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Panel on Financial Affairs
Meeting on 6 July 2015

**Background brief on the proposals to improve the regulatory regime
for listed entity auditors**

Purpose

This paper provides background information on the proposals to improve the regulatory regime for listed entity auditors, and summarizes the major views and concerns expressed by Members relating to the independent audit oversight reform at meetings of the Panel on Financial Affairs ("FA Panel") and the Legislative Council ("LegCo") since 2013.

Background

Establishment and existing functions of the Financial Reporting Council

2. At present, Hong Kong's regulatory regime for auditors is primarily administered by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is a statutory professional body established by the Professional Accountants Ordinance (Cap. 50) ("PAO"). HKICPA is empowered under PAO to, inter alia, set admission and registration criteria and continuing professional development ("CPD") requirements for its members; set accounting, auditing and professional ethical standards; and conduct investigations and exercise disciplinary powers where warranted.

3. In the wake of the Asian financial crisis in the late 1990s and major audit failures of listed companies such as Enron and Worldcom in the United States ("US") in early 2000s, there was considerable public demand for strengthening the regulation of the accountancy profession in Hong Kong. To enhance the independence of the auditor regulatory regime, LegCo enacted the Financial Reporting Council Ordinance (Cap. 588) ("FRCO") in July 2006 to establish the Financial Reporting Council ("FRC") as an

independent investigatory body of auditing and reporting irregularities in relation to listed entities. FRC became fully operational in July 2007.¹

4. The key functions of FRC are to:

- (a) conduct independent investigations into possible auditing and reporting irregularities related to listed entities;
- (b) enquire into possible non-compliances with financial reporting requirements on the part of listed entities; and
- (c) require listed entities to remove any non-compliance identified.

5. While FRC may initiate investigations or enquiries upon receipt of complaints or on its own initiative, it is not empowered to discipline or prosecute. All other regulatory powers with respect to the audit profession continue to be vested with HKICPA under PAO. To avoid overlap with the work of other regulatory bodies, FRC has signed Memoranda of Understanding with HKICPA and other regulators including the Securities and Futures Commission ("SFC"), the Stock Exchange of Hong Kong Limited ("SEHK"), the Hong Kong Monetary Authority and the Insurance Authority on the protocols for referring cases/complaints to FRC for investigation and enquiry. Any auditing or reporting irregularities identified by FRC will be referred to HKICPA, and any non-compliances relevant to the Listing Rules will be referred to SFC or SEHK for necessary action.

Independent audit oversight reform

6. According to the Government, it has become international standards that auditor regulatory regimes should be independent of the audit profession and be subject to independent oversight by bodies acting in the public interest. Against this international trend, Hong Kong's present regulatory regime is considered as largely a self-regulatory regime. This has rendered Hong Kong not eligible to be represented on the International Forum of Independent Audit Regulators ("IFIAR")², thus hindering cooperation between Hong Kong regulators and their counterparts in overseas jurisdictions.

¹ The Financial Reporting Council Bill was introduced into LegCo on 29 June 2005 and passed on 13 July 2006 as FRCO, which was commenced in phases through four notices made by the Secretary for Financial Services and the Treasury in 2006 and 2007.

² IFIAR is an international organization for independent regulators of auditors established in September 2006. Its membership is restricted to regulators that are both independent of the audit profession and engaged in audit regulatory functions in the public interest. At present, IFIAR comprises independent auditor regulators from 50 jurisdictions. It has become an increasingly influential organization, which convenes to discuss issues relating to international audit quality and regulatory and market developments having an impact on auditing.

7. In addition, the auditors' regulatory regime in Hong Kong is lagging behind comparable jurisdictions. In its recent review on Hong Kong's securities market as part of the Financial Sector Assessment Programme, the International Monetary Fund has expressed concerns about the lack of independence of the Hong Kong's regime as well as the effectiveness of the enforcement framework and made recommendations for improvement.

8. To address the above, the Government proposes to enhance the independence of the existing regulatory regime for listed entity auditors, with a view to ensuring that the regime is benchmarked against international standards. With reference to IFIAR's Charter and Core Principles for Independent Audit Regulators, the European Union's Statutory Audit Directive, and the International Organisation of Securities Commissions' Objectives and Principles of Securities Regulatory and Principles for Auditor Oversight, the Government has developed reform proposals in collaboration with FRC and HKICPA and conducted a three-month public consultation on the proposals from June to September 2014. The Government plans to introduce an amendment bill into LegCo in the 2016-2017 legislative session for reforming the regulatory regime.

Major reform proposals for public consultation in 2014

9. According to the reform proposals, FRC will perform the role of the independent audit oversight body through expansion of its regulatory remit. HKICPA will continue to perform the statutory functions of registration of listed entity auditors, setting CPD requirements and setting professional ethical, auditing and assurance standards, subject to oversight by FRC. This proposal has taken into account the fact that HKICPA has been equipped with the necessary infrastructure and experience in discharging such functions, and FRC is already statutorily empowered to conduct independent investigations into possible auditing/reporting irregularities in relation to listed entities and has accumulated expertise in financial reporting regulatory issues.

10. The major changes in respect of the functions of FRC and HKICPA and FRC's funding mechanism under the reform proposals are as follows:

- (a) FRC will exercise oversight of HKICPA's statutory functions. It will receive periodic reports from HKICPA, conduct quality review, and give HKICPA written directions in relation to HKICPA's performance of such functions.
- (b) The statutory function to conduct recurring inspections of auditors in respect of their listed entity audit engagements will be transferred from HKICPA to FRC. To minimize any overlap/gap

in the inspection work of FRC and HKICPA, FRCO and PAO will be amended to provide for sharing of inspection results between the two regulatory bodies.

- (c) FRC will be vested with direct disciplinary powers concerning listed entity auditors. It will be empowered to impose a range of disciplinary sanctions, including reprimand, removal of a person's name from the register of listed entity auditors, pecuniary penalty, etc.³ To provide an alternative route for concluding a disciplinary matter in a less-costly manner, FRC will also be empowered to enter into a resolution with the person subject to disciplinary action if it considers it appropriate to do so in the public interest. To ensure checks and balances against the disciplinary powers to be exercised by FRC, a new independent appeals tribunal will be set up by statute for hearing appeals.⁴
- (d) In accordance with the "user pays" principle, FRC will be funded on an equal basis by the three stakeholder groups, namely, listed entity auditors, listed entities and investors, through levies introduced on the three groups respectively.⁵

11. In addition, FRC will be empowered to decide on applications for recognizing overseas auditors to audit specific overseas entities listed in Hong Kong. This function is currently performed by SFC and the Hong Kong Exchanges and Clearing Limited which may accept certain overseas collective investment schemes and overseas-incorporated companies listed in Hong Kong respectively to engage, apart from a Hong Kong practice unit, an overseas auditor to audit their financial statements.

Deliberations of the Panel on Financial Affairs

12. The Administration briefed FA Panel on the reform proposals at the meeting on 7 July 2014. Issues relating to the independent audit oversight reform were also discussed at meetings of FA Panel on 3 May 2013, 5 May 2014 and 4 May 2015 during the annual briefings on FRC's work. The major concerns and views expressed by Panel members at the above meetings are summarized in the ensuing paragraphs.

³ To enhance transparency, FRC will also be required to issue guidelines to indicate the manner in which it will exercise the power to impose a pecuniary penalty, and the factors it will consider when determining the level of the pecuniary penalty.

⁴ The proposed independent appeals tribunal shall comprise a chairman, who should be a person qualified for appointment as a judge of the High Court, and two members who are not public officers. All of them are to be appointed by the Chief Executive.

⁵ Under the existing arrangement, FRC is jointly funded by the Companies Registry Trading Fund, SFC, the Hong Kong Exchanges and Clearing Limited and HKICPA. The combined contribution from the four parties in 2014 was \$19.4 million.

Progress of the reform and stakeholder engagement

13. At the meetings on 3 May 2013, 5 May 2014 and 4 May 2015, Panel members enquired about the progress of the auditor regulatory reform and urged FRC to gauge the views of the accounting profession on the relevant proposals as early as possible. There was a suggestion that the Government should set up a representative consultative committee to seek views of all stakeholders on the subject.

14. FRC advised that it had been assisting the Government in developing the auditor regulatory reform proposals, including commissioning an international comparative study on the topic of independent audit oversight and publishing the consultancy findings in October 2013. The Government pointed out that in working out the reform proposals it had been maintaining close contact with FRC and HKICPA. The Government would continue to liaise with and gauge the views of various stakeholders, including regulators, the auditing industry and listed companies during the consultation process.

15. At the meeting on 4 May 2015, a Panel member expressed concern that the audit profession still had reservations about some major reform proposals after the public consultation and asked whether the Government would consider launching another consultation before introducing the relevant amendment bill into LegCo.

16. The Administration advised that it had identified a few areas for further engagement with the relevant stakeholders, including HKICPA, with a view to enhancing mutual understanding and facilitating formulation of a way forward that would balance the interests of all parties concerned. The Administration assured members that after issue of the consultation conclusions, there would still be room for discussing certain details with stakeholders when preparing the amendment bill within the framework of the consultation conclusions.

The proposed regulatory framework and new powers of the Financial Report Council

17. At the meeting on 7 July 2014, Panel members expressed concerns that the proposals to expand FRC's regulatory remit might lead to over-concentration of powers in FRC, and entrust HKICPA with the role of the Registrar of Listed Entity Auditors ("Registrar") might result in a cumbersome regulatory structure. There were views and suggestions that FRC should take up the registration function in respect of listed entity auditors, separate its investigation and disciplinary mechanisms and explore setting up an independent body to consider disciplinary sanctions on listed

entity auditors to ensure FRC's fairness and due process in exercising its powers.

18. The Administration explained that the reform proposals would meet the prevailing international standard that auditor regulatory regime should be independent of the audit profession and address concern about the effectiveness of the existing disciplinary mechanism of HKICPA. Entrusting FRC with the role of an independent audit oversight body in lieu of setting up a new statutory body would also address the concern that the regulatory framework could become cumbersome after the reform.

19. On the concern about over-concentration of powers in FRC, the Administration pointed out that there would be checks and balances to ensure fairness and due process when FRC discharged its investigatory and disciplinary powers, including deploying separate teams of staff members to undertake the investigation and disciplinary work respectively, requiring FRC to provide reasons for its disciplinary decisions and provide the parties concerned with opportunities of being heard before FRC arrived at its disciplinary decisions. There would also be an independent appeal mechanism under the proposed regime, as well as an expert panel to provide advice to FRC on individual disciplinary cases, in particular on issues concerning the application of prevailing auditing standards.

20. In response to members' request, the Administration subsequently provided information on the practices adopted by member jurisdictions of international bodies, including the Organisation for Economic Co-operation and Development, with regard to their arrangements for powers of investigation into reporting/auditing irregularities and determination of related disciplinary sanctions. The information indicates that the proposed regime for Hong Kong is similar to the practices in the US and Canada under which the auditor oversight body would be responsible for both the investigation and the determination of related disciplinary sanctions. The disciplinary decisions of the oversight body would be subject to appeal to an independent tribunal to be appointed by the Government. On the other hand, while the practices in the United Kingdom and Singapore are not the same as those in the US and Canada, their respective independent auditor oversight bodies perform a leading role in their regulatory regimes and they are the designated authority to appoint specialized committees for making disciplinary sanctions or making recommendations on disciplinary sanctions.

21. On the registration of listed entity auditors, the Administration responded that it would be appropriate for HKICPA, which had established infrastructure and accumulated experience in discharging registration functions, to assume the role of the Registrar while being subject to independent oversight by FRC. To enhance transparency and facilitate

public inspection, there would be a new statutory requirement for HKICPA to establish and maintain a register of listed entity auditors. If a disciplinary decision made by FRC involved removal of a regulated person from the register, HKICPA would need to enforce the disciplinary decision by following stipulated procedures.

Pecuniary penalty

22. At the meeting on 7 July 2014, Panel members expressed different views on the proposed pecuniary penalty on listed entity auditors for contravention of requirements under the new regulatory regime. While small and medium-sized audit firms had expressed concern that the proposed maximum penalty of \$10 million would pose threat to their viability, some members were worried that the proposal requiring FRC to consider before imposing the fine whether the fine would put the firm or individual concerned in financial jeopardy might weaken the deterrent effect of the penalty.

23. The Administration explained that \$10 million was the proposed maximum penalty level and the proposal had already taken into account the views of different stakeholders. To ensure that the pecuniary penalty would be imposed in a fair and reasonable manner, FRC would be statutorily required to issue guidelines setting out the factors it would consider when determining the level of pecuniary penalty, including proportionality of the penalty to the nature and seriousness of the irregularity, amount of profits accrued or loss avoided as a result of the irregularity, the audit fees received, and other circumstances of the subject auditors, such as size and financial resources of the firm or individual.

Question raised at Council meeting

24. At the Council meeting of 27 February 2013, Hon Kenneth LEUNG raised a written question which conveyed the concerns of some practising accountants about their audit work being subject to a dual regulatory regime involving FRC and HKICPA, and the increase in the administration cost as a result. The Administration responded that FRC had been maintaining regular dialogues with HKICPA with a view to ensuring that there would not be any overlap of efforts between the two regulatory bodies in reviewing financial reports of listed entities. The proposals of the independent audit oversight reform would be mapped out taking in account the need to minimize compliance burden.

Latest development

25. The Administration will brief FA Panel on the consultation conclusions of the reform proposals and the way forward at the meeting on 6 July 2015.

References

26. A list of relevant papers is at **Appendix**.

Council Business Division 1
Legislative Council Secretariat
30 June 2015

Appendix

List of relevant papers

| Date | Event | Papers/Minutes of meeting |
|------------------|---|---|
| 27 February 2013 | Hon Kenneth LEUNG raised a written question regarding regulation of accounting firms | <u>Hansard</u> |
| 3 May 2013 | The Panel on Financial Affairs ("FA Panel") discussed the work of the Financial Report Council ("FRC") since April 2012 | <u>Powerpoint presentation materials at the meeting</u> (LC Paper No. CB(1)976/12-13(02)) <u>FRC's paper</u> (LC Paper No. CB(1)929/12-13(07)) <u>Minutes</u> (LC Paper No. CB(1)1789/12-13) |
| 10 October 2013 | FRC published a report on independent audit oversight | <u>Press release</u> <u>Report by FRC</u> |
| 5 May 2014 | FA Panel discussed the work of FRC since April 2013 | <u>Powerpoint presentation materials at the meeting</u> (LC Paper No. CB(1)1375/13-14(03)) <u>FRC's paper</u> (LC Paper No. CB(1)1309/13-14(07)) <u>Minutes</u> (LC Paper No. CB(1)1942/13-14) |
| 7 July 2014 | FA Panel discussed the proposals to improve the regulatory regime for listed entity auditors | <u>Powerpoint presentation materials at the meeting</u> (LC Paper No. CB(1)1762/13-14(01)) <u>Administration's paper</u> (LC Paper No. CB(1)1668/13-14(01)) <u>Minutes</u> (LC Paper No. CB(1)1998/13-14) <u>Administration's follow-up paper</u> (LC Paper No. CB(1)1913/13-14(02)) |

| Date | Event | Papers/Minutes of meeting |
|-------------|---|---|
| 4 May 2015 | FA Panel discussed the work of FRC since April 2014 | <u>Powerpoint presentation materials at the meeting</u> (LC Paper No. CB(1)833/14-15(02)) <u>FRC's paper</u> (LC Paper No. CB(1)780/14-15(03)) |