit business, the greater the punishment. This is clearly unfair on a firm which may have a larger and more successful non-audit practice. Such a criterion would be unjust and arbitrary because it is irrelevant to the severity of the misconduct.

8. Under the Financial Reporting Council Ordinance, members with “knowledge and experience in PIE engagements” are not less than one-third of the total number of members of the governing board of the FRC. We believe it is critical that there should be sufficient FRC members having appropriate skills, up to date auditing experience and knowledge and full understanding of the audit process to ensure that the strategy and direction of the FRC, decisions on outcome of inspections, investigation and disciplinary proceedings are fairly and appropriately conducted. Accordingly, we consider that it is appropriate to have a guideline to clearly set out the prerequisite of the FRC members with relevant knowledge and experience in PIE audit engagements so as to increase the transparency of the process for appointment of FRC members.
9. FRC should ensure that all decisions on inspection and investigation outcomes, participation in disciplinary proceedings and determination of sanctions will be undertaken by different personnel/departments in the FRC. Separation of the responsibilities and activities of inspection, investigation and disciplinary is of utmost important to the function of the FRC. Chief executive officer of the FRC should not be involved in the determination of sanctions, ensuring that the FRC deals with individual cases in a fair and consistent manner, and actions taken and decisions made adhere to internal procedures and sanctions guidelines.

10. FRC should has a role in encouraging improvements of accounting and auditing. FRC should not only regulate the PIE auditors, but also need to focus more in regulating the PIE and the persons responsible for the preparation of financial statements of the PIE, such as the financial controller and the finance director.

Should you have any questions or would like to discuss any of the points in more detail, please do not hesitate to contact us.

Yours sincerely,

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Convenor of Mid-Tier Firm Alliance

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Attendees for the meeting with FRC on 4 April 2019
Mr Raymond Cheng – Chairman of HLB Hodgson Impey Cheng Limited
Mr Stephen Wong – Managing Partner of RSM Hong Kong
Mr Ronald Yam – Partner of RSM Hong Kong
Mr Albert Chan – Director of Ting Ho Kwan & Chan CPA Limited
Mr Charbon Lo – Director of Crowe (HK) CPA Limited
Mr Danny Choi – Director of Baker Tilly Hong Kong Limited
Mr David Li – Deputy Managing Partner of Li, Tang, Chen & Co
Mr Derek Chan – Director of HLM CPA Limited
Mr Kenny Wong – Director of HLM CPA Limited
Mr Patrick Sze – Managing Partner of ZHONGHUI ANDA CPA Limited
Mr Wilkie Au – Director of HLB Hodgson Impey Cheng Limited