

Clerk to Bills Committee on Financial Reporting Council (Amendment) Bill 2018
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

9 March 2018

Dear Sir

Financial Reporting Council (Amendment) Bill 2018

Introduction

1. ACCA was very pleased to have had the opportunity to respond to the consultation last year on the Proposed Regulatory Regime for Listed Company Auditors in Hong Kong. We have followed developments with interest and are pleased to note that an overwhelming majority of the respondents were supportive of the objective and direction of the reform. In addition, we are pleased that many of our suggestions contained in our submission have been taken into account in the drafting of the Amendment Bill.
2. However, there are some matters on which some respondents made specific comments on the proposals and on which there continues to be debate and a lack of consensus between the various stakeholders. We welcome the invitation on 21 February for further stakeholder engagement and we are grateful to have the opportunity of commenting on the Government's consultation conclusions and the draft Amendment Bill. Our comments below focus on the main areas which remain the subject of debate.
3. If there are any matters arising from the enclosed submission that require further clarification, please do not hesitate to contact me (tel: +44 (0)20 7059 5931, email: sha.alikhan@accaglobal.com).

Planned expenditure

4. The respondents' views summarised under Question 42 in the consultation conclusions note that a number of respondents requested an indication of the quantum of costs that would be required by the future FRC. The Government has responded by confirming that it will work out the details based on the framework of the consultation conclusions and estimate the required budget in due course.

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5. We understand that the FRC has proposed a budget of HK\$90 million (US\$11.5 million). In considering whether this amount is excessive or insufficient, it is very difficult to draw comparisons between the budgets of national regulators as their responsibilities and the audit markets which they regulate, vary in size and nature. Nevertheless, costs incurred by established regulators in other territories may provide a guide as to what level of expenditure might be required.
6. For example, commentators in Hong Kong have drawn comparisons with the audit market in Canada. Operating costs of the Canadian Public Accountability Board (CPAB) for 2016 amounted to approximately US\$13 million. The CPAB's member's profile on the IFIAR web site as of December 2016 states there are 281 participating audit firms registered with the CPAB and therefore subject to inspection, although CPAB's mandate is limited to the inspection of firms that audit the 7,400 entities that are classified as Canadian reporting issuers. The profile goes on to say that the Canadian member firms of the Big 4 global network firms audit 60% of Canada's reporting issuers, representing more than 90% of the market capitalization. While this information may be useful, it does not provide directly comparable information.
7. It is not possible at present to assess whether the budget proposed for the Hong Kong FRC of HK\$90 million (US\$11.5 million) will enable it to efficiently and effectively fulfil its mandate. We would support the view that while regulation should be effected as efficiently as possible, it is essential for the FRC to be adequately funded, and any amount set aside for the budget should be fully costed, transparent, carefully monitored and revised, if necessary.

Funding mechanism

8. In our previous submission, we supported the view that the FRC should be funded by various levies and we recommended that for ease of operation FRC should be funded directly by HKEx who will determine the amounts which should be recharged to various relevant market participants. The principle should be that those who will benefit from the system of regulation should be the ones to pay for it, and we would support the view that the costs of regulation should be met by listed entities, investors, and auditors of listed entities.

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9. As a comparison, the CPAB derives its operating budget from Canadian reporting issuers. Each year, it invoices the participating audit firm which, in turn, invoices its reporting issuer clients. The fee is designed to cover CPAB's annual operating costs and to provide a reasonable reserve for contingencies.
10. In the UK, the FRC's audit and assurance regulation and enforcement is funded in part by a preparer's levy (the largest slice being from listed companies based on market capitalisation), and partly by contributions from the accountancy profession. The professional bodies fund the FRC's performance of any tasks that have not been delegated to the professional bodies, where these relate to the regulation of auditors. This covers the cost of direct audit quality reviews of PIE auditors, oversight of inspections of non-PIE auditors undertaken by the professional bodies themselves, audit enforcement activities and standard-setting procedures.
11. As suggested in our submission to the consultation, and based on the system adopted by the FRC in the UK, if the system of regulation is extended to cover oversight by the FRC of HKICPA's regulatory activities, HKICPA should also make a contribution to the FRC's costs.

Proposed maximum level of pecuniary penalty (HK\$10 million)

12. Some respondents had concerns over the maximum fixed penalty cap proposed of HK\$10 million, and the variable element of "three times of the profit gained or loss avoided", on the ground that the proposal would drive SMPs out of the market.
13. We understand the concerns which recognise that pecuniary penalties are likely to have a more significant financial impact on SMPs than, for example Big-4 firms. We welcome the Government's response that it is not the intention for pecuniary penalties to be used as a tool to put LEAs into financial jeopardy, and that in determining the level of pecuniary penalty to be imposed, FRC will have regard to the principles of fairness and proportionality, taking into account the circumstances of each case.

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14. Where appropriate we would encourage the FRC to make use of non-financial penalties as well as financial penalties, as was used by the PCAOB in 2016 in its enforcement action taken against Deloitte Brazil following its audit of Gol Linhas Aereas Inteligentes SA. The wide-ranging settlement included an US\$8m fine, a restriction on accepting certain audit clients, the appointment of an independent monitor to assess remedial action and additional training for audit staff.
15. Turning to the quantum of the pecuniary penalty, it is worth noting that five of the most significant fines imposed on audit firms during 2017 were as follows:
- £5.1 million (HK\$55 million) by UK FRC to PwC over the RSM Tenon audit
 - £5 million (HK\$54 million) by UK FRC to PwC over the Connaught audit
 - US\$6.2 million (HK\$48 million) by US Securities and Exchange Commission (SEC) to KPMG over Miller Energy audit
 - £1.8 million (HK\$19 million) by UK FRC to Ernst Young over Tech Data audit
 - US\$1 million (HK\$8 million) by PCAOB to PwC over the Merrill Lynch audit
16. Used appropriately, the maximum cap of a pecuniary penalty of HK\$10 million does not appear to be excessive when compared to the above penalties. The Government recognises in its consultation conclusions that the UK FRC has no statutory cap on penalties. We welcome the Government's clarification in the consultation conclusions that the HK FRC would be required by law to issue guidelines on how it may impose a pecuniary penalty.

Investigation and disciplinary procedures

17. We note that section 21H (page C207) of the Amendment Bill gives the FRC wide powers in respect of investigation and discipline over PIE auditors. This section deals with follow-up action of the FRC having regard to an inspection report arising from a quality assurance review.
18. This section gives the power to the FRC to take no action, require the auditor to take corrective action regarding compliance with the law or a professional standard, determine that an auditor should have an early follow-up review, and/or to initiate an investigation. In our view, such powers vested in the FRC are not unreasonable.

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19. However, under section 21H the FRC also has the power to impose a sanction on the auditor or to take any other follow-up action that the FRC considers appropriate.
20. The Council of the FRC, which will be responsible for the system of investigation (including quality assurance) and discipline, will therefore also be involved in taking disciplinary decisions and for deciding on and imposing regulatory actions on auditors. This should be avoided as it goes against the general principle that there should be a separation of powers between the executive and those responsible for enforcement. The executive is the Council of the FRC and therefore decisions on enforcement should be separate, and would normally take the form of a committee comprised of persons independent from the executive.
21. The same principle is recognised in IFAC's Statement of Membership Obligation (SMO) 6, which states that institutional rules shall exist that prevent the body responsible for the investigation and disciplinary system from influencing the disciplinary tribunal's operational work, decision making, or imposition of sanctions. Although the FRC is not a member of IFAC, the SMOs are considered to be best practice, and the principle of separating the executive from those responsible for enforcement should be observed.
22. This point was made in our submission, and is essential in order to ensure the integrity and credibility of the arrangements. Persons against whom disciplinary action is to be taken must be treated fairly and justly, there must therefore be a proper separation of the functions of investigation (including quality assurance) and the imposition of sanctions.

FRC oversight of regulatory activities of HKICPA

23. The FRC is to exercise oversight of HKICPA activities in registration, continued professional development and standard setting with respect to LEAs.
24. We support the proposal that the FRC, upon being satisfied that it is in the public interest to do so, will give HKICPA written directions in relation to the performance of such functions and the exercise of such powers. We also agree that it should be a statutory obligation for HKICPA to act in accordance with such written directions.

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25. However, we suggest that the issue of such a direction should only be exercised where HKICPA has not already rectified the non-compliance in question either on its own initiative or upon the request of the FRC, and it is in the public interest to do so. We are pleased to note that the FRC will set out the relevant considerations in giving any written directions to HKICPA.
26. There is a similar system operating in the UK, where the FRC has statutory powers in relation to the oversight of the components of audit regulation delegated to the accountancy bodies. It can require information from professional bodies, and can serve an enforcement order (and impose a financial penalty) on the professional body that fails to meet its regulatory responsibilities.
27. The UK FRC will usually first attempt to work with the accountancy body to correct non-compliance through co-operation. If compliance with the requirements is not achieved by this approach within a reasonable timeframe and to the FRC's satisfaction, the FRC can impose enforcement measures on the professional body. The accountancy bodies would be likely to take whatever action is necessary to comply with any requests from the FRC as the issue of a direction and related publicity would be damaging to their reputations.

Approval of third country auditors

28. In the consultation conclusions, it was noted that some respondents pressed for more details of the matters which might be taken into account before recognising an overseas auditor to audit an overseas entity listed in Hong Kong. In our earlier submission, we also expressed a view that it was far from clear how the FRC will make the assessment that the auditor must demonstrate that it has adequate resources and possesses the capability to perform the audit of the relevant overseas entity listed in Hong Kong.
29. In our earlier submission we suggested that the FRC should seek a reference from the audit regulator in the jurisdiction where the auditor is based and only register the auditor if the reference received is considered satisfactory. Such a reference should include the outcome of the latest quality assurance review carried out by the national regulator on the non-Hong Kong firm.

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30. Our earlier submission also suggested that the FRC takes steps to assess the effectiveness of the system of audit regulation in the jurisdiction where the overseas audit firm is based. The FRC could place some reliance on the regulatory systems of those countries that the European Commission has determined is equivalent to that required of EU Member States.
31. In terms of what information is required from the applicant non-Hong Kong firms, the Government has indicated that the FRC will issue guidance notes on what would be taken into account in considering an application for recognition from an overseas auditor.
32. When issuing guidance notes, the FRC should, on application for recognition of a non-Hong Kong auditor, and in addition to the criteria already outlined, consider the requirements of the UK FRC before registration as a third country auditor in the UK.
33. Applying such requirements to Hong Kong, this would require the majority of the audit firm's principals, and the proposed individual auditors to hold an audit qualification equivalent to that required in Hong Kong; an undertaking that the non-Hong Kong audit entity will carry out the relevant audits in accordance with international auditing standards and code of ethics; an undertaking by the non-Hong Kong audit entity that it will publish an annual transparency report, including a description of the internal quality control system of the audit entity and a statement on the effectiveness of its functioning; and, agreement by the non-Hong Kong audit entity to cooperate on inspections.
34. Ultimately, for non-Hong Kong audit entities registered in countries where the system of regulation is not considered to be of a sufficient standard, for example those territories outside of the EU and territories considered to have equivalent regulatory systems, the FRC should have the authority to directly regulate such entities.

Composition of the FRC

35. ACCA believes that the system of regulation should be independent from both auditors and accountants because accountants and auditors are inextricably linked. For example, accountants and auditors practise as partners within the same firm, often they hold the same professional qualification and there are many accountants who have been auditors themselves previously.

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36. In view of the above, we believe that the FRC should comprise a majority of non-accountants, to demonstrate its independence of both the accounting and auditing professions.
37. We would draw your attention to the composition of the board of the UK Financial Reporting Council and the US Public Company Accounting Oversight Board. Non-accountants are in a majority on the boards of both organisations.
38. We would also draw your attention to a significant difference in the proposed composition of the HK FRC compared with EU requirements. The proposal is that the HK FRC may include auditors although they must be in a minority. In contrast the EU Statutory Audit Directive 2014/56 requires that the competent authority with ultimate responsibility for audit regulation shall be governed by non-practitioners (persons other than auditors) who are knowledgeable in the areas relevant to statutory audit. (Paragraph 3 of Article 32 and paragraph 15 of Article 2)
39. The above has been interpreted by the UK, Irish and other EU member state governments as prohibiting auditors from sitting on the boards of the audit regulatory bodies. This significant difference could result in the HK FRC not being considered sufficiently independent of the auditing profession and, therefore, the HK system of audit regulation not being perceived as robust as that in the EU.

PIE Engagements

40. We were very pleased to note that certain non-audit assurance engagements for PIE entities have been brought into the scope of the FRC. We believe that including these engagements, which relate to public listings, mergers and acquisitions and are specified in Schedule 1A paragraphs 2 and 3, serves the public interest. We would be supportive of the inclusion into scope of any other non-audit assurance reports that might be considered to be of the public interest.

Yours sincerely



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