

## **National Institute of Accountants of Australia – China Branch**

### **Legislative proposal to establish Financial Reporting Council (HK)**

The National Institute of Accountants (NIA) of Australia has reviewed the proposed legislation to establish a Financial Reporting Council in Hong Kong. The NIA is broadly supportive of the proposals as set out in the draft legislation and believes that it will provide reassurance for the markets and the users of financial reports and help to cement the position of Hong Kong as the region's financial centre. The issues of audit independence and the quality of audits is a paramount issue, not just in Hong King but the world over. While the NIA is broadly supportive of the proposed legislation the NIA believes that further reforms could be taken to provide even greater confidence.

#### *Establishment of the FRC, its composition and operational structure*

The NIA is pleased that the decision was taken to ensure that the Financial Reporting Council (FRC) is an independent statutory body rather than set it up as a company limited by guarantee. The purpose of the FRC and the public good are served by the FRC being a statutory body.

The NIA believes that the proposed mix of representatives is the right mix. It is important to ensure that the FRC is not captive of the profession but it is also important to ensure that it does not become captive of business interests either. Therefore, it is important that the members of the Board have a broad set of experiences and skills. Where possible, those "lay" members should have at least a working knowledge of financial and accounting issues. There should also be some consideration to ensuring that there is one representative of the wider community, who is not a representative of the business community.

One area of potential additional reform would be for the FRC in Hong Kong to take on the role of oversight of the adoption of accounting and auditing standards. The NIA is not suggesting that the FRC take a role in setting the standards, but act in manner similar to the FRC in Australia and provide a mechanism for public oversight. It is important that the public have confidence in the standards and ensuring they have public oversight is one means that this can be achieved. The adoption of International Accounting Standards should make this process easier to achieve and ensure that Hong Kong has a prominent role in the development of the standards. The NIA also believes that it is important that standard setters in Asia and Australasia areas must work strongly together in relation to international accounting standards to ensure that there is adequate weight given to issues of importance to our region and to avoid a European hegemony in the development of standards.

#### *Financial arrangements for the FRC*

The Hong Kong FRC is proposed to be funded through a mechanism in which the four principle stakeholders are the HKEx, the HKICPA, the SFC and the Administration. The NIA believes that this is a suitable mechanism. One of the problems for the Australian FRC arrangements is that of funding. In principle it is meant to be funded by 1/3<sup>rd</sup> each by the Commonwealth Government, the profession (via the three professional accounting bodies) and the business community. While the Commonwealth and the profession have provided funding, because no one source of funding was allocated in relation to the Business sector, there has not been

any funding from that sector. By setting out that the HKEx should provide funding, it eliminates the problem we have experienced here in Australia.

The NIA is pleased to see that the FRC appears to have greater control over its own budget as this is important to the proper functioning of an independent statutory body. The NIA believes that the FRC should have to keep and maintain proper sets of accounts and that the Director of Audit should have responsibility for the audit. It will be important for the FRC to set the tone in relation to audits.

#### *Accountability and independence of the FRC*

It is important to ensure that the FRC act properly and be accountable for the actions it takes, however, it is also important that the FRC be seen to be and in fact be independent. The NIA has some concerns with the proposed measures to ensure accountability.

**CE's direction:** While the NIA observes that the CE will still have the power in section 14 to make written directions, after consultation with the Chair of the FRC, that direct the FRC, where it is "in the public interest". The NIA would be concerned with the potential for political interference through the use of such power. The NIA is pleased that there is some limitation on the power to direct the council to come to a particular decision, however, there still arises the specter of interference, and the FRC will need to act carefully to ensure that it is not seen as being compromised.

**Need for separate Appeals Tribunal:** The NIA agrees that since the proposals in relation to the FRC only provide it to have investigative powers that there is no need to have a separate appeals tribunal. If however, the FRC was to have a role in relation to Disciplining auditors, as the NIA will suggest it should, there would need to be an appeals tribunal.

#### *Audit Investigation Board*

The NIA agrees that an independent and effective investigation regime is fundamental to ensuring public trust in the audit profession. However, the NIA believes that public trust is best served by also having an independent disciplinary system for company auditors, in concert with maintaining discipline by the profession. Such a "dual" system is applied in other jurisdictions, including Australia. The NIA believes such a system should be considered for adoption in Hong Kong. This dual public and professional system is important because of the nature of auditing. While there are professional considerations where auditors are found to have acted wrongly, there are also public issues due to the important role audits play in the public confidence in company financial reports.

The NIA would perceive that the proposed Audit Investigation Board (AIB) would stay as proposed. Its role would still be limited to investigating and gathering evidence to determine if there is a "case to answer" by an auditor. The point of difference though would be that rather than simply handing over its findings and documents to the profession to then take action, the AIB would instead present its evidence and findings to a Audit Discipline Board (ADB) and act in more of a prosecutorial manner.

The proposed ADB would need to be made up of a mixture of people with audit and accounting backgrounds and lay persons. The NIA would suggest that there be a panel of audit/accountancy experts and a panel of lay person, from whom would be drawn the members of an Audit Disciplinary Tribunal (ADT). One of the roles of the ADB would be to draw up the list of the expert panels and to determine who from

each panel would be drawn upon to make up an ADT. The ADB would also determine the date for any ADT and would also set the procedures and policies for hearing a matter before an ADT. The ADB would also sit as an appeals board to decisions of an ADT. The decisions of the ADT/ADB would need to be made public.

The NIA would perceive that only the most serious cases investigated by the AIB would need to be referred to the ADB. Less serious issues could still be referred only to the profession to take action. Such cases would be those where re-education/further training is warranted or where there has been no breach of the law but a breach of a professional standard.

The role of the profession, through the HKICPA, would not need to be altered. While it is important that there be public findings against auditors, the profession still has a role in disciplining its own members and taking appropriate action to ensure the highest standard by auditors. The AIB would refer less serious matters to the HKICPA to take action. In the more serious cases sent to the ADB, the HKICPA should wait until a determination has been made by the ADB. Then it should have regard to the decision of the ADB and the information presented by the AIB to determine if there is the need for further action at the professional level (eg removing the person as a member of the HKICPA).

The NIA has reviewed the list of “irregularities” that could be investigated by the AIB, and agrees with all those in the list. The NIA though would also suggest that some additional irregularities might also be looked into. In particular, the issue of “independence” could be seen as a separate and distinct category of irregularity. The independence of an auditor is very important to ensuring a proper audit has occurred. In other jurisdictions from time to time there have been concerns about the lack of independence in relation to certain audits. It is important for the public perception that auditors be and be seen to be independent. Therefore the NIA would suggest that auditor independence be a separate “irregularity” that could be investigated by the AIB.

### *Conclusion*

The NIA therefore believes that the proposed legislation to establish the FRC in Hong Kong is a positive development. While the NIA would have preferred to see more of our suggestions to the consultation paper addressed, none of these omissions are detrimental to the overall effectiveness of the FRC as set out.

14 September 2005