18 September 2014

Division 4
Financial Services Branch
Financial Services and the Treasury Bureau
15/F Queensway Government Offices
66 Queensway
Hong Kong

Dear Sir

Consultation Paper on Proposals to Improve the Regulatory Regime for Listed Entity Auditors (the Consultation Paper)

The Financial Reporting Council (FRC) actively supports the initiative to further enhance the independence of Hong Kong’s auditor regulatory regime. To this end, we commissioned an international comparative study on independent audit oversight, which was published in October 2013. The report covers six specific jurisdictions - the European Union, the United Kingdom, the United States, Canada, Australia and Singapore - which regulate some of the largest global capital markets, and provides valuable information to assist the public in considering the issues involved in the Consultation Paper. The report reveals that auditor regulators of major jurisdictions worldwide are independent of the profession with authority over at least auditors of listed entities.

We are pleased, as a statutory body independent of the audit profession, to have the opportunity to continue contributing to such an important initiative for Hong Kong. In this letter, we have highlighted our key recommendations from a public interest perspective, having due regard to the international best practices and experience as well as our local auditor regulatory framework which have largely been covered in our published international comparative study. Our detailed comments on the questions in the Consultation Paper are set out in the Appendix to this letter.
Reform objectives and scope

Effective oversight of auditors is crucial to the reliability and integrity of the financial reporting process which in turn are fundamental to the successful operation of financial markets and essential in enhancing investor confidence. It is of critical importance that Hong Kong, as a major international financial centre, has an auditor regulatory regime that is considered by international regulators, e.g. International Monetary Fund, as independent and robust in safeguarding the interests of the investing public. We agree that the objective of the reform is to enhance the independence of Hong Kong’s auditor regulatory regime from the profession with a view to ensuring it is benchmarked against international standards and practices and continues to be appropriate in the local context.

We believe that the reform should at a minimum enable Hong Kong to be eligible for membership in the International Forum of Independent Audit Regulators (IFIAR) and to attain regulatory equivalence status with the European Commission (EC), after which the FRC can enter into reciprocal arrangements with overseas regulators to facilitate cross-border regulatory cooperation. This would enhance international recognition of our auditors and bring Hong Kong in line with about 40 jurisdictions around the world which currently meet the regulatory or equivalence requirements of the EC and are also members of IFIAR.

While we are generally supportive of the proposal that the new regulatory regime would cover auditors of public interest entities (PIEs) which will initially be defined to only cover listed entities, we are mindful that the European Statutory Audit Directive requires oversight of regulation of all statutory auditors. Some larger capital markets worldwide already define PIEs more broadly than just listed entities and the International Ethics Standards Board for Accountants may also in the future extend the scope of PIEs. To benchmark the new auditor regulatory regime ultimately adopted by Hong Kong against international standards and to minimize the risk that it would not meet the EC equivalence requirements, we recommend that the new legislation should provide for the flexibility to amend the definition of PIEs by regulation.

Independent auditor oversight regime

It is a fundamental principle that the future auditor oversight body is independent of the audit profession; and the FRC meets this requirement. We support the
proposal to enlarge the regulatory remit of the FRC by empowering it, in addition to the existing investigatory powers under the FRC Ordinance, to be directly responsible for inspection and discipline of auditors of PIEs, and to oversee (as detailed below) the statutory functions proposed to be accorded to the Hong Kong Institute of Certified Public Accountants (HKICPA) in respect of registration, continuing professional development (CPD) and standards setting on professional ethics, auditing and assurance related to PIEs.

We consider that the FRC should have the sole discretion to determine whether and when it is appropriate to delegate any of its functions and powers to other persons or entities in the discharge of its statutory duties.

Oversight

To ensure that the oversight is effective, in addition to the arrangements proposed in the Consultation Paper (i.e. receive periodic reports, conduct quality review and give written directions), we consider that the FRC should also be given the power to require, at any time, information from the HKICPA. Moreover, to ensure that the FRC has the ability to enforce its directions and decisions on a timely basis, the FRC should be equipped with the reserve powers to act itself where circumstances so warrant in respect of matters subject to its oversight, namely registration, setting of CPD requirements, setting of standards on professional ethics, auditing and assurance.

Inspection of listed entity auditors

To ensure a comprehensive review of listed entity auditors and to fulfil international expectations and requirements, the scope of inspection and the statutory powers of inspectors/reviewers should also cover the quality control system of listed entity auditors, not just their listed entity audit and assurance engagements as proposed in the Consultation Paper.

According to the published international comparative study, four out of the five independent auditor oversight bodies are directly responsible for conducting inspections of audit firms undertaking audits of PIEs. To achieve the highest level of independence and in line with international standards and practices, we do not consider it appropriate for the FRC to delegate to HKICPA its functions and
powers to inspect listed entity auditors in respect of their listed entity audit and assurance engagements or their quality control systems.

**Disciplinary system**

An effective and efficient disciplinary system underpins the success of a regulatory regime.

We agree that the FRC should be vested with disciplinary powers, including powers to issue fining/punishment guidelines and impose proportionate disciplinary sanctions. We fully support the principles of fairness and natural justice and we will observe and follow due process.

FRC is constituted as an independent regulatory body by statute and it meets the “independence” requirement for IFIAR membership and for attaining the regulatory equivalence with the EC. To address the proposal that “FRC would be required to put in place appropriate arrangements to ensure that its investigative staff will not be involved in the disciplinary process and the determination of disciplinary sanctions”, we are committed to implementing appropriate measures to segregate the investigative and disciplinary functions.

Regarding the basis of determination of the maximum pecuniary penalty, we consider that reference to a multiple of profit gained or loss avoided by the auditor in question is not appropriate and is difficult to quantify. We recommend a reference to a multiple of the engagement fee which is more objective and appropriate for the type of engagements performed by auditors of PIEs.

Hong Kong Standard on Quality Control 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements (HKSQC 1)* stipulates that the firm’s chief executive officer (or equivalent) or managing board of partners (or equivalent) shall assume ultimate responsibility for the firm’s system of quality control. We consider that to stipulate the individual/individuals (i.e. the practice unit’s chief executive officer (or equivalent) or members of the managing board of partners (or equivalent)) who assume(s) ultimate responsibility for the system of quality control of a practice unit should be held accountable for the absence/systemic failure of such system would not only be consistent with the existing obligations under the local standard but would also prevent a gap in the statutory framework. These individuals would be
subject to disciplinary sanctions in this regard only if serious firm-wide or systemic
deficiencies are identified and their particular circumstances would be taken into
account on a case by case basis.

Governance of the FRC

We appreciate the significance of the composition and governance of the future
auditor oversight body. We are supportive of the proposal of abolishing the
existing nomination arrangements which stem from the present funding mechanism.
We consider that the independence of Council of the FRC (Council), both in fact
and in the eyes of the public, is paramount at all times and therefore the majority of
Council members should be non-practitioners. To have at least two Council
members who possess knowledge of and experience in the auditing of Hong Kong
listed entities would definitely be helpful.

Our experience has been that there is often difficulty in achieving a quorum at
meeting which is currently stipulated in the FRC Ordinance as two thirds of the
members of the Council. We recommend the appointment of more than the
proposed minimum number of (7) members to the Council as well as the lowering
of the quorum for a meeting of the Council to half of the Council members.

Conclusion

We believe that the reform should at a minimum enable Hong Kong to be eligible
for membership in the IFIAR and to attain regulatory equivalence status with the
EC. While there can be different approaches to meeting this objective, we support,
subject to our submissions herein, the proposals set out in the Consultation Paper
in relation to the six functional areas i.e. registration, CPD, setting of standards,
inspection, investigation and discipline. We would invite the Financial Services
and the Treasury Bureau (FSTB) to vigorously pursue a robust auditor regulatory
regime for Hong Kong that is at least on par with other major international
financial centres.

We have also taken this opportunity to recommend some changes to the existing
provisions of the FRC Ordinance including the abolition of the Audit Investigation
Board (AIB) and the Financial Reporting Review Committee (FRRC) under the
new auditor regulatory regime. Please see our submission in this regard under
“Other matters” in the Appendix.
If you require further information or clarifications, please feel free to contact the undersigned at 2810 6321 or our Chief Executive Officer, Mr Mark Dickens at 2236 6001.

Yours faithfully

John Poon
Chairman

JP/MD/fw
Encl
This is an appendix to the letter from the Chairman of the FRC dated 18 September 2014 to the FSTB in response to the Consultation Paper on Proposals to Improve the Regulatory Regime for Listed Entity Auditors. Unless otherwise specified, the capitalized terms in this Appendix have the same meaning as set out in the letter.

Response to specific questions

Basic parameters of reform

**Question 1**

Do you agree with the proposed objective of the reform, i.e. to enhance the independence of the regulatory regime for auditors of listed entities from the profession itself with a view to ensuring that the regime is benchmarked against international standards and practices and continues to be appropriate in the local context?

We agree that the objective of the reform is to enhance the independence of the auditor regulatory regime of Hong Kong from the profession with a view to ensuring it is benchmarked against international standards and practices and continues to be appropriate in the local context.

We believe that the reform should at a minimum enable Hong Kong to be eligible for membership in the IFIAR and to attain regulatory equivalence status with the EC, after which the FRC can enter into reciprocal arrangements with overseas regulators to facilitate cross-border regulatory cooperation. This would enhance international recognition of our auditors and bring Hong Kong in line with about 40 jurisdictions around the world which currently meet the regulatory or equivalence requirements of the EC and are also members of IFIAR. We understand that it would also benefit those Hong Kong audit firms which provide audit services to entities with securities listed in the European Economic Area. Besides, as a major international financial centre, it is of critical importance that our auditor regulatory regime is considered by international regulators, e.g. International Monetary Fund as independent and effective in safeguarding the interests of the investing public.
Question 2
Do you agree that the new regulatory regime should only cover auditors of public interest entities, which will be defined to cover listed entity auditors?

While we are generally supportive of the proposal that the new regulatory regime would cover auditors of PIEs which will initially be defined to only cover listed entity auditors, we are mindful that Articles 46 and 29 of the European Statutory Audit Directive requires oversight of regulation of all statutory auditors. PIEs defined in the aforesaid Directive include credit institutions and insurance undertakings in addition to listed entities. Some larger capital markets worldwide already define PIEs more broadly than just listed entities and the International Ethics Standards Board for Accountants may also in the future extend the scope of PIEs. To benchmark the new auditor regulatory regime ultimately adopted by Hong Kong against international standards and to minimize the risk that it would not meet the EC equivalence requirements, the new legislation should provide for flexibility to amend the definition of PIEs.

Question 3
Do you agree that the definition of public interest entities should be set out in the main legislation such that any change in future could only be made by way of an amendment bill?

We understand that some jurisdictions define PIEs by regulation or legislation while others include guidance in their professional standards. We recommend that the new legislation should provide flexibility to amend the definition of PIEs by regulation.

Question 4
Do you agree that FRC should become the independent auditor oversight body with respect to listed entities in Hong Kong by enlarging its regulatory remit?

It is a fundamental principle that the future auditor oversight body is independent of the audit profession; and the FRC meets this requirement. We, therefore, support the proposal to enlarge the regulatory remit of the FRC to enable it to become the independent auditor oversight body with respect to listed entities in Hong Kong.
Registration

Question 5
(a) Do you agree that a listed entity auditor must be a practice unit as defined under the existing PAO and a fit and proper person to be registered as a listed entity auditor?

We agree that a listed entity auditor must be a practice unit as defined under the existing Professional Accountants Ordinance and that only a fit and proper person can be registered as a listed entity auditor as this helps ensure the quality of listed entity audits and enhance investor protection.

(b) If yes, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for considering whether a person is fit and proper to be registered as a listed entity auditor, i.e. by reference to the existing fit and proper test for becoming a CPA?

We agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements as set out in paragraph 3.6 of the Consultation Paper for considering whether a person is fit and proper to be registered as a listed entity auditor. We note that the Consultation Paper provides that there will be regular reviews of the qualification and experience requirements in future.

Question 6
(a) Do you agree that in order for an application for registration as a listed entity auditor to be approved, the individuals who are authorised by the auditor to perform the roles of an audit engagement authorised person, an engagement quality control reviewer or a quality control system responsible person should be fit and proper persons to perform such roles?

Yes. This helps ensure the quality of listed entity audits, promotes confidence in the financial markets and protects the investing public.
(b) If so, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for individuals taking up such roles with respect to a registered listed entity auditor when considering whether they are fit and proper to perform those roles?

We agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for the abovementioned individuals when considering whether they are fit and proper to perform those roles. We note that the Consultation Paper provides that there will be regular reviews of the qualification and experience requirements in future.

Question 7
Do you agree that an individual, partnership or body corporate who wishes to enter into an audit engagement with a listed entity in Hong Kong should be required to register as a listed entity auditor, and that it shall be a criminal offence if an unregistered person entered into an audit engagement with a listed entity?

Yes. This secures maximum accountability and transparency.

Question 8
(a) Do you agree that HKICPA Registrar should be assigned the role of Registrar of Listed Entity Auditors and be vested with the registration functions and powers as outlined in paragraph 3.23, and FRC should exercise oversight through arrangements as proposed in paragraph 3.24?

Subject to the independent oversight by the FRC, we agree that HKICPA Registrar should be assigned the role of Registrar of Listed Entity Auditors and be vested with the registration functions and powers as outlined in paragraph 3.23 of the Consultation Paper to avoid duplicating the infrastructure and efforts used to collect information which might already be available to the HKICPA Registrar. To ensure that the oversight is effective, in addition to the arrangements as proposed in paragraph 3.24 of the Consultation Paper, we consider that the FRC should also be given the power to require, at any time, information from the HKICPA. Moreover, to ensure that the FRC has the ability to enforce its directions and decisions on a timely basis, the FRC should be equipped with the reserve powers to act itself in respect of registration where circumstances so warrant.
Do you agree that FRC should publish the periodic reports received by the HKICPA Registrar as mentioned in paragraph 3.24(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?

We fully support the transparency and accountability principles and agree that the FRC should provide information on the results of its quality review and the written directions given to the HKICPA Registrar in its annual report. However, we have reservations on publishing the actual periodic reports received from the HKICPA Registrar on a website as the periodic reports may contain some confidential or sensitive information or information of proprietary nature. Relevant information from the periodic reports would be provided in the FRC’s annual report and on its website.

Question 9
Do you agree that any person subject to a registration decision by the HKICPA Registrar may appeal against the decision, and any such appeal should be handled by an appeal mechanism which is independent of both the HKICPA Registrar and FRC?

Yes.

Question 10
Do you agree with the proposal that registration shall remain in force until 1 January in the year following the year in which the auditor was so registered, and each registration is subject to annual renewal?

We consider that registration should remain in force until 1 January of the year following the year in which the auditor was registered or the date an order to remove a registrant from the register of listed entity auditors takes effect as a result of disciplinary action, whichever is earlier. Each registration should be subject to annual renewal.

Question 11
Do you agree that the register of listed entity auditors should include the types of information on each registered listed entity auditor as proposed in paragraph 3.27?

Yes. This ensures greater transparency.
Question 12
Do you agree that FRC should be vested with statutory powers to take over SFC/HKEx’s existing roles in receiving and making decisions on applications for recognizing overseas auditors of specific overseas entities which have been approved for listing in Hong Kong on a case-by-case basis?

We support the proposal to empower the FRC to receive and make decisions on applications for recognizing overseas auditors of specific overseas entities which have been approved for listing in Hong Kong on a case-by-case basis. This helps ensuring applications would be considered in a consistent manner.

Question 13
Do you agree that an applicant must meet the criteria as proposed in paragraph 3.30 for being recognised as an overseas auditor of the overseas entity listed in Hong Kong as set out in its application?

Yes. We believe these criteria not only provide well-balanced assessment of an applicant but also allow for regulatory assistance for subsequent regulation of an overseas auditor.

During the transitional period before the FRC signs bilateral agreements with overseas regulators, the FRC would recognize overseas auditors currently accepted by the Stock Exchange of Hong Kong and the Securities and Futures Commission (SFC) to ensure that overseas incorporated listed entities and their auditors will not be affected.

Question 14
Do you agree that the recognition of an overseas auditor of an overseas entity listed in Hong Kong should remain in force until the following 1 January or the time when the overseas auditor ceases to be the auditor of the listed entity in question, whichever is earlier, subject to renewal of the recognition?

We consider that the recognition of an overseas auditor of a specified overseas entity listed in Hong Kong should remain in force until the following 1 January, or the time when the overseas auditor ceases to be the auditor of that entity or fails to meet the recognition criteria set out in Paragraph 3.30 of the Consultation Paper, whichever is earlier, subject to renewal of the recognition.
Question 15
Do you agree that the HKICPA Registrar shall maintain and update a list of overseas auditors who were recognised by FRC for entering into audit engagements with specific overseas entities listed in Hong Kong, and make available for public inspection/publish on HKICPA’s website the list?

Yes. This provides a one-stop portal for information on auditors of listed entities in Hong Kong.

Setting of continuing professional development requirements

Question 16
(a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers with regard to setting CPD requirements for listed entity auditors, subject to independent oversight by FRC in accordance with paragraph 4.6?

Subject to independent oversight by the FRC, we agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers with regard to setting CPD requirements for listed entity auditors. To ensure that the oversight is effective, in addition to the arrangements as proposed in paragraph 4.6 of the Consultation Paper, we consider that the FRC should also be given the power to require, at any time, information from the HKICPA. Moreover, to ensure that the FRC has the ability to enforce its directions and decisions on a timely basis, the FRC should be equipped with the reserve powers to act itself in respect of setting of CPD requirements where circumstances so warrant.

(b) Do you agree that FRC should publish the periodic reports received by it as mentioned in paragraph 4.6(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?

Similar to our response to Question 8(b), we agree that the FRC should provide information on the results of its quality review and the written directions given to the HKICPA Registrar in its annual report but should not be obliged to publish the actual periodic reports received from the HKICPA Registrar on its website. Relevant information from the periodic reports would be provided in the FRC’s annual report and on its website.
Setting of standards on professional ethics, auditing and assurance

Question 17
(a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing and assurance to be observed, maintained or otherwise applied by CPAs (practising), and FRC should exercise oversight of the performance of such functions and the exercise of such powers by HKICPA which are applicable to listed entity auditors as proposed in the arrangements set out in paragraph 5.8?

Subject to independent oversight by the FRC, we agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing and assurance to be observed, maintained or applied by CPAs (practising) for audit and assurance engagements with regard to Hong Kong listed entities. To ensure that the oversight is effective, in addition to the arrangements as proposed in paragraph 5.8 of the Consultation Paper, we consider that the FRC should also be given the power to require, at any time, information from the HKICPA. Moreover, to ensure that the FRC has the ability to enforce its directions and decisions on a timely basis, the FRC should be equipped with the reserve powers to act itself in respect of setting of standards on professional ethics, auditing and assurance where circumstances so warrant.

(b) Do you agree that FRC should publish the periodic reports received by it as mentioned in paragraph 5.8(a) on its website, and provide information on the results of its quality review and the written instructions given by it in its annual report?

Similar to our responses to Questions 8(b) and 16(b), we agree that the FRC should provide information on the results of its quality review and the written directions given to the HKICPA Registrar in its annual report but should not be obliged to publish the actual periodic reports received from the HKICPA Registrar on its website. Relevant information from the periodic reports would be provided in the FRC’s annual report and on its website.
Question 18
Do you agree that HKICPA and FRC should establish procedures to ensure that the HKICPA Council would duly take into account FRC’s views before it makes any decision on the setting of standards on professional ethics, auditing and assurance in relation to listed entity auditors?

To ensure efficient and effective co-operation and co-ordination between the HKICPA and the FRC, we recommend that the two parties should enter into a memorandum of understanding which would set out the working arrangements in this respect to ensure that the HKICPA Council would duly take into account FRC’s views before it makes any decision on the setting of standards on professional ethics, auditing and assurance in relation to listed entity auditors.

Inspection

Question 19
Do you agree with the proposal to transfer statutory functions for conducting recurring inspections of listed entity auditors in respect of their listed entity audit engagements from HKICPA to FRC, with FRC being given the necessary powers as set out in paragraph 6.13 (which are similar to the powers which HKICPA is equipped with under its practice review programme)?

We support the proposal to transfer statutory functions for conducting recurring inspections of listed entity auditors in respect of their listed entity audit and assurance engagements from the HKICPA to the FRC, with the FRC being given the necessary powers as set out in paragraph 6.13 of the Consultation Paper. While we note paragraph 6.1 of the Consultation Paper states that inspection programme usually include review of both internal quality control systems and individual engagements, paragraph 6.12 refers only to listed entity audit engagements. To ensure a comprehensive review on listed entity auditors and to fulfil international expectations and requirements, the scope of inspection should also cover the quality control system of the listed entity auditors.

Paragraph 6.1 of the Consultation Paper states that “Usually, inspection programme would include reviewing both the internal quality control system of practice units and their individual audit engagements. The former would address the practice unit’s overall quality control system as reflected in its organization, policies and procedures, while the latter would include reviewing selected audit
files in order to assess the application of the practice unit’s quality control system and its compliance with applicable laws, rules and professional standards.”

In the “Core Principles for Independent Audit Regulators”, IFIAR specifies that “Audit regulators should ensure that inspections include effective procedures for both firm wide and file reviews.” The firm wide procedures should address the audit firm’s quality control system as reflected in the firm’s organization, policies and procedures. The European Statutory Audit Directive requires that the scope of the quality assurance review shall include an assessment of the internal quality control system of the audit firm. IOSCO’s Principles for Auditor Oversight also stipulate that reviews should be designed to determine the extent to which audit firms have adequate quality control policies and procedures that address all significant aspects of auditing.

In addition, we consider that the new regulatory regime should stipulate expressly that the FRC should have the power to require listed entity auditors to provide information, including but not limited to that in the current HKICPA’s Practice Review Self-assessment Questionnaire, so that the FRC would be able to assess the risk-profile of individual listed entity auditors.

**Question 20**
**Do you agree that FRC’s inspection programme should adopt the statutory procedures as set out in paragraph 6.14 with reference to the existing arrangements for HKICPA’s practice review programme?**

We agree, in principle, that the FRC’s inspection programme should include the statutory procedures as set out in paragraph 6.14 of the Consultation Paper in relation to the findings of the FRC’s inspection on a listed entity auditor.

**Question 21**
**Do you agree that FRC may delegate its inspection functions and relevant powers to committees formed under its auspices?**

We consider that the FRC should have the sole discretion to determine whether and when it is appropriate to delegate its inspection functions and powers to other persons or entities in the discharge of its statutory duties. We do not favour following the existing arrangements under the Professional Accountants Ordinance and using a statutory committee to exercise the inspection functions.
Question 22
What are your views on whether FRC should be allowed to delegate to HKICPA its functions and powers to inspect listed entity auditors in respect of their listed entity audit engagements; and if so, what checks-and-balances measures should be introduced to ensure proper delegation and accountability for the quality of the work so delegated to HKICPA?

To achieve the highest level of independence and in line with international standards and practices, we do not consider it appropriate for the FRC to delegate to HKICPA its functions and powers to inspect listed entity auditors in respect of their listed entity audit and assurance engagements or their quality control systems.

According to the published international comparative study on independent audit oversight, most independent auditor oversight bodies of overseas jurisdictions (i.e. the Public Company Accounting Oversight Board of the United States, the Canadian Public Accountability Board, the Australian Securities and Investments Commission, and the Accounting and Corporate Regulatory Authority of Singapore) are directly responsible for conducting inspections of audit firms undertaking audits of PIEs, except for the Financial Reporting Council of the United Kingdom.

Question 23
Do you agree that FRC reviewers should be given the proposed statutory powers as set out in paragraph 6.17 in relation to their inspections?

The proposed statutory powers as set out in paragraph 6.17 of the Consultation Paper are in relation to audit engagements. Consistent with our response to Question 19, we consider that FRC inspectors/reviewers should be given the statutory power to inspect, make copies or record, enquire, have access to, require production and answer in relation to the policies and procedures of the listed entity auditor’s system of quality control for listed entity audit and assurance engagements.

Question 24
(a) Do you agree with the proposal to provide for criminal offences against a person who fails to comply with the requirements in relation to FRC’s inspections?

Yes. This is in line with the FRC Ordinance in relation to investigation and enquiries.
(b) If so, do you agree that the provisions on such criminal offences should be modelled on the existing provisions in the FRCO concerning failure to comply with requirements in relation to an investigation into relevant irregularities?

Yes, for the sake of consistency and fairness.

**Question 25**
Do you agree that the secrecy provisions in the PAO and the FRCO should be suitably amended to provide that both HKICPA and FRC could share their inspection results with each other to facilitate them to coordinate their inspection activities?

Yes. This helps avoid duplication of efforts and unnecessary burden on auditors who have listed entity audit engagements and non-listed entity audit engagements.

**Investigation and disciplinary proceedings**

**Question 26**
Do you agree that FRC should continue to be responsible for conducting independent investigations into relevant irregularities by listed entity auditors?

We are committed to conducting independent investigations into relevant irregularities by listed entity auditors in a fair, impartial and efficient manner.

**Question 27**
Do you agree that a disciplinary action may be imposed on a listed entity auditor, a person approved to be its audit engagement authorised person and/or a person approved to be its engagement quality control reviewer if the listed entity auditor and/or the person concerned (as the case maybe) is proved to have committed an irregularity in relation to an audit engagement?

Yes. We believe that this secures maximum accountability.
Question 28
Do you agree that the definition of “irregularity” under the new regulatory regime should be refined to cover irregularities in respect of all audit and assurance engagements undertaken by listed entity auditors with listed entities as required under the Listing Rules?

Yes. This not only enhances investor protection but also ensures consistency in regulating engagements undertaken by listed entity auditors.

Question 29
What is your view on whether the new regime should specifically provide that the individual/individuals who assume(s) ultimate responsibility for the system of quality control of a practice unit would be held accountable for the absence/systemic failure of such system, and whether it should stipulate expressly that such responsible person(s) shall be the practice unit’s chief executive officer (or equivalent) or, if appropriate, members of the practice unit’s managing board of partners (or equivalent)?

Paragraph 18 of HKSQC 1 states that “The firm shall establish policies and procedures designed to promote an internal culture recognizing that quality is essential in performing engagements. Such policies and procedures shall require the firm’s chief executive officer (or equivalent) or, if appropriate, the firm’s managing board of partners (or equivalent) to assume ultimate responsibility for the firm’s system of quality control.”

HKSQC 1 has already stipulated that the firm’s chief executive officer (or equivalent) or managing board of partners (or equivalent) shall assume ultimate responsibility for the firm’s system of quality control. We consider that to stipulate the individual/individuals (i.e. the practice unit’s chief executive officer (or equivalent) or members of the managing board of partners (or equivalent)) who assume(s) ultimate responsibility for the system of quality control of a practice unit should be held accountable for the absence/systemic failure of such system would not only be consistent with the existing obligations under the local standard but would also prevent a gap in the statutory framework.

In cases where serious firm-wide or systemic deficiencies are identified, the FRC may need to hold the persons registered as responsible for the firm’s system of audit quality control, the firm, or both accountable. One consideration is that if individuals with responsibility for the firm’s system of audit quality control are not required to be held accountable, the “firm” itself would need to be subject to
disciplinary proceedings for cases involved firm-wide or systemic deficiencies. This would affect all partners/directors of the firm, irrespective of whether they are involved in the firm’s system of audit quality control, and may severely impact the firm.

**Question 30**

Do you agree that FRC, as the future independent auditor oversight body, should be vested with disciplinary powers, including powers to make decisions on disciplinary cases, concerning listed entity auditors, subject to the requirements for ensuring fairness and a due process as proposed in paragraphs 7.21 to 7.24?

An effective and efficient disciplinary system underpins the success of a regulatory regime. In this connection, we agree that the FRC should be vested with disciplinary powers, including powers to make decisions on disciplinary cases, concerning listed entity auditors. We fully support the principles of fairness and natural justice and we will observe and follow due process, e.g. inform the person subject to disciplinary proceedings in writing of the apparent prima facie case against him, give a reasonable opportunity of being heard before exercising disciplinary powers, issue fining/penalty guidelines and impose proportionate disciplinary sanctions.

FRC is constituted as an independent regulatory body by statute and it meets the “independence” requirement for IFIAR membership and for attaining the regulatory equivalence with the EC. To address the proposal that “FRC would be required to put in place appropriate arrangements to ensure that its investigative staff will not be involved in the disciplinary process and the determination of disciplinary sanctions”, we are committed to implementing appropriate measures to segregate the investigative and disciplinary functions.

**Question 31**

Do you agree that FRC should be empowered to exercise the range of disciplinary powers on a person subject to disciplinary action outlined in paragraph 7.27?

We consider that the basis of determination of the maximum pecuniary penalty by reference to a multiple of profit gained or loss avoided by the auditor in question is not appropriate and is difficult to quantify. It should be a factor to be considered when determining the level of pecuniary penalty to be imposed but not a basis for maximum pecuniary penalty. Audit is not a transaction but a service where the
audit fee charged is referenced to the hours expended on an audit engagement. The profit or loss of an engagement may involve numerous indirect costs which would be subject to arbitrary allocation. We recommend a reference to a multiple of the engagement fee which is more objective and appropriate for the type of engagements performed by auditors of PIEs.

Apart from the range of disciplinary powers outlined in paragraph 7.27 of the Consultation Paper, we consider that the FRC should be given the power to order a person subject to disciplinary action to pay to the FRC the costs and expenses in relation or incidental to disciplinary proceedings.

**Question 32**

Do you agree that FRC should be required by law to issue guidelines to indicate the manner in which it exercises its power to order a person subject to disciplinary action to pay a pecuniary penalty, and to have regard to the issued guidelines when exercising such power?

Yes.

**Question 33**

Do you agree that any pecuniary penalty paid to or recovered by FRC would be paid by FRC into the Government general revenue?

We agree that any pecuniary penalty paid to or recovered by the FRC would be paid by the FRC into the Government general revenue to avoid any perceived conflict of interest.

**Question 34**

Do you agree that FRC may enter into a resolution with the person subject to disciplinary action at any time it is contemplating exercising its disciplinary power, and in exercising such power, FRC must consider it appropriate to do so in the interest of the investing public or in the public interest?

Yes, but the FRC should have the ability to enter into a resolution at any time during the disciplinary process. This would further enhance regulatory efficiency, save costs and time for the person subject to disciplinary action and the FRC, and reduce the burden on those subject to disciplinary action. In exercising this power, the FRC should satisfy itself that it is in the interest of the investing public or in the public interest.
Question 35
Do you agree that any amount paid to or recovered by FRC arising from a resolution would be paid by FRC into the Government general revenue?

We agree that any amount paid to or recovered by the FRC arising from a resolution apart from the expenses of the investigation and the proceedings would be paid by the FRC into the Government general revenue to avoid any perceived conflict of interest.

Appeal mechanism

Question 36
Do you agree that a new independent appeals tribunal should be set up for hearing appeals in respect of registration decisions made by the HKICPA Registrar and disciplinary decisions made by FRC?

Yes.

Question 37
(a) Do you agree that a person who disagrees with a registration decision made in respect of him or is aggrieved by a disciplinary decision made in respect of him may apply to the new independent appeals tribunal for a review of the decision within 21 days after a notice of the relevant decision has been served upon him?

Yes.

(b) If so, do you agree that the independent appeals tribunal may, upon application by the relevant person, grant an extension to application for review of a specified decision, and that such extension should only be granted after the applicant and FRC have been given a reasonable opportunity to be heard on the proposed extension and the independent appeals tribunal is satisfied that there is a good cause for granting the extension?

We agree with the above proposal which would be less vulnerable to being abused.
Question 38
Do you agree with the composition of the independent appeals tribunal as proposed in paragraph 8.6, i.e. a chairman who is a person qualified for appointment as a judge of the High Court and two members who are not public officers, all to be appointed by the Chief Executive?

Yes.

Question 39
Do you agree that the independent appeals tribunal may exercise the proposed powers as outlined in paragraph 8.7 in the review proceedings?

In principle, we agree that the independent appeals tribunal may exercise the proposed powers as outlined in paragraph 8.7 of the Consultation Paper in the review proceedings. For clarity, in addition to ordering a person to attend before it to give evidence, the independent appeals tribunal should be empowered to order a person to provide documentary evidence.

Question 40
Do you agree that sittings of the independent appeals tribunal should be held in public unless in the interests of justice it determines otherwise?

Yes.

Question 41
(a) Do you agree that a party to the appeal who is dissatisfied with a determination of the independent appeals tribunal may further appeal to the Court of Appeal on a question of law, fact, or mixed law and fact?

Yes.

(b) If so, do you agree that no appeal to the Court of Appeal may be made unless leave to appeal has been granted by the same Court, and the leave may only be granted if the Court of Appeal is satisfied that the appeal has a reasonable prospect of success or there is some other reason in the interests of justice why the appeal should be heard?

Although we appreciate that the proposals set out in the Consultation Paper would avoid abuse of the appeal mechanism, we are neutral on these proposals.
Funding mechanism

Question 42
Do you agree that under the new regulatory regime, FRC should be funded by way of introducing three new levies on (a) listed entities; (b) securities transactions; and (c) listed entity auditors such that they will each provide roughly equal contributions to FRC i.e. one third from listed entities, one third from securities investors and one third from listed entity auditors?

It is of fundamental importance that the new auditor regulator should have adequate funding, including a buffer for litigation, to discharge its responsibilities. Both the IFIAR and European Statutory Audit Directive require the auditor regulator should have a stable source of funding, which is secure and free from influence by audit profession and sufficient to execute its power and responsibilities. As long as the above requirements are fulfilled, we are neutral as to how the future operations of the FRC would be funded.

Question 43
Do you agree that –
(a) the levy on listed entities should be based on the prevailing formula under which listed entities pay their annual listing fees to HKEx, and that the levy should be collected by HKEx on behalf of FRC;
(b) the levy on securities transactions should be based on the modus operandi for the existing levy charged by SFC under the Securities and Futures Ordinance, and that the levy should be collected by SFC on behalf of FRC; and
(c) the levy on listed entity auditors should be directly proportional to the number of listed entity audit engagements entered into by the listed entity auditors, and that the levy should be collected by the HKICPA Registrar on behalf of FRC?

As mentioned earlier, as long as the source of funding is free from undue influence by the audit profession, we are neutral as to how the future operations of the FRC would be funded.
Question 44
Do you agree that the three levies should be stipulated in subsidiary legislation subject to negative vetting by the Legislative Council?

To be consistent with other statutory fees and charges, we agree that any levies as finally determined to be appropriate should be stipulated in subsidiary legislation subject to negative vetting by the Legislative Council.

Question 45
Do you agree that FRC should be required to review the levels of the three levies once its reserve has reached a level equivalent to 24 months of its operating expense, after deducting depreciation and all provisions?

Subject to the final determination of the source of funding of the FRC, we support the proposal requiring the FRC to review the levels of the any levies once its reserve has reached a level equivalent to 24 months of its operating expenses.

Governance of the FRC

Question 46
(a) Do you agree with the proposed new composition of FRC membership, i.e. not fewer than seven members appointed by the Chief Executive, together with the FRC Chief Executive Officer as an ex-officio member, and abolishing the existing arrangements for the nomination of FRC members and for the Registrar of Companies to be an ex-officio member as set out in paragraph 10.6?

We are supportive of the above two proposals.

Our experience has been that there is often difficulty in achieving a quorum at meeting which is currently stipulated in the FRC Ordinance as two thirds of the members of the Council. Taking into account that more members would come from the profession (at least two persons who possess knowledge of and experience in the auditing of Hong Kong listed entities and ex-auditors may qualify as non-practitioners), we recommend the appointment of more than the proposed minimum number of (7) members to the Council as well as the lowering of the quorum for a meeting of the Council to half of the Council members.
(b) Do you agree that there should be at least two persons who possess knowledge of and experience in the auditing of Hong Kong listed entities out of the FRC members to be appointed by the Chief Executive?

To have members who possess knowledge of and experience in the auditing of Hong Kong listed entities in Council would definitely be helpful to enable the FRC to discharge its functions and duties in a more efficient and effective manner. Subject to our response to Question 47, we support that there should be at least two Council members who possess the relevant knowledge and experience in the auditing of Hong Kong listed entities.

**Question 47**

Do you agree that FRC will be required to have a chairman and a majority of members who are non-practitioners, with a non-practitioner being defined as a person who (a) is not, or has not during the previous three years been, a CPA (practising); and (b) is not, or has not during the previous three years been, a partner, director, agent or employee of a practice unit?

We consider that the independence of Council, both in fact and in the eyes of the public, is paramount at all times and therefore, we agree that the FRC will be required to have a chairman and a majority of members who are non-practitioners, with the definition as set out in Paragraph 10.8 of the Consultation Paper.
Other matters

We take this opportunity to recommend the following changes to the existing provisions of the FRC Ordinance to streamline the operations.

(a) Abolition of the AIB and the FRRC

To enhance the efficiency of the existing investigative and enquiry functions, we propose abolishing the AIB and the FRRC and allowing any persons authorized by the Council to initiate and conduct an investigation or enquiry. This allows an authorized person to initiate an investigation or enquiry in a more timely manner and provides increased flexibility in resource allocation as the number of persons involved in investigations and enquiries could be adjusted in proportion to the complexity of the case.

According to the existing FRC Ordinance, if it appears to the Council that there are circumstances suggesting or if the Council has reasonable cause to believe that there is or may be a relevant irregularity in relation to a listed entity, the Council needs to certify this in writing and it may conduct the investigation or direct the AIB to investigate the irregularity and the question whether or not there is such an irregularity. The Council cannot delegate to staff its powers to initiate an investigation. Further, when it directs the AIB to conduct an investigation, all members of the AIB who are not conflicted in a particular investigation need to be involved in each step of the investigation. This leads to inefficiencies in initiating and conducting investigations. Likewise, if it appears to the Council that there is or may be non-compliance with accounting requirements, the Council may direct the FRRC to conduct an enquiry and this process is also unnecessarily cumbersome.

The above proposed measures would not affect the fairness and checks and balances in relation to investigations or enquiries. Any persons under investigation or enquiry will be given a reasonable opportunity of being heard before the finalization of the report. The FRC will then consider the final report to determine the appropriate course of action according to the powers stipulated in the FRC Ordinance.
(b) Amendment of the definition of “relevant financial report”

We request the FSTB to consider revising the definition of “relevant financial report” in the FRC Ordinance to ensure it covers all entities listed on the Stock Exchange of Hong Kong.

If, after considering an enquiry report, it appears to the Council that there is a relevant non-compliance in relation to a listed entity, the FRC can give a notice to the listed entity concerned requesting it to revise the relevant financial report and/or take other remedial action. The FRC may also apply to the Court of First Instance for an order requesting directors of the listed entity to cause the relevant financial report to be revised. However, “relevant financial report” defined in Part 2 of the FRC Ordinance refers to the Hong Kong Companies Ordinance. As the majority of Hong Kong listed entities are not incorporated in Hong Kong under the Hong Kong Companies Ordinance, this renders the power to secure removal of non-compliance inapplicable to most listed entities.