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March 9, 2018

FRC Bills Committee
Legislative Council
Central
Hong Kong

Dear Sir,

ACGA Submission on Financial Reporting Council (Amendment) Bill 2018

The Asian Corporate Governance Association (ACGA) welcomes the opportunity to respond to the Financial Reporting Council (Amendment) Bill 2018 and attend the hearing at the Legislative Council on March 20, 2018. This is a significant step forward for Hong Kong's audit regulatory regime and will bring it in line with international norms.

ACGA is a not-for-profit membership association chartered under the laws of Hong Kong and founded in 1999. The Association is dedicated to working in a constructive manner with listed companies, investors, auditors and regulators across Asia to improve corporate governance standards and practices, which we believe are a foundation for long-term economic development. We are guided by a practical, long-term approach that is relevant to each individual market. Our operations are supported by a membership base of institutional investors, Asian listed companies, insurance and accounting firms, and universities. ACGA has more than 110 corporate members, two thirds of which are institutional investors with more than US$30 trillion in assets under management globally. They are also significant investors in the Hong Kong market.

High-level comment

ACGA welcomes the enhancement of the FRC's role as the independent regulatory entity for external auditors of listed companies in Hong Kong. This is an issue that ACGA has been focussed on since 2009, following an invitation to speak at the annual meeting of the International Forum of Independent Audit Regulators (IFIAR) that year in Singapore. The role and effectiveness of independent audit regulators has since become an important part of our regional survey on corporate governance (CG) in Asia, called "CG Watch", which ranks 12 markets in Asia-Pacific on the macro quality of their CG systems. As the following table shows, Hong Kong's score has suffered materially compared to its nearest rival, Singapore, from the lack of an independent audit regulator:

CG Watch: Accounting & auditing score				
	2010	**2012**	**2014**	**2016**
Hong Kong	80	75	72	70
Singapore	88	87	85	87

Source: ACGA, "CG Watch" 2010, 2012, 2014 and 2016

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Specific comments

ACGA supports the direction proposed in the Bill regarding the respective roles of the FRC and Hong Kong Institute of Certified Public Accountants (HKICPA), namely adding inspection and enforcement/disciplinary functions to the FRC's existing investigation work, and retaining auditor registration, CPD requirements and standard setting within the Institute. We wish, however, to comment on the following four factors:

1. Funding

While we broadly support the funding model proposed of three new levies on securities transactions, public interest entities (PIEs), and PIE auditors, we have doubts as to whether the initial budget of HK$90m at 2016 prices (approx HK$99m when the new FRC is expected to start in 2019) will be sufficient. This may be enough to get the new regulator up and running, but it is unlikely to be adequate as its role expands. In simple terms, the proposed budget is slightly more than three times the FRC's current restricted budget for one function (investigation). With the addition of inspection and discipline, and with the growth of Hong Kong's capital market, it is reasonable to assume that the Council's workload will more than triple as demands on its resources grow. Indeed, the Legco briefing paper says as much: "Under the new regime, the scope of FRC's work will be increased by more than three-folds to cover also recurring inspections, enforcement/discipline, recognition of overseas auditors, oversight of HKICPA's regulatory functions in respect of PIE auditors, and enhanced cooperation and interface with relevant international bodies and overseas audit regulators, etc." It is worth noting also that the proposed budget seems low relative to independent audit regulators in other international financial centres.

2. EU Equivalence

In order for Hong Kong's new audit regulator to properly supervise the overseas auditors of any overseas corporation or collective investment scheme listed in Hong Kong, one important element is European Union recognition. While the FRC Bill achieves most of what is required for EU equivalence, it falls short in one area: the composition of the new governing body overseeing the new FRC.

On the one hand, the Bill enhances the independence of the FRC by removing appointees from HKICPA, the Securities and Futures Commission, Hong Kong Exchanges and Clearing, and an ex-officio appointee by the Financial Secretary. On the other, it envisages that "at least two persons should possess knowledge of and experience in PIE engagements so as to ensure sufficient expertise in the FRC", and "the number of members who are non-practitioners must exceed the number of members who are practitioners", according to the brief prepared for the Legislative Council by the Financial Services and Treasury Bureau (see page 11). This language could be interpreted as allowing current PIE auditors to sit on the FRC governing body, something that would be contrary to an EU directive in 2016 stating that all members of an independent audit regulatory governing body should be non-practitioners.

The solution to this problem would be to reword the FRC Bill to state that practitioners (ie, "practicing CPAs" who audit listed companies) are not eligible to sit on the governing body,

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whereas former practicing CPAs or partners/directors/employees of CPA firms would be eligible after a suitable cooling-off period (defined as three years under EU rules). This would likely satisfy EU standards and retain the spirit of the Bill, which seeks to strengthen accounting and auditing expertise in the FRC governing body.

3. Scope of PIE engagements

The Bill limits the regulatory jurisdiction of the new FRC to three areas (Clause 77):

- Audits of annual financial statements of listed companies and collective investment schemes;
- Specified audit reports required in listing documents; and
- Accountants' reports required under the Listing Rules for reverse takeovers and very substantial acquisitions.

However, this leaves out a range of duties assigned to auditors under the Listing Rules, such as reporting on any continuing connected transactions each year (Rule 14A.56), reviews of profit forecasts (Rule 14.62) and major transactions (Rule 14.67). Listed companies can also choose to have their interim (half-yearly) accounts reviewed by auditors. As the Bill does not cover these additional areas, any complaints by investors would need to be directed to the HKICPA under the new regime, not the FRC. This has the potential to create confusion in the market, will most likely lead to regulatory inefficiency and will almost certainly undermine confidence in the new system. We recommend that any assurance reports required from reporting accountants under the Listing Rules be covered by the new legislation.

4. Standard setting

While we support the direction of the new FRC Bill, we suggest that Hong Kong may need in future to establish independent entities for the setting of both accounting and auditing standards. Internationally, accounting standards are set by a body independent of the accounting profession, the International Accounting Standards Board (IASB), and many developed markets have their own independent entities, such as the Financial Reporting Council in London that develops UK Accounting Standards. While international standards of auditing are set by a collective industry body, the International Federation of Accountants (IFAC), a review has recently been initiated by IFIAR over the governance and efficacy of this process. This area will likely continue to evolve.

We trust the above comments are helpful and look forward to the Legislative Council hearing.

Yours truly,

Jamie Allen
Secretary General

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