



9 March 2018

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

By email: bc_04_17@legco.gov.hk

Dear Sirs,

Financial Reporting Council (Amendment) Bill 2018

The Hong Kong Institute of Certified Public Accountants (HKICPA) is a statutory body established by the Public Accountants Ordinance for the registration, education and regulation of the accountancy profession in the public interest. It is the only body authorised by law to set and promulgate financial reporting, auditing and ethical standards for professional accountants in Hong Kong.

Since its establishment the HKICPA has taken its regulatory responsibilities very seriously and has invested significant resources in establishing effective regulatory functions covering all members including auditors. As an innovator in the area of regulation HKICPA has been instrumental in introducing key elements of the regulatory regime in Hong Kong. Inspection of audit practices was introduced more than 25 years ago, one of the first jurisdictions in the world to set up such a programme. It was primarily at the suggestion of and with the active participation of HKICPA that the Hong Kong Government established the Financial Reporting Council to take over investigation of potential audit deficiencies in audits of Hong Kong listed entities in 2017. Under the current arrangements, prima facie cases identified by FRC investigation are referred to the HKICPA for consideration of disciplinary proceedings against the auditor carried out under the system set up by the PAO. The HKICPA will act as the complainant in proceedings which are conducted and concluded by an independent disciplinary committee with lay majority.

HKICPA, in continuing to monitor trends and developments in international regulation, saw that, even though the quality of regulation in Hong Kong has been very high, international models have clearly moved to independent regulators over the last 15 years. Acting in the public interest, HKICPA initiated discussions with the Government and the FRC on development of a suitable, independent regulatory model for Hong Kong that would maintain the international reputation of the Hong Kong capital market. Later, the Government took the lead and developed the appropriate legislation to establish the FRC as an independent audit regulator.

Therefore we are pleased to finally see the introduction of the bill. An independent full scoped audit regulator under the new regime will strengthen Hong Kong's reputation as an international financial and capital market.

We have worked very closely with the Government and the FRC to ensure the model being proposed meets IFIAR benchmarks and will be effective and fair. We have raised many issues regarding structure, composition and operational features of the system. We are pleased the bill has addressed many of our concerns, but there are a number of fundamental matters that should be addressed.

Full description of the proposed regulatory model

We would like to offer our view that the Bill and supporting information needs to be presented in a way that enables legislators to have a clear understanding of the system that they are being asked to introduce. An effective regulatory system is the sum of very many detailed and complex parts.

In essence the proposed regulatory model gives the FRC responsibilities and powers, in respect of audit practices that audit listed entities, to carry out routine inspections, to conduct investigations into complaints and suspected audit failures, to apply disciplinary proceedings where a prima facie case has been found and to determine and apply sanction where standards have not been applied or the auditor has otherwise failed to act appropriately. In addition the FRC will exercise oversight on the HKICPA activities of registering audit firms and individuals, setting auditing standards and audit related ethical standards and Continuing Professional Development requirements insofar as they relate to audits and auditors of listed entities.

The Bill is not a user-friendly representation of the whole of the system but is rather a legally phrased narrative, addressing separate parts of the system, in no particular order, without giving a clear picture of the whole. During development of the draft legislation we asked on more than one occasion for the government to provide an overall illustration of the whole system showing where the constituent parts sit and how they operate together. We believe that such an approach would be much more helpful and instructive, giving an overall picture of the system and allowing legislators to see where and how the various parts of the model are dealt with – in primary or subsidiary legislation, as part of FRC developed internal processes and guidance, or in the MoU covering FRC oversight of HKICPA and other cooperation arrangements between the two bodies. We suggest that legislators would find this approach constructive and helpful in facilitating finalization of the legislation.

Professional skills in the public interest

The move to an independent regulatory model is a matter of great public interest and importance for Hong Kong. In our view a fundamental and pervasive matter of principle is that the new system must be populated by sufficient people with appropriate professional skills and knowledge at all levels of operations and decision making to ensure that its regulatory functions are efficiently, effectively and fairly discharged. In our discussions with Government we have raised this concern around a number of provisions in the draft legislation, specifically the composition of the FRC Council which is the key decision making body, composition of the Public Interest Entities Auditors Review Tribunal and the scope and role of the Independent Reviewer.

Composition of the FRC Council

There continues to be a difference of opinion between HKICPA and the Government on what number of FRC Council members should have audit knowledge and experience to ensure decisions made on the activities of auditors are appropriately well informed. The Bill provides for at least two (out of nine), we have suggested the number should be at least one third. It is a matter of public interest that the independent regulator should have the necessary audit and accounting related knowledge to assess audit quality and complicated accounting issues in what are often very complex listed company audits. We believe that our suggestion is a more appropriate starting point to ensure that such skills are available.

We are concerned that the view has again been raised that the future membership of the FRC Council should be aligned to EU regulations that require that the governing body of an independent regulation must consist entirely of non-practitioners. Some parties seem to be saying that this would be acceptable as relevant skills and experience can be fully provided by non-practitioner members of the FRC where the non-practitioners are in fact former practitioners who have served an appropriate cooling off period. Typically such individuals would have been very senior in their firms. We accept that such individuals could bring experience and wisdom to the process but question how relevant their skills and experience remain over the passing of years since their direct involvement in audits, both within their firms and subsequently. Given the rapid rate of change in accounting and auditing standards there will be an equally rapid degradation of skills over time if they are not being continually refreshed. We therefore submit that the value of current knowledge possessed by practitioner members must remain vitally important.

However, to argue about who could actually possess and retain relevant skills misses the fundamental point that "all non-practitioners" requirements apply to bodies that are constituted in a different way to the FRC. European audit regulators tend to have a governing body that is focused on strategy and direction rather than direct execution and operational details. In such bodies the operational decisions such as sanctioning decisions are made in committees or boards where current skills and experience of auditing can be accommodated. The lack of such skill sets in a strategically focused governing body therefore does not cause a problem. In contrast, the Bill proposes a mechanism where all decision making is vested in and will be carried out by the FRC Council. The Council will make decisions, including application of sanctions, on individual cases based on inspection, investigation and disciplinary proceedings. With such a hands-on operational role we are firmly of the view that there needs to be current and relevant skills within the FRC Council.

Size and composition of the Public Interest Entities Auditors Review Tribunal

On the same point of principle we have suggested that the tribunal should consist of up to five members with two having PIE audit knowledge to give flexibility in allowing a tribunal of different size and composition to be constituted to deal with cases of different complexities and to balance as necessary efficiency and effectiveness of the review mechanism. The Bill retains provision for a three person tribunal chaired by a judge or equivalent. There are no provisions for the qualifications of other tribunal members. When we raised this issue previously the

Government responded that there was no need for tribunal members to have audit knowledge as they could refer to expert evidence that had been brought to the case at earlier stages of the process. In our view this is not the same as having a decision maker with appropriate knowledge of their own. We believe that the principle of having appropriately skilled decision makers at all levels of the system is very important.

Independent reviewer

Our final point under this same matter of principle is that there should be a clear explanation of the exact qualifications, role and scope of review of the Independent Reviewer who may be appointed if an auditor disagrees with the findings and proposed sanctions of the enforcement arm of the FRC. This provision is not explicitly included in the Bill but was proposed by the Government in response to our concerns about fair and fully informed inspection/investigation conclusions. We understand that the Government is prepared to deal with the matter as a policy commitment to provide certainty and understanding.

Segregation of responsibilities

The Government has given us assurances that the FRC will be required to develop administrative procedures to ensure segregation between the functions of inspection/investigation, disciplinary proceedings and final decision making by the Council. We believe it would be helpful for this requirement to be expressed clearly in the Bill or otherwise be reflected in the operational structure of the new FRC.

FRC operational budget and funding arrangements

A second major issue that we believe must be addressed relates to the proposed operational budget and funding arrangements of the FRC. HKICPA feels that the proposed \$90 million annual budget, a three-fold increase, requires better justifications. Judging from our own experience in regulation, inspection and discipline, the figure seems very high considering the number of PIE auditors under the purview of FRC. The number of audit firms captured by the new system will be around 45. We have calculated the annual costs currently incurred by us in respect of the responsibilities to be transferred at around \$12 million, the number which we have provided to independent consultants engaged by the Government to develop a budget for the new FRC. The proposed "additional" budget for the new FRC is five times the current costs of regulating this relatively small population of audit firms. We feel that is only reasonable for all proposed funding parties and the legislators to be given an explanation for this substantial increase, including details of the proposed operational structure which will presumably support the need for this level of funding.

We still believe that the primary, if not sole, funding source should be investors as they will be the primary beneficiaries of the new regulatory regime and funding from this source will clearly underscore the independence of the new system. In finalizing the sources of funding for the FRC, stakeholders should be aware that any levy on audit firms will ultimately be deemed to be part of the costs of an audit and in some way will be passed on to and borne by the audit clients and investors. However, if the proposed tripartite funding arrangement goes ahead the Government needs to be more forthcoming and transparent with all funding parties,

including PIE auditors, to ensure everybody is comfortable with the long term funding arrangements and that their required contribution is reasonable and fair. If the proposed model does go ahead then the HKICPA would want enough time to propose an alternative model for determining the auditor levy as the proposed continuation of the "per listed company client" charge will not necessarily continue to be appropriate in the significantly changed circumstances. We have discussed this with the Government which has been open to receiving alternative levy calculation mechanisms.

FRC oversight of HKICPA activities

Another matter that could be considered as part of the operational structure of the FRC concerns FRC oversight of HKICPA registration, CPD and standard setting functions as they relate to PIE audits and auditors. The Bill proposes that whereas some functions (inspection and enforcement) are transferred from HKICPA to the FRC, other functions will be retained by the HKICPA subject to oversight by the FRC. We suggest that this aspect of the proposed new regime should also be fully set out and explained to allow legislators to understand how the future system will work. The Bill allows for the FRC to issue directions to the HKICPA "upon being satisfied that it is in the public interest to do so". In our view the due process that will be followed to allow the FRC to issue directions should be spelt out. HKICPA has a very robust due process for setting professional standards and our CPD and membership requirements are benchmarked with other leading accountancy bodies so any direction should be given after no less robust due process. The MoU is an appropriate basis to set out operational aspects of the oversight relationship between the FRC and the HKICPA but the power to give directions which potentially could compel the HKICPA to depart from established public policy is a fundamentally different matter that should be dealt with more formally and publically. We do not believe that this matter of principle should be sorted out between the FRC and the HKICPA in a memorandum of understanding (MoU) as has been suggested by the Government. It would be helpful for legislators to understand how and where all aspects of the proposed system will be addressed – in primary or subsidiary legislation, guidelines or MoU.

Scope of FRC activities

During the course of development of the draft legislation it came to our attention that what believed to be a clear and widely understood definition of what audit and assurance engagements were within the scope of the FRC was not as clear as we thought. In our view the new system covered all "external" assurance opinions – statutory audits and most assurance reports required to be made public under the Listing Rules. To clarify the scope of the legislation the Government developed the concept of PIE and non-PIE engagements which are set out in Schedule 1A Part 1 of the Bill (see further comments in the appendix to our letter). The result is a rather complicated and not entirely clear list of engagements which are apparently the full set of engagements that are within scope of the new system. We suggest that thought could be given to simplifying the definition by reference to the Companies Ordinance and the Listing Rules which would be understandable and allow some flexibility to accommodate new types of engagements should the CO and/or Listing Rules change in the future.

Regulation of non-Hong Kong auditors

The Bill is unclear how non-Hong Kong auditors will be regulated. Apart from regulatory cooperation agreements between the FRC and the corresponding non-Hong Kong regulators, we believe the Bill allows the FRC the discretion to seek assistance from auditor regulators in other jurisdictions. FRC must retain regulatory powers over non-Hong Kong auditors and should not cede regulatory powers to overseas regulators and the Bill should explicitly specify that the FRC has full, ultimate and direct regulatory powers over all auditors recognized or accepted into the Hong Kong market. We are concerned that to solely rely on overseas regulators without retaining the power to take direct action when necessary will not be sufficient to protect the interests of investors in Hong Kong and will not provide a level playing field of equally robust regulation of Hong Kong and non-Hong Kong auditors. We appreciate that reaching cross border arrangements with other regulators is a sensitive and often long drawn out process. One of the key issues around effectiveness of auditor regulation in Hong Kong is that local regulators must have full access to audit working papers. In view of the particular relevance of cross border regulation to the Hong Kong listed company market we believe this is an important issue of investor protection. Appropriate arrangements have to be in place before the new regulatory regime comes into effect.

Consequential amendments to the Professional Accountants Ordinance

There seems to be an omission from the Bill that needs to be addressed to allow HKICPA Council to delegate the power and duty to register PIE auditors. Under part 3 of the FRC (Amendment) Bill, HKICPA Council is responsible for approving or rejecting applications for registration as PIE auditors. Under section 52(1) of the Professional Accountants Ordinance ("PAO"), Council may delegate to any person or to a committee any of the powers or duties granted to or imposed on the Council under the PAO. The Bill has not provided for a consequential amendment to add the Financial Reporting Council Ordinance ("FRCO") to section 52(1) of the PAO. It is proposed that a consequential amendment be made to section 52(1) of the PAO such that Council may delegate its powers or duties granted to or imposed on the Council under any other ordinance.

Other matters

There are a few other matters that we have raised with the Government that we understand the Government has committed to introducing, either in the legislation or in the operational structure of the future FRC:

- Explanation of the criteria that will have to be met to elevate a case from inspection to disciplinary proceedings. The FRC has power to take action, including imposing sanctions, based on inspection findings and disciplinary panels have similar powers. It is unclear what the interface is between the two functions and how elevation to disciplinary proceedings will be triggered. The HKICPA has proposed criteria to the Government as part of a broader submission on sanctions determination and application and the Government reacted positively to our proposal which we would hope to see reflected in the Bill.



- We accept that detailed drafting of guidelines on determination and application of sanctions will be for the FRC to complete but we believe it is reasonable to expect the legislation to include at least a reference to the principles that such guidelines should be based on. This would go some way to address concerns expressed by some of our member firms about imposition of significant monetary sanctions of up to \$10 million or three time "profit or loss".

We have additional comments on specific sections of the Bill, some of which reflect the comments of principle set out above and some of which are more in the nature of drafting points. We provide these additional comments in Appendix 1.

We thank you for your attention to this letter and look forward to being able to communicate our thoughts directly to the Committee in due course. We appreciate that this is a complex and technical subject and while we have attempted to explain the key principles and issues we realize that the detail may not be easy to grasp when coming to the matter for the first time. Accordingly we would be happy to meet again with the Committee to facilitate a full understanding of the issues by Committee members.

Yours sincerely,

A handwritten signature in blue ink, appearing to read 'Raphael Ding', is written over a horizontal line.

Raphael Ding
Chief Executive & Registrar

Appendix

Comments on individual clauses of the Bill

7. Composition of the FRC. See above for our concerns about the numbers of Council members with knowledge of PIE auditing. We have also questioned whether it is appropriate for executive directors to participate in decision making on cases they have run at inspection, investigation or disciplinary level. FSTB has previously advised that administrative measures will be developed to address this. There is no reference to this point in the Bill – either in section 7 or Schedule 2 Part 4 on FRC meeting procedures – and we would hope to see this in the Bill or dealt with by a policy commitment.

20ZE. Etc. Recognition of overseas auditors. See above on our concerns about effective regulation of overseas auditors.

20ZT.(3)(b) This section requires that a Mainland auditor recognized by the FRC may only carry out PIE engagements for Mainland corporations listed in Hong Kong and that such engagements must be carried out in accordance with China Accounting Standards for Business Enterprises (CASBE) or Mainland Auditing Standards. This is factually incorrect. The audit cannot be carried out "in accordance" with accounting standards (CASBE). There is confusion between the existing arrangements by which Mainland auditors can audit Mainland entities listed in Hong Kong and the standards that apply to such audit engagements.

21F. Criminal offences relating to non-compliance with directions given in respect of inspections. We continue to object to this in principle. We understand that similar provisions already exist in the FRCO relating to FRC investigations and that other regulators with investigation functions also have similar powers at their disposal. However, we consider that there is a fundamental difference between routine inspection programs which are not based on the suspicion or presumption of wrongdoing and investigations which by their nature are triggered by suspicions. In our view if an auditor that has registered as a party to a regulatory regime fails to cooperate with the regulator then the correct outcome is a penalty applied by the regulator using sanctions prescribed by regulations, potentially even exclusion from the regulatory regime which would prevent the auditor from auditing listed entities. Criminal sanctions are not necessary.

21H. Referral to a disciplinary hearing is no longer among the follow-up actions available to the FRC based on an inspection report. Previously in the draft legislation this was a specified outcome of inspection. Presumably it is not now the intention that inspection cannot result in a disciplinary hearing? It is now even less clear how the two functions interface and what is the point of escalation to disciplinary proceedings. Also see **37A** below. Inspections can result directly in "sanctions" – are these the same sanctions that are available under disciplinary proceedings? It is not clear whether only certain sanctions are available at the inspection level while more "serious" sanctions have to follow disciplinary proceedings. It is important that there is clarity around these issues and comprehensive sanctioning guidelines, as requested in the letter above, should be made available to provide such clarity.

37A. Misconduct seems to be the criteria for matters going to disciplinary proceedings. Also see **21H** above. The definition of misconduct appears to be serious omissions or commissions such as involving integrity or damaging the reputation of the profession but trying to follow all the cross-referencing within the Bill and the FRCO it does seem that a simple failure to comply with professional standards could constitute misconduct. This is not in accordance with our understanding obtained from our previous discussions with the Government. As commented above it is important that stakeholders and legislators understand how the regulatory system fits together and operates as an entirety and not a number of separate parts. Guidance that provides appropriate clarification should be available when the Bill is being considered.

37N. Public Interest Entities Appeal Tribunal. Our key views on the composition of the Tribunal are provided in the above letter.

50C. Levies payable by PIE auditors. See comments above.

60B. Power to make regulations. These provisions are generally about types of information to be provided and in what form it should be provided. There is nothing to address the requests we have made to see the administrative arrangements that FSTB has said will be in place to restrict executive directors participation in decision making and segregation between functions.

Part 7. Transitional Arrangements are limited to PIE engagements undertaken but not completed before the 2018 Ordinance commencement date and investigations initiated before the 2018 Ordinance commencement date. We suggest that the provisions could be more comprehensive, at least addressing the principle of cooperation between HKICPA and FRC in effecting an effective handover of responsibilities and operations after the commencement date and the basis on which work in progress at the commencement date will be concluded.

Schedule 1A. PIE Engagements and Non-PIE Engagements. At the commencement of the Bill it is clearly stated that the objective of the exercise is to make the FRC an effective regulator of listed entity auditors. A listed entity is then defined as a listed corporation or a listed collective investment scheme. In Schedule 1A there are definitions of PIE and Non-PIE engagements, both are within scope of the FRC. After some detailed explanation from FSTB we understand that the additional definitions have been developed and included in the Bill to differentiate between listing of equity shares and listing of other securities. Apparently during consultation "listed entities" were defined only in respect of equity listings! The FSTB chose to add the further PIE and Non-PIE definitions to address this anomaly. In our view the approach taken in the Bill is confusing and it would be simpler to re-define "listed entities" to embrace both equity and non-equity listings.