

Submission Prepared by the Hong Kong Society of Accountants

**Concerning
“Enhancement on the Regulation of Listed Companies and
Corporate Governance of Companies”
Before the Legislative Council Panel on Financial Affairs
Monday, 7 April 2003, 10:45 a.m.**

Introduction

1. We welcome this opportunity to contribute our views to the discussion of the subject “Enhancement on the Regulation of Listed Companies and Corporate Governance of Companies”.
2. In your invitation to attend this meeting, the Panel made reference to:
 - (a) recent allegations relating to false financial documents of listed companies that have aroused public concern over the quality of listed companies and their professional advisers;
 - (b) calls for regulators to strengthen regulation of relevant parties involved in the listing process and monitoring of listed companies; and
 - (c) calls for upgrading the corporate governance of companies.
3. All these issues relate to the call for action to restore investors’ confidence in the securities market.
4. The collapse of Enron, WorldCom and others abroad has generated significant debate in the public arena, both internationally and locally, regarding the regulation of the accountancy profession and in particular, whether the self-regulatory mode is operating in the way it is meant to be or should be continued. Locally, there are allegations relating to false financial documents of listed companies.
5. The issues being discussed by the Panel today highlight the need of those who govern and manage listed companies to be “fit and proper persons”. They must be people of integrity, and be accountable to their shareholders and other stakeholders. Their advisors—sponsors, merchant bankers, financial advisors, lawyers, valuers, accountants and auditors—must also recognize that they owe a duty of care to the shareholders and the investing public.

6. In this presentation, we would like to focus on the reform proposals that the Society has initiated to strengthen the oversight of the accountancy profession in Hong Kong. However, make no mistake. Strengthening oversight of the accounting profession, whilst it is important and fashionable, is only an auxiliary measure in enhancing the regulation and corporate governance of listed companies. Directors, management, shareholders, regulators, and other advisors must each do their part.
7. The Society has been a self-regulating organization (“SRO”) established under the Professional Accountants Ordinance since 1973. In the past 30 years, we have made much progress in the development of the accounting profession in Hong Kong. As a SRO, we have been able to react quickly to market developments, and have made some timely changes to the accounting profession. For example, in the mid 1990s, recognizing the growing importance and recognition of international accounting standards, we commenced the process of transforming our accounting, auditing, and ethical standards, which up to that point were British-based, to conform with international standards and practices. Two years ago, recognizing the need for our disciplinary process to be more transparent, we moved quickly and were able to secure the support of our membership to open up our disciplinary hearings.
8. We have also contributed to upholding the quality of published financial statements in Hong Kong. The Society is the first organization in Hong Kong to review published financial statements regularly and to monitor their compliance with promulgated standards. Inquiries and suggestions for improvements are made to our members, who relay the recommendations for improvements to the listed companies.
9. In 1995, we published a report that highlighted a number of significant shortcomings in the corporate governance practices in Hong Kong, and since then, we have published a number of papers on corporate governance that have spurred further discussions and initiatives on improving corporate governance practices in Hong Kong.
10. However, the Society recognizes that, arising from the corporate failures and irregularities both overseas and locally, there is increased public demand for **oversight**, and **greater transparency, independence and accountability** in the regulation of public company auditors. In this connection, we recognize that public oversight is a major element in the maintenance of confidence in the audit profession.

Principles for Auditor Oversight

11. There are, however, different forms and structures of oversight. In October 2002, the Technical Committee of the International Organization of Securities Commissions (“IOSCO”) published a list of general principles for oversight of auditors that audit financial statements of companies whose securities are publicly traded in the capital markets. These principles provide a good basis for developing regimes or reforms relating to the oversight of auditors.

The key principles for oversight of auditors, as stipulated by IOSCO, are:-

- ❑ **Auditors are licensed** by establishing proper qualification requirements
- ❑ There are **effective standards** to ensure auditors are independent
- ❑ **A body** exists, acting in the public interest, **to oversee the quality and implementation of professional standards**
- ❑ **Auditors are subject to discipline** by an oversight body that is independent of the audit profession and adequately funded and operates in the public interest
- ❑ The oversight body has the **authority to carry out disciplinary action**
- ❑ The oversight body has a process of performing **regular quality reviews** to monitor the audit procedures and practices of audit firms.

12. Most recently, the European Commission has also proposed a set of principles for public oversight of the European Union (“EU”) audit profession for application by its member states. The key principles are not dissimilar to those of the IOSCO. In brief, they require the public oversight mechanisms to:-

- ❑ Be applied to **all auditors**
- ❑ Involve **significant participation of non-auditors**
- ❑ Comprise **education, licensing and registration** of auditors, **standard-setting, quality assurance** and **disciplinary systems**
- ❑ Include **investigation and disciplinary powers**
- ❑ Be **transparent**
- ❑ Be **independently and adequately funded**

Regulatory functions of the Society

13. Both IOSCO and EU recognize that one size does not fit all. The principles recognize that it is not necessary to establish a separate oversight body. The oversight mechanisms could be functioning effectively in the existing regulatory framework. We believe that the regulatory functions outlined in the IOSCO and EU principles have, for the most part, been incorporated in the functions of the Society, which include the following:

- (a) Governance through a Council with broader public interest representation
- (b) Membership admission
- (c) Licensing of auditors
- (d) Standard-setting
- (e) Quality control (monitoring financial statements of listed companies and on-site practice reviews of audit working papers)
- (f) Investigations and complaints handling
- (g) Disciplinary proceedings

14. We believe that our current regime, reinforced by the new package of proposals, to be set out below, will address all the IOSCO and EU principles in both substance and in form.

15. In respect of **membership admission**, the Society's own entrance examination under the Qualifying Programme was a key factor in facilitating the signing of the Mutual Recognition Agreements with ACCA and CPA Australia, and the Reciprocal Membership Agreements with seven premier overseas bodies:-

- Institute of Chartered Accountants in Australia
- Institute of Chartered Accountants in England and Wales
- Institute of Chartered Accountants in Ireland
- Institute of Chartered Accountants of New Zealand
- Institute of Chartered Accountants of Scotland
- Institute of Chartered Accountants of Zimbabwe
- South African Institute of Chartered Accountants

16. The signing of these agreements underlines our commitment to adopt similar stringent admission criteria. We are also reviewing our membership admission and renewal criteria to ensure that our members meet the prescribed standards of qualifications and competencies.

17. In respect of **standard-setting**, the Society sets ethics, auditing and accounting standards ("professional standards"), compliance with which is required by all the Society's members, whether they act as auditors, financial statements preparers, CFOs, executive or independent directors.

18. As mentioned earlier, our professional standards have converged or are converging with internationally accepted best practices as promulgated by the International Accounting Standard Board ("IASB") and the International Federation of Accountants ("IFAC"). Under the Society's convergence programme, we have developed an active standard-setting agenda aimed at

eliminating existing differences between our professional standards and international standards. We actively provide feedback to the international standard-setting process and, as with these standard-setting bodies, we have a due process of issuing exposure drafts for public consultation and debate with all interested parties in Hong Kong on our localized standards.

19. In addition, we have also opened up the composition of our standard-setting committees to include lay members in line with the recommendations made by the Standing Committee on Company Law Reform (“SCCLR”) in its Phase I Corporate Governance Review. The members of these committees include consumers, academia, independent directors, relevant regulators and financial statements preparers and auditors so that views from all interested parties can be heard and discussed.
20. In respect of **quality control**, the Society has had in place since 1988 a Professional Standards Monitoring Committee (“PSMC”) whose role is to conduct a continuous review of published financial statements (mainly those of listed companies) prepared and audited by its members. In addition, since 1992, the Society has introduced a continuous programme of practice review, under which all auditors (and not only auditors of listed companies) are subject to on-site inspections by the Society’s staff who review audit working papers to ensure that all members in public practice maintain, observe and apply professional standards. In the case of material non-compliance, disciplinary action is taken.

Proposals for regulatory reforms

21. In response to international and local developments, in late January 2003, the Society submitted to the FSTB a package of proposals for regulatory reforms in the accountancy profession in Hong Kong to enhance the transparency, independence and effectiveness of the oversight of the Society’s functions. There are four components in this package. These are:-

- I. Expand lay members in Council

22. Increase lay members in Council, the Society’s governing body. We propose that lay participation, including government appointed officials on Council, should be increased from the present 2 to 6. This will increase the percentage of the lay members and Government appointed officials on Council from the current 13% to 26%. The additional 4 lay members would be appointed by the Government.

II. Expand the size and lay members in Investigation Committees

23. Expand the membership of any Investigation Committee instigated by Council from 3 to 5 to deal with an investigation concerning alleged accounting, auditing and/or ethics irregularities, and alter the composition of the Committee, with the majority of members (including the chairman) being lay persons. The chairman will be appointed by the Government.

III. Lay majority for Disciplinary Committees

24. Alter the composition of the 5-member Disciplinary Committee instigated by Council, with the majority of members (including the chairman) being lay persons. The chairman will be appointed by the Government.
25. We believe that the above three components are the key steps in enhancing oversight of the Society's key functions and thus the oversight over the accounting profession. The Council is the ultimate governing body responsible for the overall direction, policies, and operations of the Society. Increasing participation of lay persons with the appropriate experience and community standing will enhance the objectivity of the Council's decisions and ensure that public interest is balanced against professional interests. Another two important areas that would need to be safeguarded are investigations and disciplinary actions. These two areas, though instigated by the Council, are already performed by separate groups of persons appointed by the Council. Additionally, under the PAO there are strict rules governing independence and conflicts of interest. A Council member cannot simultaneously be a member of an Investigation Committee or a member of a Disciplinary Committee. As a matter of policy, Council does not appoint the same individuals to serve on both of these committees. This segregation of duties is to avoid conflicts of interest arising and to ensure that there is independence, fairness and objectivity in all decisions made. We believe that the addition of lay participation in and the appointment of the right persons to these three bodies will provide the necessary safeguards against professional interests overriding public interest.

IV. Establishment of an Independent Investigation Board

26. As a variation of the proposal of expanding lay participation and majority in Investigation Committees, we have offered the option of establishing an Independent Investigation Board ("IIB") to further enhance the objectivity, independence, and power of investigation into any alleged accounting, auditing and/or ethics irregularities related to "**listed entities**". Under this scenario, alleged accounting, auditing and/or ethics irregularities related to "non-listed entities" will continue to be investigated by Investigation Committees instigated by Council.

27. We propose that this IIB may either operate completely outside the Society, or be placed under the Society's secretariat for administrative support. In order to achieve the objective of further enhancing objectivity, independence, and adequate powers, the IIB should be subject to the following three principles:

- i. majority lay membership;
- ii. independent funding; and
- iii. reasonable suspicion of a disciplinable offence under the PAO.

28. Under this proposal, the IIB and Investigation Committees constituted by the IIB are to investigate cases and complaints concerning professional accountants. The scope of the investigation is to determine whether the professional accountants involved have committed any disciplinable offence under the PAO, which is narrower than the investigation powers of the securities regulators or law enforcement agencies. We recommend that the IIB, if established, should be accountable to the FSTB whose role should be to oversee the effective operation of the IIB, including the appointment of suitably qualified persons for the Board of the IIB and its Investigation Panels, a regular review of the IIB's reports and operations, and assistance in funding.

29. In addition to the above proposals, we proposed to the FSTB in April 2001, as mentioned earlier, to open the Society's disciplinary hearings to the public. This will greatly enhance the transparency of the Society's disciplinary processes, again to ensure that public interest is, and will continue to be, and seen to be, served.

30. We believe that the proposals for regulatory reforms will go a long way towards addressing the call for more transparency, independence and oversight of the accountancy profession. It is our view that the proposals are practical and cost effective solutions for Hong Kong.

Considerations in formulating reform proposals

31. In making our proposals to enhance transparency, independence and accountability of the oversight of the accountancy profession, we have taken into account:

- ❑ the corporate culture and environment in Hong Kong;
- ❑ the effectiveness of these reforms; and
- ❑ the cost effectiveness.

Corporate culture and environment

32. We wish to reiterate that both IOSCO and the EU recognize that in view of the wide range of different legal, business and professional environments and regulatory structures that exist in different jurisdictions, oversight of auditors could occur in several ways, including by self-regulating professional organizations, such as the Society.
33. We believe that Hong Kong should take a more pragmatic and considered approach in identifying a suitable regulatory framework for listed companies. The market size, corporate culture, investors' mindset and operating environment of listed companies in overseas markets are significantly different from that in Hong Kong; so are the laws and the regulatory framework. For example, in the US, the granting of share options to company executives as remuneration, which may have fuelled the desire to show continued improved growth and profits, is the norm. However, the use of share options is not a wide-spread practice nor is the extent the same in Hong Kong, probably because many Hong Kong listed companies are family-owned and controlled. Its directors are also major shareholders and the interests of management are therefore more aligned to the interests of shareholders.
34. Moreover, because the US has a culture of litigation and relies heavily on the courts to settle disputes, the standard setters in the US have adopted "rule-based" accounting standards to "minimize" differing interpretations. In contrast, Hong Kong accounting standards follow the International Accounting Standards that are more "principle-based".
35. There is a danger, in our view, that importing an elaborate regulatory regime into Hong Kong, in the name of "international best practices" when there are none at this time, may prove to be an overkill which may stifle rather than improve the Hong Kong market.

Effectiveness of reforms

36. As far as we are aware, the regulatory reforms introduced or contemplated in other major overseas jurisdictions over the last twelve months or so are still untested for their effectiveness. For example, the Public Company Accounting Oversight Board ("PCAOB") established in the US under the Sarbanes-Oxley Act, with a proposed annual budget of US\$98 million, has yet to become fully operational. It has made a number of proposals to increase control over the audit profession. While many of these may lead to increased auditor independence, they are also creating many unprecedented and unintentional operational problems and difficulties, which may in the long run stifle the development of

markets. It is unlikely that PCAOB's target of being fully operational by April 2003 will be met and it will probably take at least a year or more before any assessment can be made to determine whether the new regulatory structure is effective.

37. In the absence of any evidence to show that oversight mechanisms elsewhere will actually be effective, we believe that it is premature for Hong Kong to immediately copy oversight models. Hong Kong has achieved its success because of our ingenuity and minimal governmental intervention. Reforms copied wholesale from other jurisdictions could eventually prove to be misfits and stifling to our own growth and development.

Cost effectiveness

38. We believe that it will not be in the interests of the public and the Government to establish a further separate oversight body for the accountancy profession. Establishing another oversight body will only duplicate the Society's existing role, require substantial funding and infrastructure support and will go well beyond what is necessary for Hong Kong. As an illustration of the disparity in the size and complexity of the accountancy professions regulated in different jurisdictions, the regulatory framework in the US regulates some 300,000 professional accountants spread over 50 states and the regulatory framework in the UK regulates over 300,000 professional accountants from 6 different accounting institutes. In contrast, the Hong Kong Society of Accountants regulates 20,000 professional accountants in one city.
39. In some overseas jurisdictions, a separate independent oversight body may be more justifiable to harmonize disparate rules which might apply to different accounting bodies. Hong Kong, in contrast, has an established and tested single accountancy body and there are no apparent benefits in terms of greater consistency, effectiveness and efficiency in adding another layer of regulation. There is thus a need to maintain a sense of proportion, complexity, and scale in developing a regulatory framework appropriate for Hong Kong.
40. Moreover, the substance of our proposals, in particular, by adding a majority of lay members to Investigation Committees and Disciplinary Committees, is that the auditor oversight function is effectively filtered down to the working level as members of these Committees are directly involved in the monitoring and enforcement work over the quality of auditors. This is more effective than a passive role of overseeing a professional body.
41. The nature of the regulatory regime should not be a primary concern but rather its substance and effectiveness. We understand that the FSTB shares the same view.

42. It is also worth noting that our proposals cover not only auditors of listed companies but also auditors of non-listed companies. The role of the Society to protect the “public interest” is therefore wider than the remit of other overseas reforms that are primarily concerned with listed companies.

The need for retention of disciplinary powers

43. There has been a suggestion that the Society’s powers to discipline auditors should perhaps also be moved over to the IIB, if the IIB is established. In this respect, we consider that as long as the Society acts as a licensing body for its members and member firms (and not just auditors), supported by the full range of other ancillary functions (such as standard setting, membership admission, quality assurance and professional development), the disciplinary powers over its members and member firms for breaches of professional standards should remain with the Society. There is only one “membership licence” that a member or firm needs to hold for offering a range of services to clients, including work for listed companies.

44. It would be incongruous for powers to discipline to be separated from the Society as there are public expectations that the Society, being the licensing body, should be able to hand down sanctions on its members over breaches of its standards and in particular the suspension and withdrawal of licences. The Society feels very strongly that the power to discipline any professional accountant (including an auditor) should be retained by the Society irrespective of whether the misconduct concerns a listed or a non-listed entity.

45. Our proposals for a lay majority including a lay chairman on Disciplinary Committees will ensure independence and transparency of the Society’s disciplinary process. Furthermore, the opening up of Disciplinary Committee hearings to the public will further add to the checks and balances to ensure that there is transparency and that the public interest is, and is seen to be, served.

Phased approach in implementing reforms

46. We appreciate that some of our proposals, and in particular the establishment of the IIB, will require wider consultation with relevant market players. The first three components of our proposals relating to the composition of Council, investigation and disciplinary committees are relatively straightforward. Nevertheless, amendments to the PAO will be required and this calls for the support of the Legislature.

47. In this regard, the Society believes that its proposals may be considered for implementation in two phases. Phase 1 is to implement the proposals concerning changes to the composition of Council and matters related to the investigation and disciplinary committees as soon as practicable. Phase 2 concerning the establishment of the IIB can be implemented at a later stage once a wider consultation exercise has been completed.

Continuous review and other initiatives

48. As a top tier accountancy body, we have a standing agenda to continuously seek opportunities to improve standards and to enhance the reputation of the Hong Kong accountancy profession at home and abroad. Illustrated below are some of our recent initiatives.

49. We have accelerated our review of our practice review programme. Last year, upon completion of 1,000 practice reviews under the first cycle and after an internal review conducted by the Society's Practice Review Committee, we decided to engage Joint Monitoring Unit Limited of the U.K. as our external consultant to assist in an independent review of the Society's existing processes and to implement improvements. We plan to make our practice review programme more efficient and effective by moving away from a random to a risk-based approach in selecting and conducting quality reviews of members in practice. This will require the use of an annual practice profile questionnaire, and the consultant will be assisting us in developing the appropriate supporting systems. In addition, we will further increase our manpower resources for practice reviews to improve the speed of such work.

50. At the international level (through our representation on IFAC) we have helped to drive the development of a more extensive Code of Ethics for professional accountants in business, which is now a high-priority project for IFAC. Locally in Hong Kong, we have provided comments and suggestions in response to various corporate governance consultations, including the Stock Exchange's consultation papers on amendments to the listing rules relating to corporate governance and on listing and de-listing criteria; the study by the Expert Group to Review the Operation of the Securities and Futures Market Regulatory Structure and the Insurance Authority's Guidance Note on the Corporate Governance of Authorized Insurers. The Society also has a working group which is developing additional guidance for accountants in connection with initial public offerings (IPOs) and examination of prospective financial information.

51. As part of the joint efforts by the Society and SFC to enhance the auditors' awareness of the special audit risks associated with audits of Mainland Private Enterprises, discussion forums will be organized to provide direct communication and exchange between the officials of the SFC and auditors on topical issues.
52. Moreover, a further comprehensive review of the Society's self-regulatory processes will be carried out. A special Task Force has been formed to consider recent international developments concerning the accounting profession and what further changes are needed in Hong Kong.

Closing remarks

53. In addition to our leadership position in Hong Kong, the Hong Kong Society of Accountants plays a significant role in the development and regulation of the international accountancy profession as a Board Member of the IFAC and an Executive Committee member of Confederation of Asian and Pacific Accountants ("CAPA"). In recent years, we have increasingly contributed to the development of international best practices and kept ourselves abreast of international trends.
54. We recognize the important role of the accounting profession in contributing to the enhancement on the regulation and corporate governance of listed companies. We believe that our proposals will go a long way towards addressing the call for more transparency, independence and oversight of the accountancy profession in Hong Kong. If endorsed by Government and the Legislature, this package of proposals will be in line with international market trends and well ahead of the governance structure, in terms of its openness and lay participation, of other professional bodies in Hong Kong.
55. Moving forward, we need the support of the Government, members of this Panel and the Legislature to pass the necessary amendments to the PAO as soon as possible. We hope that an early decision can be made on the proposed option of establishing the IIB. We also hope that there is an early formation of an independent Financial Reporting Review Panel, which we fully support, as recommended by the Standing Committee for Company Law Reform.

2 April 2003,
Hong Kong Society of Accountants