Hong Kong Institute of
Certified Public Accountants
香港會計師公會

11 April 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

We are most grateful to the Committee for considering the submissions made by the HKICPA and for the opportunity given to our Chief Executive to speak directly to the Committee at its meeting on 20 March 2018. Many of the matters raised during the Committee meeting are quite specialized and we are pleased to respond to the request by Committee members to provide further explanations about certain key issues. In this letter we will address:

- Guidance on sanctions determination and application:
- Regulation of non-Hong Kong auditors;
- EU equivalence; and
- The scope of assurance engagements covered by the Bill.

In addition to this written submission we would be pleased to provide additional direct explanations on these key areas to Committee members when required by the Committee.

1. Guidance on sanctions determination and application

We fully acknowledge that an effective regulatory regime must include the ability of the Regulator to apply appropriate sanctions and have expressed our support for the range of sanctions included in the Bill. However, during and since the public consultation we have consistently asked that guidelines on sanctions determination and application should be available at the same time as draft legislation. Understandably, the subject of sanctions is something that many auditors take very seriously. A matter that has the potential to affect the professional reputation, and perhaps the livelihood, of firms and individuals generates responses at an emotional level. The availability of guidance during the passage of legislation would address concerns and be a significant step in establishing trust in the FRC and the new regime which will be essential for it to be effective.

Our response to the public consultation (**Attachment 1**) included a suggested set of sanctioning guidelines which we developed with reference to published sanctioning guidelines of overseas and local regulatory bodies. We believe that these guidelines remain relevant and are a reasonable basis for development of guidelines by the FSTB. We would be happy to help with this exercise.

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2. Regulation of non-Hong Kong auditors

The Bill contains provisions for the recognition of non-Hong Kong auditors (excluding Mainland) including reference to the regulatory system in the auditor's home jurisdiction (Clause 20ZF).

(2) The FRC must not grant a recognition application unless it is satisfied that –
(b) the overseas auditor specified in the application –
(ii) is subject to the regulation of an overseas regulatory organization recognized by the FRC;
(c) an agreement of mutual or reciprocal cooperation is in force between the FRC and the overseas regulatory organization referred to in (b)(ii); and
(d) the overseas auditor has adequate resources and possesses the capability to carry out a PIE engagement for the applicant.

(3) The FRC may recognize an overseas regulatory organization for the purposes of subsection (2)(b)(ii) if it is satisfied that –
(i) the organization performs a function that is similar to a function of the FRC under this Ordinance; and
(ii) the organization is composed of a majority of persons who are independent of the accountancy profession.

In our view the recognition process and criteria remain loose and do not focus on how effective regulation can be exercised by the FRC over non-Hong Kong auditors. What should be included in "*an agreement of mutual or reciprocal cooperation*"? How and by whom will it be determined that "*the overseas auditor has adequate resources and possesses the capability to carry out a PIE engagement for the applicant*"? What would constitute "*a function that is similar to a function of the FRC*", given that FRC has several functions? The point about the composition of the overseas regulatory organization assumes that all such organizations will be structured in the same way as the FRC so maybe it should refer to composition of the governing body of the organization.

Most importantly the Bill does not stress the need for primacy of the FRC as the regulator of <u>all</u> auditors of Hong Kong listed entities. Although the proposed legislation projects the FRC to be the primary regulator of all auditors of Hong Kong listed entities, the proposed legislation seems to allow the FRC the discretion to choose not to directly regulate, by way of inspection or investigation and sanctioning, non-Hong Kong auditors.

In respect of Mainland auditors, Clause 20ZT effectively proposes that the current arrangement of endorsement by Mainland authorities in accordance with the mutual recognition agreement will continue without the need to apply recognition criteria applicable to other non-Hong Kong auditors. This is explained in paragraph 13 of the Legislative Council Brief but it is not made clear that the assessment and approval of Mainland auditors is done by Mainland regulators with no input or influence by Hong Kong regulators. The arrangement is enabled by Chapter 19A of the HKEx Main Board Listing Rules and it will be effectively continued under the new regime.

Although we accept that this arrangement has been in place for some time there is now an opportunity to ensure that the Hong Kong regulatory system is made fully effective. In the consultation conclusions published in December 2010 HKEx repeatedly stated that reliance on the memorandum of understanding and co-operation agreements between Mainland and Hong Kong regulators would be key in accepting Mainland auditors into the Hong Kong market (**Attachment 2**). However, the current memorandum of understanding and co-operation agreements between Mainland and Hong Kong regulators are not legally binding and deal with general co-operation and sharing of information between parties relating to investigation and inspection only; they do not explicitly address how regulatory bodies will exercise sanctions, including financial penalties. Currently the HKICPA as a regulator of Hong Kong auditors has no authority over Mainland and other non-Hong Kong auditors. Nor do any other Hong Kong regulators. The Bill places the FRC as regulator of all auditors of companies listed in Hong Kong and as such it should have mechanisms in place to carry out its responsibilities.

An associated issue that also needs to be addressed is the inability of Hong Kong regulators to access working papers of Hong Kong auditors for engagements carried out under Temporary License (for Hong Kong based companies (listed or private) with operations in Mainland) or Provisional Regulations (for Mainland companies listed in Hong Kong). These restrictions, imposed by Mainland laws and regulations, plus the audits by Mainland auditors of Mainland firms listed in Hong Kong mean that audits of entities accounting for up to 70% of the listed cap of entities listed in Hong Kong may be outside the reach of the Hong Kong auditor regulator.

3. EU equivalence

EU "equivalence" is governed by the EU Statutory Audit Directive (SAD) and associated regulations. Non-EU auditors of non-EU entities that are listed on exchanges in EU member states have to register and be subject to direct regulation by the national regulator of the particular member state. EU member state regulators can disapply or modify this requirement if the non-EU (third country) auditor is subject to systems of quality assurance, investigation and penalties and public oversight that meet requirements equivalent of Articles 29, 30 and 32 of the SAD respectively.

In 2016 Article 32 was amended to require that the system of public oversight is governed by only non-practitioners (a minority were previously permitted). Article 32 continues to require that the non-practitioners who govern the system are "knowledgeable in the areas relevant to statutory audit".

To answer the question about who would benefit from Hong Kong being recognized as EU equivalent we have to look at the relevant parties:

Hong Kong auditors that have clients listed on EU member state exchanges

Hong Kong auditors' ability to sign off on audit reports on EU listed entities is not affected whether Hong Kong achieves EU equivalence or not. The "saving" is that the auditors have no requirement to provide additional information (including transparency reports) to or be subject to direct inspection by the EU member state regulators. However, since the transitional status of Hong Kong was

rescinded a few years ago Hong Kong auditors have been subject to direct regulation and have not been complaining about the situation being too onerous. There is only a small number of Hong Kong auditors registered with EU member state regulators.

EU regulators

Presumably it would be less demanding to recognize equivalence than exercise direct regulation on third country auditors.

Hong Kong listed companies that are also listed in EU member states

Intuitively it would appear that it should be more convenient for a Hong Kong company to retain its Hong Kong auditor but in practice there is no difference for the company whether the auditor was recognized under the equivalence regime or directly regulated by an EU regulator.

Should EU equivalence be pursued?

We accept that in the very early stages of considering a new independent regulatory system for Hong Kong EU equivalence was considered as an objective. At this stage the issue was all about Hong Kong imminently losing its transitional status which brought the matter into focus. Nothing could be done to sufficiently change the Hong Kong system and the status of Hong Kong was officially changed to "non-equivalent" in 2013. Hong Kong auditors and listed companies have operated in this system ever since with no complaints being heard. The HKICPA member consultation in late 2013 identified that within the profession there was little support for making EU equivalence a key objective of the reform process. Our position on this matter and conclusion from the member consultation was clearly stated as "***Our position remains that EC equivalence brings little additional benefits to Hong Kong over and above IFIAR membership and whether we should continue to support it as a policy objective depends on the "price" the profession needs to pay.***"

In the 2014 public consultation document there was reference to the EU audit requirements as examples of developments in other jurisdictions and some comments on equivalence but this was not stated as an objective of reform but used as benchmarks or best practice.

The specific question that was asked in the consultation paper was about benchmarking to international standards and not whether EU equivalence should be pursued. **In the Consultation Conclusions the government said "*We have set out in the consultation paper the importance of enabling Hong Kong to be eligible for being represented in IFIAR and making reference to the relevant principles of the European Union (EU) in designing the new regulatory regime.*"** In our view referencing points of principle from other systems does not amount to a commitment to achieve EU equivalence.

There was no further public discussion of EU equivalence until October 2016 when the FRC press release about the updated Deloitte report on independent oversight made reference to the new EU regulations about an all non-practitioner governing body and EU equivalence. The HKICPA responded at that time. The

matter has been raised again by the FRC in a press conference the day before the Bills Committee meeting on 20 March 2018. **In our view the wholly non-practitioner model is not appropriate for the proposed new system in Hong Kong as the FRC Council will be the decision making body for most operational decisions on inspection, investigation and discipline unlike the regulatory organizations in many other jurisdictions where decisions are taken by committees and panels including persons with appropriate and up to date knowledge of auditing and the overall governing body takes a strategic role.**

As happened with the 2016 changes to EU rules and regulations, new equivalence requirements could be introduced at any time. Would it be desirable to make an ongoing commitment that could lead to the automatic import of rules and regulations developed by another jurisdiction? A commitment to achieve and maintain EU equivalence would mean that future changes to equivalence requirements would require changes to Hong Kong legislation.

4. The scope of assurance engagements covered by the Bill

The Bill specifies that the FRC will regulate registered and recognized PIE auditors and the title of the Bill refers to "auditors of listed entities". However, the actual scope of assurance engagements covered by the Bill is unclear.

Firstly, the inclusion in the Bill of the terminology of "PIE" and "non-PIE" is confusing.

PIE is defined in the Bill as (a) a listed corporation (equity); or (b) a listed collective investment scheme. **Non-PIE** means a listed corporation that is not a listed corporation (equity). The intention is clearly to capture debt listings, which were not specified in the public consultation documents. However, the inclusion of the term "non-PIE" in a Bill that is intended to regulate audits of public interest entities, defined as listed entities, is extremely confusing. We suggest that the two definitions are combined into a single definition of a PIE.

PIE and non-PIE engagements listed in Schedule 1A Part 1 are all external reporting engagements and there is no logic in requiring some (PIE engagements) to be subject to inspection and investigation and others (non-PIE engagements) to be subject only to investigation as is currently specified in the Bill. All external reports will be used by investors and should all be subject to the inspection and investigation processes of the FRC. Accordingly, CPA firms carrying out "non-PIE" engagements should also be required to be registered with the FRC. The simplest solution, as suggested above, would be to move all the "non-PIE engagements" under Schedule 1A Part 2 into the list of "PIE engagements" under Schedule 1A Part 1 and subjecting all to both inspection and investigation.

Secondly, we believe that the list of assurance engagements that are within the scope of the Bill, Schedule 1A provides the definition of PIE and non-PIE engagements, is not complete.

In the public consultation document the engagements proposed to be within the scope of the FRC were defined as statutory audits and assurance engagements required under Listing Rules 4.03 and 19.20 (reporting accountants' report in listing documents and auditors' report on annual accounts of listed companies). Consultation responses pointed out that there were more assurance engagements required by the Listing Rules.

The PIE and non-PIE engagements listed in Schedule 1A Part 1 and Part 2 do not include all the public reporting engagements that we previously understood would be included in the scope of the Bill.

To provide comprehensive inclusion of external reporting engagements and to align with the Listing Rules we believe the following engagements should also be specified in the Bill as subject to both inspection and investigation:

- Auditors report on interim financial statements (LR Appendix 16 Paragraph 43);
- Auditors opinion in interim reports (LR Appendix 16 Paragraph 51);
- Auditors report on continuing connected transactions(LR Chapter 14A);
- Auditors report on quarterly financial information (GEM Rule 18.76);
- Accountants report in connection with a major transaction (LR 4.01(3));
- Statement that the auditor or reporting accountant has reviewed the financial information to be included in the circular of a very substantial disposal (LR 14.68); and
- Review report on interim financial information (LR Appendix 16 Paragraph 46).

The Listing Rules do not require all external reporting engagements to be undertaken by the reporting entity's auditor. A CPA or firm that carries out a specified external reporting engagement but is not the entity's auditor should also be required to be registered with the FRC to allow the conduct of the relevant engagements to be appropriately regulated. This would not happen if the current distinction between PIE and non-PIE engagements is maintained.

We hope that the above information is of use to the Committee and we will be happy to provide further explanations and updates to Committee members if required.

Yours sincerely,

Raphael Ding
Chief Executive & Registrar

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Attachment 1

16 September 2014

By mail and email: rpirrlea@fstb.gov.hk

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Dear Sirs,

Proposals to Improve the Regulatory Regime for Listed Entity Auditors – Consultation Paper

The Hong Kong Institute of Certified Public Accountants (HKICPA) is the only statutory licensing body of accountants in Hong Kong responsible for the professional training, development and regulation of the accountancy profession. The HKICPA sets auditing and assurance standards, ethical standards and financial reporting standards in Hong Kong. We welcome the opportunity to comment on the above consultation paper, the outcome of which will have significant impacts on the future role and activities of the HKICPA.

Regulation of listed entity auditors is an important part of the overall system of regulation of the Hong Kong capital market. Some years ago the HKICPA recognized that Hong Kong was no longer in step with international best practice and began research and outreach work to propose changes that would meet international expectations and maintain the standing and reputation of Hong Kong's capital market and auditing profession.

From 2012 the HKICPA worked with the FSTB and the Financial Reporting Council (FRC) to develop a proposed framework that was the basis of a member consultation that concluded in January 2014. The member consultation was a major element of extensive engagement with members and other stakeholders over this very significant initiative. There were 42 written responses to the consultation paper and around 4,500 members completed an online questionnaire. There was strong support for the Council position set out in the member consultation documents.

The current public consultation is the next stage in bringing independent regulation of listed entity auditors to Hong Kong. The HKICPA remains committed to this objective. We are pleased to see that a number of significant matters and concerns raised in our member consultation have been addressed in the public consultation paper, although there are some proposals with which we still take issue. Our responses to specific consultation questions are provided in the attachment. The commentary below highlights particular matters that we believe are not the best solutions to achieving the overall objective of reform.

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Before commenting, we would like to clarify two incorrect statements included in the consultation paper.

Paragraph 3.2 states "there are 5,915 practice units qualified to sign an auditor's report in Hong Kong" and goes on to explain the make-up of this number as "4,224 CPAs (practicing), 1,259 firms of CPAs (practicing) and 432 corporate practices". The number of CPAs (practicing) is actually the total number of practicing certificate (PC) holders, the great majority of whom are partners or directors in firms and corporate practices. The HKICPA in fact has 3,600 registered practice units comprising firms, corporate practices and individual PC holders who have registered "own name" practices. Taking into account duplicate registrations of more than one mode of practice and dormant practices there are around 2,500 active practice units. The number of practice units that audit listed entities varies from time to time but is generally just over 50, as indicated in the consultation paper.

Paragraph 7.3 refers to 26 cases referred from the FRC to the HKICPA for seven of which the HKICPA Council has "initiated disciplinary proceedings and convened Disciplinary Committees". In fact at least 14 of the FRC cases have been referred to a Disciplinary Committee and others have been concluded without convening a Disciplinary Committee in accordance with formal HKICPA complaint handling procedures. Most of the FRC referrals have been made in the last two years and at 30 June 2014, 10 of the 26 cases were still being dealt with by the HKICPA, of which nine are being considered by Disciplinary Committees.

In the view of the HKICPA Council and membership the following are significant matters that need to be further considered before new regulatory arrangements are finalized.

1. Lack of detail of operations and processes

The consultation is a key stage in a very significant change in regulation in the listed entity market and affects a number of stakeholders. It is development beyond the experience of many market participants and we suggest that it would be for the benefit of all stakeholders to be provided with additional detail on how a number of proposed operations and processes are expected to work.

We have made detailed comments on these areas in this letter and in responding to specific questions. In summary we believe that further examples or details on the following areas would provide comfort to stakeholders on the reasonableness and appropriateness of the proposals and should be available at the same time that draft legislation is presented to the Legislative Council.

- Circumstances that would result in the FRC giving directions to HKICPA while exercising oversight of HKICPA activities in registration, continued professional development and standard setting.
- Circumstances in which a systemic failure in quality control would be considered to have occurred.

- Vetting procedures to be applied by FRC in making decisions about registration of non-Hong Kong auditors and the provisions that would be in mutual or reciprocal cooperation agreements with overseas regulators.
- Checks and balances to confirm separation of inspection and disciplinary processes and exercise of fairness in regulatory actions against auditors.
- Guidance on determination of appropriate regulatory action or sanctions that ensure any action taken is relevant and proportionate to the identified irregularity.
- Composition of decision making bodies.

2. Enforcement / disciplinary mechanism

We recognize the need for a regulatory body to have appropriate enforcement powers to ensure effectiveness and efficiency of the regulatory system. However, we believe that fairness and due process should not be compromised in the interest of efficiency. In our view it is critical that there should be clear separation of inspection/investigation and disciplinary responsibilities and activities within the regulatory body. The consultation proposals give some assurance that the FRC will be required to put in place arrangements to achieve this separation. However, there is at this stage no indication of how this will be done and the consultation paper implies that all decisions on inspection, investigation, disciplinary action and registration will be made by the Council of the FRC.

In our view introducing a model where all power and decision making is concentrated in a single entity within the FRC is totally unacceptable and it is not supported by models of auditor regulation operated in other significant jurisdictions. We regret that the Government has seen fit to make its preferred outcome known to the press before conclusion of the consultation.

As a result of the consultation paper putting together some elements of the current HKICPA practice review system with enforcement provisions modeled on other Hong Kong financial market regulators and some concepts and terminology from auditor regulation regimes in other jurisdictions, there is a lack of clarity about how inspection, investigation and disciplinary action will fit together. In our view there should be a more holistic approach to regulatory activities and decision making and the application of sanctions where necessary. In our responses to Questions 20 and 30 and in **Annex 1** we have provided a suggested structure and procedures that link inspection and sanctioning processes in a way that is fair, practical and efficient.

3. Type and application of sanctions

We recognize that the range of sanctions proposed in paragraph 7.27 of the consultation paper covers sanctions generally available to auditor regulators in other jurisdictions and are, with the exception of our reservations set out below, appropriate to address issues of audit quality.

We continue to have significant concerns over the proposal to set the maximum financial penalty as "the greater of – (i) $10,000,000, or (ii) three times the amount of the profit gained or loss avoided by the listed entity auditor as a result of the irregularity". The "profit/loss" measure has been taken directly from sanctions available to financial market regulators in Hong Kong. We do not believe it is an appropriate measure for penalties under an auditor regulatory regime because auditors are not market participants in the same sense as financial services providers – they do not sell financial products or hold client assets, but rather provide a service to listed companies in the same way that lawyers provide legal services. We also believe that the figure of $10,000,000 is a direct lift from financial market regulation systems. Many small and medium sized firms have expressed the view that the figure is too high and may drive firms out of the listed entity audit market.

We are not suggesting that financial penalties do not have a place in the range of sanctions but propose that it would be sufficient to have a simple monetary cap of $5,000,000 with clear and strong guidance on how to determine the appropriate amount of a penalty.

We welcome the proposal in paragraph 7.29 that the FRC will be required by law to issue guidelines to explain how it exercises its power to order a financial penalty. We believe that such guidance should extend to the exercise of all sanctions and that the guidance should be developed and presented for consideration at the same time as the main legislation. In our response to Question 32 and in **Annex 2** we provide suggested guidance on sanctions determination and application.

4. Composition of decision making bodies

We mention in this letter and in our responses to a number of consultation questions the critical importance of having appropriate skills, up to date auditing experience and knowledge and a full understanding of the audit process in any decision making organ within a regulator of auditors. We have suggested a dedicated committee is created to determine inspection outcomes but the consultation paper suggests that the FRC Council will become the decision making body in respect of all inspection and investigation work and sanctioning. As we have mentioned above this is not an acceptable model of auditor regulation. However, if it is introduced then all the above requirements, skills, experience and knowledge should apply to the FRC Council.

It must be recognized that the depth of knowledge and breadth of understanding about auditing to successfully carry out all of the proposed roles of the FRC will be far greater than needed for the currently much more limited role of the FRC. There is a big difference between deciding that an investigation report shows reasonable suspicion of an irregularity, with the final decision on sanctions left to another body, and reaching a conclusion that evidence provided by an inspection is sufficient to prove an irregularity and determining a sanction that is reasonable and proportionate.

5. Criminal offences

The consultation proposals include criminal offences for an unregistered auditor entering into an audit engagement with a listed entity and failure to comply with requirements concerning inspections and investigations or tribunal proceedings. We have made detailed comments in response to specific questions. We would like to stress our view that as a matter of principle an auditor regulation system should not need to include criminal offences as the regulatory powers available to the regulator should be sufficient to reach an appropriate resolution, the ultimate sanction being exclusion from the register and market for listed company audits.

6. Regulation of non-Hong Kong auditors

The consultation proposes that in addition to Hong Kong auditors, which will be registered based on existing HKICPA criteria for PC holders, there will be two groups of non-Hong Kong auditors registered as auditors of entities listed in Hong Kong. For one of these groups the FRC will take over approval for registration from HKEx, using broad recognition criteria that are an improvement on those currently in the Listing Rules. One of the criteria is that there must be an "agreement of mutual or reciprocal cooperation" between the FRC and the audit regulator of the home jurisdiction of the overseas auditor. Given that there is very little precedent for effective existing cross border regulation, other than the examples of PCAOB inspection arrangements, we have concerns over how effective regulation of these non-Hong Kong auditors will be achieved. Auditor regulation is not converged internationally. IFIAR is the forum in which national independent audit regulators meet and exchange knowledge and experience but IFIAR membership criteria focus on independence from the profession and do not include measures of the quality of national regulation. Furthermore, the implications of developments in overseas regulatory regimes may add complications e.g. mandatory audit firm rotation that has recently been introduced in Europe could result in an increase in the number of non-Hong Kong auditors of Hong Kong listed entities seeking recognition and approval by the FRC. The second group of non-Hong Kong auditors is the group of auditors approved by Mainland authorities to audit Mainland firms listed in Hong Kong.

We understand that regulation of non-Hong Kong auditors is not the topic of the consultation but we believe it is a very important related matter that should be addressed as part of the current audit regulatory reform. To enhance investor confidence and protection in an international business environment there needs to be confidence that auditor regulation is equally robust across jurisdictions.

7. Definition of "irregularity"

In our response to Question 28 we have expressed our view that the definition of "irregularity" should be revisited to reflect the impact of the proposed new regulatory system that will result in much changed responsibilities and scope of work of the FRC and a new relationship between the FRC and the HKICPA. The current definition was developed to meet the original remit of the FRC – an investigator of Hong Kong auditors of companies listed in Hong Kong – and to work in the situation where the PAO is the main legislation concerned with regulation of

auditors. The definition needs to be changed to focus on compliance with professional standards and, more importantly, to clearly define the authority of the independent regulator over, and its regulatory relationship with, all non-Hong Kong auditors of entities listed in Hong Kong..

8. Funding

The consultation paper proposes a three party (investors, listed entities and listed entity auditors) funding system for the future operations of the FRC, a significant change from the current four party (HKSAR Government, SFC, HKEx and HKICPA) arrangement. In our view a strong case can be made that investors, through a transaction levy, should be the main if not only funding party. We believe that regardless of the identity of future funding parties there should be an attempt to quantify future operating costs. Without this any funding party will be suspicious that they are being asked to enter into a commitment with no knowledge of the amounts involved or how FRC operational costs will be controlled in future. We believe that to give sufficient comfort over accountability and prudent financial management of the FRC the government, if not continuing as a funding party should have a representative on the Council of the FRC in addition to the FRC's annual budget being approved by the Secretary for Financial Services and the Treasury.

We believe that the comments above and included in our responses to the consultation questions are relevant to the determination of the future system of listed entity auditor regulation in Hong Kong. The HKICPA is committed to helping to scope, develop and implement a system of listed entity auditor regulation that will be internationally recognized and is effective in maintaining confidence in the quality of audit in the Hong Kong market. There should be no need for the system to include features that are not necessary to achieve such objectives. Whilst we recognize the tight deadlines and the need to proceed in accordance with a strict timetable to get an updated regulatory system in place, we suggest that given the need to provide substantially more detail to give stakeholders sufficient understanding of the operation of the new regulatory system, it would be appropriate to consider the need for some form of re-exposure of revised proposals.

If any clarification or additional information is required please contact Chris Joy [chris@hkicpa.org.hk].

Yours sincerely,

Clement Chan
President

CONSULTATION QUESTIONS AND RESPONSES

Question 1
Do you agree with the proposed objective of the reform, i.e. to enhance the independence of the regulatory regime for auditors of listed entities from the profession itself with a view to ensuring that the regime is benchmarked against international standards and practices and continues to be appropriate in the local context?

Yes. We believe that this action is appropriate to maintain Hong Kong's position and reputation as a major international capital market.

Question 2
Do you agree that the new regulatory regime should only cover auditors of public interest entities, which will be defined to cover listed entity auditors?

Yes. The intention from the outset has been that the new regime would only cover auditors of listed entities.

Question 3
Do you agree that the definition of public interest entities should be set out in the main legislation such that any change in future could only be made by way of an amendment bill?

Yes. This proposal gives more confidence that any future changes will be made only subject to due consideration and process,

Question 4
Do you agree that FRC should become the independent auditor oversight body with respect to listed entities in Hong Kong by enlarging its regulatory remit?

It is acceptable for the FRC to take on proposed new activities.

Question 5
(a) Do you agree that a listed entity auditor must be a practice unit as defined under the existing PAO and a fit and proper person to be registered as a listed entity auditor?

Yes. For Hong Kong auditors the existing definition of a practice unit in the PAO remains appropriate. Requiring individuals responsible for listed company audits to be "fit and proper" is an acceptable extension of the existing practicing certificate requirements.

(b) If yes, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for considering whether a

person is fit and proper to be registered as a listed entity auditor, i.e. by reference to the existing fit and proper test for becoming a CPA?

The current requirements meet international best practice and do not need to be changed to meet the overall objectives of reform.

Question 6
(a) Do you agree that in order for an application for registration as a listed entity auditor to be approved, the individuals who are authorised by the auditor to perform the roles of an audit engagement authorised person, an engagement quality control reviewer or a quality control system responsible person should be fit and proper persons to perform such roles?

Yes. It is appropriate to require persons with specific and important responsibilities to be fit and proper.

(b) If so, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for individuals taking up such roles with respect to a registered listed entity auditor when considering whether they are fit and proper to perform those roles?

Assuming this means that current HKICPA fit and proper requirements for membership will in future apply to all three categories of individual we agree with the proposal. The current requirements meet international best practice and do not need to be changed to meet the overall objectives of reform.

Question 7
Do you agree that an individual, partnership or body corporate who wishes to enter into an audit engagement with a listed entity in Hong Kong should be required to register as a listed entity auditor, and that it shall be a criminal offence if an unregistered person entered into an audit engagement with a listed entity?

We agree that an individual, partnership or body corporate that wishes to enter into an audit engagement with a listed entity in Hong Kong should be required to register as a listed entity auditor. We do not believe that it is necessary to make it a criminal offence if an unregistered person enters into such an audit engagement. If a CPA (firm) takes on a listed entity audit without registering as a listed entity auditor the matter should be dealt with by HKICPA disciplinary procedures. Non-CPAs providing or offering to provide audit services is already a criminal offence under s.42 of the PAO.

In any event we do not believe that an unregistered person would be appointed as auditor of a listed entity. Appointment procedures followed by the audit committee would inevitably include checking the register of listed entity auditors.

Question 8

(a) Do you agree that HKICPA Registrar should be assigned the role of Registrar of Listed Entity Auditors and be vested with the registration functions and powers as outlined in paragraph 3.23, and FRC should exercise oversight through arrangements as proposed in paragraph 3.24?

Given that we agree that HKICPA should maintain the register of listed entity auditors it is appropriate that the HKICPA Registrar should have appropriate functions and powers to carry out the role. We agree in principle that FRC should exercise oversight as described in paragraph 3.24 subject to additional explanation of how and when FRC will issue directions to HKICPA. Directions should only be made to protect the public interest and not used to circumvent due process of registration. We also believe that in the event that it needs to issue directions the FRC should be required to give full reasons for its actions to the HKICPA and the government.

(b) Do you agree that FRC should publish the periodic reports received by the HKICPA Registrar as mentioned in paragraph 3.24(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?

Paragraph 3.24(a) refers to reports received by the FRC <u>from</u> the HKICPA Registrar. We have answered the question on this basis.

The FRC should provide public information on its oversight role and activities through its own report. Reports received by the FRC from the Institute should not be published as a matter of course as to do so may inhibit co-operation and full and frank dialogue between the FRC and the HKICPA.

Question 9

Do you agree that any person subject to a registration decision by the HKICPA Registrar may appeal against the decision, and any such appeal should be handled by an appeal mechanism which is independent of both the HKICPA Registrar and FRC?

Yes. The appeal mechanism should also apply to registration decisions made by the FRC. We suggest that refusal to allow registration, and any subsequent appeal, should not be made public. Until an auditor is registered its activities are not a matter of public interest and it does not come within the scope of the new regulatory system. Refusal of registration may occur because any of the registration criteria are not met and not all such decisions will be based on the competency of the auditor. Publicity about refusal of registration could unduly affect an auditor's reputation in other aspects of its professional activities and may influence the outcome of future registration applications.

Question 10
Do you agree with the proposal that registration shall remain in force until 1 January in the year following the year in which the auditor was so registered, and each registration is subject to annual renewal?

Each registration should remain in force for one year (subject to exercise of sanctions) and should be subject to annual renewal. We suggest that the "registration year" should run from 1 July to 30 June to avoid registration happening during the "busy season" for listed entity audits which predominantly have 31 December year ends, or registration could be staggered over calendar quarters.

Question 11
Do you agree that the register of listed entity auditors should include the types of information on each registered listed entity auditor as proposed in paragraph 3.27?

The registration information proposed in paragraph 3.27 is reasonable and is mostly the same as is already included in the HKICPA record of auditors and audit firms. We support the proposal.

Question 12
Do you agree that FRC should be vested with statutory powers to take over SFC/HKEx's existing roles in receiving and making decisions on applications for recognizing overseas auditors of specific overseas entities which have been approved for listing in Hong Kong on a case-by-case basis?

Yes. It appears sensible that the role of recognizing overseas auditors of specific overseas entities should be moved to the FRC as part of the reform of the regulatory regime.

Although it should not be directly copied the FRC could, by way of reference,use the current SFC investor protection criteria for a foreign company listing in Hong Kong as an example of how a vetting mechanism could be operated.

Question 13
Do you agree that an applicant must meet the criteria as proposed in paragraph 3.30 for being recognised as an overseas auditor of the overseas entity listed in Hong Kong as set out in its application?

The criteria for recognition of an overseas auditor of an overseas entity listed in Hong Kong are a development of the criteria currently set out in the Listing Rules and as a "strengthened status quo" are acceptable in principle. However, we are concerned that a lack of detail in the proposal for "mutual or reciprocal" cooperation agreements between the FRC and overseas regulators may cast doubt on the effectiveness of regulation of non-Hong Kong auditors. We suggest that there should be an explicit requirement for FRC to communicate with relevant overseas regulators to confirm that there will be equivalent regulation of non-Hong Kong auditors.

We suggest that to give additional comfort that non-Hong Kong auditors are being assessed for registration on an equivalent basis as Hong Kong auditors there should be the same requirements for registration of engagement partners, EQC reviewers and individuals responsible for quality control. It could also be clarified that the FRC assessment of a non-Hong Kong auditor for registration would include confirmation of equivalent regulatory and sanctioning procedures and powers in the home jurisdiction. Within the membership of IFIAR there are a number of different regulatory models and IFIAR does not exercise any formal quality control over the work of member bodies. There is no certainty over consistency of approach or quality between national auditor regulators.

Furthermore, the implications of developments in overseas regulatory regimes may add complications e.g. mandatory audit firm rotation that has recently been introduced in Europe could result in an increase in the number of non-Hong Kong auditors of Hong Kong listed entities seeking recognition and approval by the FRC. The HKSAR Government policy to attract more overseas companies to list in Hong Kong will also affect the number of registration applications by non-Hong Kong auditors. We note the intention of the proposals is to ensure only competent and suitably resourced non-Hong Kong auditors are recognized as suitable to audit Hong Kong listed entities and trust that this key principle will be adhered to.

Question 14
Do you agree that the recognition of an overseas auditor of an overseas entity listed in Hong Kong should remain in force until the following 1 January or the time when the overseas auditor ceases to be the auditor of the listed entity in question, whichever is earlier, subject to renewal of the recognition?

Yes, subject to our suggestion on the "registration year" in response to Question 10.

Question 15
Do you agree that the HKICPA Registrar shall maintain and update a list of overseas auditors who were recognised by FRC for entering into audit engagements with specific overseas entities listed in Hong Kong, and make available for public inspection/publish on HKICPA's website the list?

Yes. The registration details of all auditors of Hong Kong listed entities should be kept in the same place. The Mainland audit firms identified by Mainland authorities as being qualified to audit Mainland companies listed in Hong Kong should also be included in the HKICPA Register.

Question 16
(a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers with regard to setting CPD requirements for listed entity auditors, subject to independent oversight by FRC in accordance with paragraph 4.6?

Yes. We agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers to setting CPD requirements for CPAs (practicing). HKICPA CPD requirements meet international standards (International Education Standards set by the International Accounting Education Standards Board) and are reviewed by other professional bodies that recognize the HKICPA qualification.

We also agree in principle that FRC should exercise oversight of the performance of such functions and the exercise of such powers by HKICPA which are applicable to listed entity auditors, subject to additional explanation of how and when FRC will issue directions to HKICPA. Directions should only be made to protect the public interest (e.g. if HKICPA proposed to introduce a standard, without good reason, that deviated significantly from international standards) and not to circumvent exercise of due process by the HKICPA. We also believe that in the event that it needs to issue directions the FRC should be required to give full reasons for its actions to the HKICPA and the government.

(b) Do you agree that FRC should publish the periodic reports received by it as mentioned in paragraph 4.6(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?

The FRC should provide public information on its oversight role and activities through its own report. Reports received by the FRC from the Institute should not be published as a matter of course as to do so may inhibit co-operation and full and frank dialogue between the FRC and the HKICPA.

Question 17

(a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing and assurance to be observed, maintained or otherwise applied by CPAs (practising), and FRC should exercise oversight of the performance of such functions and the exercise of such powers by HKICPA which are applicable to listed entity auditors as proposed in the arrangements set out in paragraph 5.8?

Yes. We agree HKICPA should continue to perform its statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing and assurance to be observed, maintained or otherwise applied by CPAs (practicing). We also agree in principle that FRC should exercise oversight as described in paragraph 4.6 subject to additional explanation of how and when FRC will issue directions to HKICPA. Directions should only be made to protect the public interest and not to circumvent exercise of due process by the HKICPA. We also believe that in the event that it needs to issue directions the FRC should be required to give full reasons for its actions to the HKICPA and the government and that any directions given should follow due process equivalent to HKICPA standard setting process.

Standards on professional ethics, audit and assurance issued by HKICPA are fully converged with international standards and this should remain a key principle of standard setting under the new system. Convergence with international standards and the rigour of due process at international and local level are a strength and positive feature of the Hong Kong capital market.

(b) Do you agree that FRC should publish the periodic reports received by it as mentioned in paragraph 5.8(a) on its website, and provide information on the results of its quality review and the written instructions given by it in its annual report?

The FRC should provide public information on its oversight role and activities through its own report. Reports received by the FRC from the Institute should not be published as a matter of course as to do so may inhibit co-operation and full and frank dialogue between the FRC and the HKICPA.

Question 18
Do you agree that HKICPA and FRC should establish procedures to ensure that the HKICPA Council would duly take into account FRC's views before it makes any decision on the setting of standards on professional ethics, auditing and assurance in relation to listed entity auditors?

Arrangements should be put in place to ensure that FRC can effectively carry out its oversight function. FRC will be able to put forward its view during the standard setting process, as will other stakeholders. We believe that the proposals should result in an arrangement like IAASB model where PIOB can influence the standard setting agenda but cannot dictate the conclusion. This mechanism will ensure FRC views are heard but should not constitute directions by another name.

Question 19
Do you agree with the proposal to transfer statutory functions for conducting recurring inspections of listed entity auditors in respect of their listed entity audit engagements from HKICPA to FRC, with FRC being given the necessary powers as set out in paragraph 6.13 (which are similar to the powers which HKICPA is equipped with under its practice review programme)?

Yes. This is a necessary step to ensure international recognition of the enhanced regulatory regime.

Question 20
Do you agree that FRC's inspection programme should adopt the statutory procedures as set out in paragraph 6.14 with reference to the existing arrangements for HKICPA's practice review programme?

Paragraph 6.14 largely reflects existing HKICPA practice review arrangements which are benchmarked to international best practice and have proved to be effective over several years of use. Therefore they should be adopted by FRC.

However, the relationship between inspection process and outcome and disciplinary proceedings and sanctions needs to be clarified. Is it the intention that all suspected auditing/reporting irregularities will trigger investigation/disciplinary processes? Will inspection results be sufficient to support disciplinary sanctions or will an investigation be required?

We believe that there needs to be more clarity on how inspection and discipline interact. The proposals deal with inspection and discipline almost as two disconnected activities whereas in an effective regulatory system they are part of the same process. In our responses to the consultation we have tried to use terms such as "regulatory action" rather than language that seems to emphasise the separation of the two activities.

We support the need for an inspection programme to be efficient and effective and suggest that regulatory actions available to FRC as outcomes of the inspection process should include the corrective actions proposed in paragraph 7.27. We are already considering making changes to the powers of the HKICPA practice review committee to achieve this and enhance regulatory effectiveness. We further expand on this in our response to Question 30, explaining how to balance the accepted need for effective and timely regulatory actions with the need for fairness and due process.

To facilitate a better understanding of what we see as fully co-ordinated and efficient regulatory system we attach proposals for such a system at **Annex** 1 and a diagrammatic representation of how the system would operate at **Annex 3.**

The proposed inspection powers in paragraph 6.17 (subject to our response to Question 23 on 6.17(a)) are equivalent of existing FRC investigation powers and in our view should provide sufficient evidence to support regulatory action without an additional investigation.

Question 21
Do you agree that FRC may delegate its inspection functions and relevant powers to committees formed under its auspices?

Yes. The FRC should be able to adopt operational procedures that ensure efficiency and effectiveness of the enhanced regulatory regime.

Question 22
What are your views on whether FRC should be allowed to delegate to HKICPA its functions and powers to inspect listed entity auditors in respect of their listed entity audit engagements; and if so, what checks-and-balances measures should be introduced to ensure proper delegation and accountability for the quality of the work so delegated to HKICPA?

Our views on this are neutral. We see benefits in using existing HKICPA skills and experience to develop similar capacity in FRC, especially during the initial stages of establishment of the new regime. There would need to be appropriate checks and balances to ensure proper delegation and accountability for the quality of the work so delegated but these need not be unduly complicated and could be established in a MoU between FRC and HKICPA. However, we have some concerns that without proper forward planning and control delegation could result in fluctuating demand and have a negative effect on HKICPA management of costs and resources.

Question 23
Do you agree that FRC reviewers should be given the proposed statutory powers as set out in paragraph 6.17 in relation to their inspections?

Most of the proposed statutory powers are the same as currently exist for the HKICPA system of practice review and we therefore consider them to be appropriate for the FRC reviewers. However, the proposed power of entry to auditors' premises does not exist in the PAO or the FRCO. We consider it is excessive and unnecessary for a routine inspection programme. The other proposed powers are quite sufficient to ensure access to all information that would be required to carry out a full inspection.

Question 24
(a) Do you agree with the proposal to provide for criminal offences against a person who fails to comply with the requirements in relation to FRC's inspections?

We do not agree with this proposal. The proposal is based on investigation arrangements of the FRC and other financial market regulators and fails to recognize that a routine inspection programme carried out by the regulator of listed entity auditors is entirely different to an investigation into a suspected and specific incidence of wrong-doing. Failure to comply with requirements in relation to FRC inspections should be dealt with under the enforcement powers and sanctions of the regulatory system and not criminal law. The ultimate sanction against an auditor that fails to comply with its regulator should be exclusion from the register and the listed entity audit market.

If a failure to comply with inspection requirements, or any inspection findings, raise suspicions of or reveal criminal activity by an auditor then other enforcement agencies will have powers to take action.

In its current role the FRC has no relationship with auditors that allow it to take action against failure to comply with investigation proceedings. The creation of a register of listed entity auditors and specified individuals will create a regulatory relationship and therefore criminal offences will not be needed in respect of inspections.

(b) If so, do you agree that the provisions on such criminal offences should be modelled on the existing provisions in the FRCO concerning failure to comply with requirements in relation to an investigation into relevant irregularities?

N/A

Question 25
Do you agree that the secrecy provisions in the PAO and the FRCO should be suitably amended to provide that both HKICPA and FRC could share their inspection results with each other to facilitate them to coordinate their inspection activities?

Yes. The secrecy provisions in the PAO and the FRCO should be amended as necessary to facilitate coordination of HKICPA and FRC inspection activities so as to minimize duplication of work and disruption to auditors.

Question 26
Do you agree that FRC should continue to be responsible for conducting independent investigations into relevant irregularities by listed entity auditors?

Yes. There is no reason to make any changes to this existing function of FRC.

Question 27
Do you agree that a disciplinary action may be imposed on a listed entity auditor, a person approved to be its audit engagement authorised person and/or a person approved to be its engagement quality control reviewer if the listed entity auditor and/or the person concerned (as the case maybe) is proved to have committed an irregularity in relation to an audit engagement?

We agree with this proposal – subject to our comments on the definition of "irregularity" in responding to Question 28 below. Both firm and/or individual, if proved responsible for an irregularity should be subject to regulatory action.

Question 28
Do you agree that the definition of "irregularity" under the new regulatory regime should be refined to cover irregularities in respect of all audit and assurance engagements undertaken by listed entity auditors with listed entities as required under the Listing Rules?

The regulatory regime should cover all audit and assurance engagements related to listed entities as required by the Listing Rules. However, we believe that the definition of "irregularity" should be revisited and refined to reflect the expanded scope of work of the FRC. The major activity of the FRC as an independent regulator of listed entity auditors will be regular inspections of auditors and reaching reasonable conclusions and outcomes based on the results of inspections. The main focus of inspections will be compliance with professional standards. The current definition of irregularity was developed to allow the FRC to undertake its original purpose – to investigate Hong Kong auditors. Recognizing that the HKICPA has regulatory responsibility for

inspection and disciplinary actions, the current definition of irregularity refers widely to the powers of the HKICPA under the PAO and has no provision for regulation of non-Hong Kong auditors of entities listed in Hong Kong. The definition should therefore be reviewed to reflect the proposed authority and scope of work of the FRC, to eliminate overlap with continuing statutory responsibilities of the HKICPA and to address authority over non-Hong Kong auditors.

Question 29
What is your view on whether the new regime should specifically provide that the individual/individuals who assume(s) ultimate responsibility for the system of quality control of a practice unit would be held accountable for the absence/systemic failure of such system, and whether it should stipulate expressly that such responsible person(s) shall be the practice unit's chief executive officer (or equivalent) or, if appropriate, members of the practice unit's managing board of partners (or equivalent)?

The description of the individual(s) with responsibility for a firms system of quality control is lifted from HKSQC1 and therefore we have no objection to the same description being stipulated in legislation.

However, we believe there would generally be no need to take action against individuals as systemic failures are the collective responsibility of all partners of a CPA firm. It would be useful to understand how and when the FRC would expect to take action against stipulated individuals e.g. what would be considered a "systemic" failure.

Question 30
Do you agree that FRC, as the future independent auditor oversight body, should be vested with disciplinary powers, including powers to make decisions on disciplinary cases, concerning listed entity auditors, subject to the requirements for ensuring fairness and a due process as proposed in paragraphs 7.21 to 7.24?

We accept that for the future regulatory regime to be effective the FRC will need to have appropriate decision making and sanctioning powers. In principle the proposed requirements for ensuring fairness and due process in disciplinary action go some way to establishing appropriate checks and balances which are a necessary part of disciplinary procedures. In particular, we welcome the proposal in paragraph 7.24 that inspection and investigative staff will not be involved in the determination of sanctions. However, we have some continuing concerns about how regulatory powers will be exercised in practice:

1. Paragraph 7.21 implies that a regulatory decision will be made by the FRC before a hearing takes place and therefore that the hearing will effectively be an appeal against an initial decision. We believe that an audit firm should be heard at and involved in all stages of sanctioning proceedings.

2. We appreciate that the proposal in paragraph 7.22 to form an expert panel to advise the FRC is attempting to address previously expressed concerns about regulatory decisions needing to be based on appropriate knowledge of professional standards and audit process. However, we believe that such knowledge should be within the decision making body (in the proposal the FRC) itself and that bringing in an expert panel to provide non-binding advice to the decision making body does not go far enough in addressing our concern and will only add complexity and potential confusion to the process.

3. We agree that the sanctioning mechanism must be independent from the audit profession but believe that it is also important that there is a clear separation between inspection/investigation and the sanctioning mechanism within the independent regulatory body (the FRC). The information in paragraphs7.9, 7.10 and 7.11 indicates that there are a number of different models in other jurisdictions but does not make a case for not segregating inspection and sanctions. Notwithstanding our comment above about the proposals in paragraph 7.24 it appears that the decision making entity at every stage (inspection, investigation and discipline) will be "the FRC". There is no indication that separate boards or committees will be established within the overall organization to ensure the separation of activity and responsibility that we believe is necessary. The proposed concentration of powers in a single entity is a significant step back from the current system and is not in line with international practice in auditor regulation. In our view this model is totally unacceptable.

The comments we have provided in response to Question 20 and the proposals we have made for a decision making structure to deal with inspection outcomes (**Annex 1** and **Annex 3**) are also relevant to this question. There needs to be further consideration and explanation of how inspection and sanctions are linked together to balance the different demands for efficiency and effectiveness in the new regulatory system.

We do not believe it is appropriate or efficient for all decisions on inspection and investigation outcomes, participation in disciplinary proceedings and determination of sanctions based on all three activities to be undertaken by the same body (the Council of the FRC),a body which in our view should be focusing on strategy and direction rather than involvement in operational activities. We have therefore suggested that a committee is established, responsible to the Council of the FRC, consisting of suitably skilled and experienced individuals to consider the results of inspections and decide on appropriate outcomes, including the exercise of sanctions if necessary. An auditor should have the right to the same level of representation before the committee as the

FRC inspection team. An independent tribunal will be established to hear non-acceptance of the committee's decisions and to judge on the application of more serious sanctions. Consideration should be given to remunerating volunteer members of the committee and tribunal members to facilitate timely conclusion of consideration of inspection results and appeals.

In addition to actions set out in paragraph 6.14 ((d) (to initiate disciplinary processes if an irregularity is found) may be amended or omitted if our proposals are accepted) the committee should have access to the full range of sanctions set out in paragraph 7.27. Sanctions amounting to remedial or corrective actions i.e. directing a specific course of action e.g. undertake training on a particular audit procedure or on audit approach to a specific industry, and applying conditions to registration of firms or individuals e.g. not allowed to sign audit opinions for clients in a specified industry for a period of time or until training has been undertaken will have immediate effect. The auditor can appeal to the independent tribunal against the decision and if the appeal is upheld the sanction will be revoked. The auditor can apply to the tribunal for the effect of the sanction to be stayed for the duration of the appeal process. If the committee considers that more serious sanctions may be appropriate i.e. reprimands, fines or suspension/withdrawal of registration, this will become effective only when accepted by the audit firm or individual or confirmed by a hearing before the independent tribunal. **Annex 4** sets out our views on when regulatory decisions and sanctions should become effective and be publicized.

It is important to ensure that there is no premature disclosure of the consideration of serious sanctions against an audit firm. Firms consider reputational damage to be most serious and therefore proposed sanctions should not be disclosed to the public until finalized and approved through the appeal mechanism if appropriate.

As we have explained, we do not believe that the Council of the FRC should be the sole decision making body for all areas of activity, hence the suggestion that a committee is set up with the express responsibility for concluding on the outcome of inspections and determining appropriate sanctions if necessary. This could be a sub-committee of the Council and include a number of Council members. We suggest a total of 7 members with a non-practicing majority and at least three being experienced auditors. If it is decided to proceed with the proposal that the FRC Council takes on this role then it is vital that the Council includes sufficient numbers of experienced auditors and does not include the Chief Executive who will have led the inspection process.

We believe this is a practical and workable proposal. It is very similar to the mechanism established by the UK FRC to deal with the outcomes of inspections and similar committees exist within the structure of independent regulators in other jurisdictions (e.g. Singapore, South Africa and Japan). The benefits of such an arrangement are that there is an effective and transparent separation of functions, timely corrective actions, appropriate experience and skills are embedded in the

decision making bodies at all stages and that the workload is properly managed and distributed throughout the system.

Question 31
Do you agree that FRC should be empowered to exercise the range of disciplinary powers on a person subject to disciplinary action outlined in paragraph 7.27?

Subject to the comments below relating to pecuniary penalties we believe the proposed powers in paragraph 7.27 are appropriate powers to be available to the regulator of listed entity auditors.

We do not believe that "three times the amount of the profit gained or loss avoided" is an appropriate measure to use in calculating the potential maximum amount of a pecuniary penalty. The main justification seems to be that it is a measure used by other financial regulators in Hong Kong. We do not believe that this is a fair comparison because auditors are not market participants – they do not sell financial products or hold client assets, but rather provide a service to listed companies in the same way that lawyers provide legal services.

We also believe that the proposed alternative measure of a maximum penalty of $10,000,000 is lifted directly from other financial regulatory systems and is too high. The concerns of small and medium sized audit firms about the potential effects are summarized in the consultation paper.

In our view it would be sufficient to have a simple monetary cap of $5,000,000 with clear and strong guidance on how to determine the appropriate amount of a penalty.

Question 32
Do you agree that FRC should be required by law to issue guidelines to indicate the manner in which it exercises its power to order a person subject to disciplinary action to pay a pecuniary penalty, and to have regard to the issued guidelines when exercising such power?

We believe that guidelines on how to determine the appropriate amount of a pecuniary penalty are essential and support the indicative factors that are included as examples in paragraph 7.29. The scale or severity of the auditing irregularity should be a key consideration, more so that the size of the audit firm as included in paragraph 7.29(d). We believe such guidelines should be developed as soon as possible to start to develop an understanding and trust between the FRC and the auditing profession that will be necessary for an effective and efficient regulatory regime and to be presented to the Legislative Council for consideration with the main legislation.

An example of how such guidelines could be structured is attached at **Annex 2.**

Question 33
Do you agree that any pecuniary penalty paid to or recovered by FRC would be paid by FRC into the Government general revenue?

Yes. This arrangement would avoid any accusations that FRC disciplinary action is influenced by funding requirements.

Question 34
Do you agree that FRC may enter into a resolution with the person subject to disciplinary action at any time it is contemplating exercising its disciplinary power, and in exercising such power, FRC must consider it appropriate to do so in the interest of the investing public or in the public interest?

We agree that provision for settlement as an alternative resolution to potential or ongoing regulatory action should be allowed subject to suitable guidelines and policies to avoid any allegation that settlement is being used to short cut due process. The overriding principle must be resolution by settlement is in the public interest.

Question 35
Do you agree that any amount paid to or recovered by FRC arising from a resolution would be paid by FRC into the Government general revenue?

Yes. See our response to question 33.

Question 36
Do you agree that a new independent appeals tribunal should be set up for hearing appeals in respect of registration decisions made by the HKICPA Registrar and disciplinary decisions made by FRC?

Yes. We agree that an independent tribunal should be set up and that it should hear appeals from both sources. There may also be appeals against registration decisions made by the FRC which should also be heard by the tribunal. The tribunal should be supported by an independent secretariat. To make good use of existing and appropriately skilled resources such support could come from the Market Misconduct Tribunal secretariat.

Question 37
(a) Do you agree that a person who disagrees with a registration decision made in respect of him or is aggrieved by a disciplinary decision made in respect of him may apply to the new independent appeals tribunal for a review of the decision within 21 days after a notice of the relevant decision has been served upon him?

Yes. 21 days seems a sufficient length of time for an auditor to decide whether to apply for a review of a registration decision or sanction proposed by the FRC (subject to our proposals in Annex 1 on decision making structure and exercise of sanctions).

Decisions on registration of non-Hong Kong auditors are proposed to be made by the FRC not the HKICPA Registrar. Paragraphs 8.3 and 8.4 should recognize that the appeal mechanism will also cover appeals against an FRC registration decision. As explained in our response to Question 9 decisions to refuse registration should not be made public.

(b) If so, do you agree that the independent appeals tribunal may, upon application by the relevant person, grant an extension to application for review of a specified decision, and that such extension should only be granted after the applicant and FRC have been given a reasonable opportunity to be heard on the proposed extension and the independent appeals tribunal is satisfied that there is a good cause for granting the extension?

Yes there should be provision for extension of application for review of a decision provided there is good cause.

Question 38
Do you agree with the composition of the independent appeals tribunal as proposed in paragraph 8.6, i.e. a chairman who is a person qualified for appointment as a judge of the High Court and two members who are not public officers, all to be appointed by the Chief Executive?

We agree with the proposal for the qualification requirements for the chairman of the independent appeals tribunal. However, we believe that it is important that the composition of the tribunal ensures that the tribunal has sufficient understanding of professional standards and the audit profession. To achieve this, our preference would be for a five member tribunal with two having up to date auditing knowledge and experience.

Question 39
Do you agree that the independent appeals tribunal may exercise the proposed powers as outlined in paragraph 8.7 in the review proceedings?

We agree with the powers proposed for the independent appeals tribunal in paragraph 8.7.

Question 40
Do you agree that sittings of the independent appeals tribunal should be held in public unless in the interests of justice it determines otherwise?

Public sittings of the tribunal would be in line with existing HKICPA disciplinary proceedings rules. However, as we have stated in our response to Question 30 concerns over premature disclosure of regulatory action and potential consequential damage to an auditor's reputation need to be addressed. At the very least hearing of cases concerning registration and corrective sanctions should not be held in public and such decisions should not be made public until conclusion of tribunal hearings.

Question 41
(a) Do you agree that a party to the appeal who is dissatisfied with a determination of the independent appeals tribunal may further appeal to the Court of Appeal on a question of law, fact, or mixed law and fact?

Yes, we agree.

(b) If so, do you agree that no appeal to the Court of Appeal may be made unless leave to appeal has been granted by the same Court, and the leave may only be granted if the Court of Appeal is satisfied that the appeal has a reasonable prospect of success or there is some other reason in the interests of justice why the appeal should be heard?

We have some concern that this proposal limits an auditor's ability to appeal to the Court of Appeal and that such limitation does not currently exist under the HKICPA disciplinary process.

Question 42
Do you agree that under the new regulatory regime, FRC should be funded by way of introducing three new levies on (a) listed entities; (b) securities transactions; and (c) listed entity auditors such that they will each provide roughly equal contributions to FRC i.e. one third from listed entities, one third from securities investors and one third from listed entity auditors?

The re-introduction of listed entity auditors into the future FRC funding model came as a surprise as discussions at the tripartite meetings for the development of the Draft Framework had been made on the basis that listed entity auditors would not be a funding party. We believe that better justification should be given for including listed entity auditors as contributors of one third of future FRC funding.

As the change in the regulatory system is designed to enhance investor confidence and protection we believe that the most appropriate source of future funding for the FRC is through transaction levies. The actual amount paid by investors would vary based on market cap of the listed entities traded and volume of transactions and therefore more significant and active market participants would bear proportionally more of the costs of funding the enhanced regulatory system.

We also believe that for any proposed future funding party to be able to fully respond to the proposals there must be an indication of the quantum of costs that will be needed to establish and operate the new regime.

We have a concern that there is insufficient detail on checks and balances that will be in place to ensure that future operating cost of the FRC will be properly monitored and controlled and that funding parties are not being expected to write blank cheques. Without compromising the independence of the FRC there needs to be a degree of accountability to funding parties. Given that under the proposals the government will not be a future funding party and will not be represented on the council of the FRC we question whether, in these circumstances, approval of FRC annual budget by the Secretary for Financial Services and the Treasury will be a sufficient control mechanism.

In view that a major aim of changing the regime for regulating auditors of listed entities is to reinforce Hong Kong's status as an international financial centre we believe that it is entirely appropriate that the government continues, if not as a funding party of the FRC then at least with representation on the council of the FRC. This would provide all funding parties and market participants with confidence that there would be appropriate monitoring of governance and operations of the FRC.

Question 43
Do you agree that –
(a) the levy on listed entities should be based on the prevailing formula under which listed entities pay their annual listing fees to HKEx, and that the levy should be collected by HKEx on behalf of FRC;
(b) the levy on securities transactions should be based on the modus operandi for the existing levy charged by SFC under the Securities and Futures Ordinance, and that the levy should be collected by SFC on behalf of FRC; and
(c) the levy on listed entity auditors should be directly proportional to the number of listed entity audit engagements entered into by the listed entity auditors, and that the levy should be collected by the HKICPA Registrar on behalf of FRC?

Subject to our overall comment in response to question 42 we believe the proposed bases of charging and collection mechanisms are acceptable. We do not agree that the HKICPA Registrar should be responsible for collecting the levy from listed entity auditors. The HKICPA will not be a funding party and does not have the same sort of transactional relationship that HKEx and SFC have with listed entities and market participants respectively. There seems to be no good reason why the FRC could not collect the levy from listed entity auditors directly.

We also question how and by whom the levy will be collected from non-Hong Kong auditors.

Question 44
Do you agree that the three levies should be stipulated in subsidiary legislation subject to negative vetting by the Legislative Council?

Subject to our overall comment in response to question 43 and on the basis that this question is to do with setting or adjusting the quantum of levies we agree with this proposal.

Question 45
Do you agree that FRC should be required to review the levels of the three levies once its reserve has reached a level equivalent to 24 months of its operating expense, after deducting depreciation and all provisions?

In our view a reserve equivalent to 24 months of operating expenses, after deducting depreciation and provisions, is excessive and that 12 months would be acceptable. Therefore the level of all levies should be reviewed when a reserve of 12 months expenses has been reached.

Question 46
(a) Do you agree with the proposed new composition of FRC membership, i.e. not fewer than seven members appointed by the Chief Executive, together with the FRC Chief Executive Officer as an ex-officio member, and abolishing the existing arrangements for the nomination of FRC members and for the Registrar of Companies to be an ex-officio member as set out in paragraph 10.6?

We believe that the absolute number of FRC members is not the key issue but there seems to be no good reason for reducing the number of members from the existing level given that the significant increase in activities under the new regime will result in a far heavier workload for the FRC. We suggest the FRC should have no fewer than nine members with at least one third having appropriate knowledge and experience of listed entity auditing. There must be enough FRC members to ensure there are always sufficient numbers to reach reasoned decisions in the inevitable event that individual members are excluded by conflicts of interest.

We mention here and elsewhere in our response the critical importance of having appropriate skills, up to date auditing experience and knowledge and a full understanding of the audit process in any decision making organ within a regulator of auditors. We have suggested a dedicated committee is created to determine inspection outcomes but the consultation paper suggests that the FRC Council will become the decision making body in respect of all inspection and investigation work and sanctioning. As we have stated in our response to Question 30 we do not believe that such an arrangement is acceptable but if this is the model introduced then our comments above on requirements for skills, experience and knowledge should apply to the FRC Council.

It must be recognized that the depth of knowledge and breadth of understanding about auditing to successfully carry out all of the proposed roles of the FRC will be far greater than needed for the currently much more limited role of the FRC. There is a big difference between deciding that an investigation report shows reasonable suspicion of an irregularity, with the final decision on sanctions left to another body, and reaching a conclusion that evidence provided by an inspection is sufficient to prove an irregularity and determining a sanction that is reasonable and proportionate.

As we have noted in our response to Question 30, if the FRC Council does become the decision making body in respect of all inspection and investigation work and sanctioning then the inclusion of the CEO in the Council would give rise to unacceptable conflicts of interest.

(b) Do you agree that there should be at least two persons who possess knowledge of and experience in the auditing of Hong Kong listed entities out of the FRC members to be appointed by the Chief Executive?

We believe that it is critical that there should be sufficient FRC members with up to date knowledge and experience of auditing Hong Kong listed entities to ensure that the strategy and direction of the independent regulator and, if such powers do rest with the Council, decisions on outcome of inspections, investigation and disciplinary proceedings are appropriately informed. We suggest that at least one third of FRC members should have such knowledge and experience.

Question 47
Do you agree that FRC will be required to have a chairman and a majority of members who are non-practitioners, with a non-practitioner being defined as a person who (a) is not, or has not during the previous three years been, a CPA (practising); and (b) is not, or has not during the previous three years been, a partner, director, agent or employee of a practice unit?

We agree with the definition of non-practitioner and that the FRC should have a chairman and majority of members who are non-practitioners.

Annex 1

Proposed operational details for the new regulatory system

Enforcement procedures and sanctions based on inspection findings

Procedures – key features

1. Enforcement/disciplinary procedures and regulatory actions including sanctions available to the FRC under the new system will only apply to poor quality audit work (failure to comply with quality control, audit or ethics standards issued by the HKICPA) identified by inspection of listed company auditors that warrants regulatory action.

2. FRC enforcement procedures will not replace the HKICPA's disciplinary arrangements over members' professional conduct. The scope of the FRC enforcement procedures extends only to non-compliance with quality control, auditing or ethical standards in connection with the audits of listed entities. The FRC only has authority over firms and individuals named in the register of listed entity auditors.

3. Wider implications about e.g. professional conduct or integrity of HKICPA members will be assessed and dealt with under existing HKICPA disciplinary arrangements. As a general principle HKICPA will not take disciplinary action that duplicates FRC enforcement action.

4. Results of inspections by FRC staff will be reported to an appropriately constituted and skilled committee of the FRC (equivalent of the HKICPA practice review committee) which will consider whether poor quality audit work has been identified that warrants regulatory action. It is not intended that regulatory action will be taken against auditors for every technical failure (the results of most inspections will be dealt with by outcomes described paragraph 6.14 of the consultation paper).

5. Auditors will be provided with a copy of the inspection report and given the opportunity to respond. Auditors' responses to the report will be presented to the committee for consideration along with the report. Auditors should be given the same opportunity for representation before the committee as inspection staff.

6. The decision making committee of the FRC should be independent of the inspection teams (to maintain independence inspection teams should not provide secretarial support to the committee). The committee should include a sufficient number of individuals with up to date experience of auditing listed companies and appropriate competencies to ensure that conclusions on "adequacy" of audit are made on a fully informed basis. Any perceived need for "lay" committee members (and/or chairperson) should not outweigh the need for the committee to be appropriately skilled and experienced to achieve its objectives.

7. The committee will be able to take the actions set out in paragraph 6.14 of the consultation paper but in addition should have the ability to consider sanctions set out in paragraph 7.27 and referred to as disciplinary powers.

8. Procedures to apply sanctions should only be undertaken when the continued activity of a listed company auditor without conditions or restrictions could adversely affect a listed company audit client; and/or a sanction is necessary to ensure audit functions are undertaken, supervised and managed effectively.

9. The range of sanctions will be as set out in the consultation paper – reprimand, directions, conditions, monetary penalty, suspension or revocation of registration. The committee may accept written undertakings from an auditor as an alternative to sanctions if that is considered a more acceptable course of action.

10. If the committee decides that there are matters that warrant regulatory action it will determine and offer an appropriate sanction to the auditor. The basis of decision must be made known to the auditor and the auditor given an opportunity to make further representations (initial representations on the inspection findings will have been made to the committee at the same time as the findings are presented).

11. The committee should consider all sanctions available and determine which is appropriate. Sanctions that are of a corrective nature i.e. direct remedial actions and impose conditions on registration, will have immediate effect but may be revoked if not accepted and an appeal to the independent tribunal is upheld. The auditor can apply to the tribunal for the effect of the sanction to be stayed for the duration of the appeal process. More serious sanctions i.e. reprimand, fines and suspension/withdrawal of registration, will take effect only when accepted by the auditor or confirmed by a hearing before the independent tribunal.

12. The committee may vary its proposed sanction after receiving further representations from the auditor.

13. If the auditor accepts the sanction the matter is concluded on that basis. The basis of conclusion, including the sanctions accepted, will be made public.

14. If the auditor does not accept the sanction the matter will be referred to the independent (external to the FRC) tribunal. Cases involving corrective sanctions will be heard as an appeal against the committee decision. In cases where punitive sanctions are proposed the tribunal will not be advised of the sanction offered by the committee and refused by the auditor and will deal with the case as a first hearing.

15. The tribunal (at least five members) will have a lay majority and chair and include members with sufficient audit experience to give the matter a full and fair hearing. Consideration should be given to remunerating tribunal members to encourage timely proceedings and decisions.

16. Tribunal hearings will consider the case again, as if it was the committee. Tribunal consideration and determination of sanctions will follow the same principles that apply to the committee.

17. Tribunal hearings will be public, unless not in the public interest. Auditors have the right to be present and be heard and witnesses may be called.

18. Tribunal findings and decisions on sanctions will be made public. Tribunal decisions may be appealed to the Court of Appeal.

Sanctions - principles

19. Sanctions guidance and application should be consistent with the five principles of good regulation – proportionality, accountability, consistency, transparency and targeting – and the overarching principles of fairness and natural justice.

20. Sanctions should be determined by reference to the general regulatory objectives of the inspection programme. The purpose of using sanctions to deal with a failure to comply with professional standards is as a deterrent against future non-compliance to protect the public and the wider public interest.

21. Determination of sanctions should involve consideration of the whole circumstances and seriousness of the failure. A wide range of factors should be considered including financial benefit or loss, number of people affected, whether the failure involved ethical issues and previous record of the auditor on complying with standards.

22. There are a wide range of factors to consider in deciding what type of sanction is most appropriate – a brief summary is provided below. Sanctions can be used in combination but the appropriateness of each should be considered separately. (see **Annex 2** for more detailed guidance on determination of sanctions.)

23. Directions and/or conditions might be appropriate when there are shortcomings in a particular area of practice or to address a repeated but relatively minor breach of standards. (Directions and/or conditions do not extend to suspension of registration.)

24. Suspension of registration may be appropriate when directions, conditions or penalties are not sufficient to address concerns that shortcomings in competence or failure to comply with standards are so serious that the auditor should not be permitted to undertake audits for a period, or when the failure is so serious that public confidence in the quality of auditors is damaged.

25. Withdrawal of registration is the most serious sanction that should be reserved for fundamental failings in compliance and where continuing practice would be so damaging to public and market interest that withdrawal is the only appropriate and proportionate sanction.

Annex 2

Determination of sanctions

Summary of approach

1. Committee or tribunal will make a decision whether a listed company auditor has failed to comply with professional standards, and if so whether:

    a. Their continued registration or continued registration without direction or condition would adversely affect a listed company audit client or any other person; and/or
    b. A sanction is necessary to ensure that their audit functions are undertaken, supervised or managed effectively.

2. When the committee or tribunal is satisfied that these tests have been met and that a sanction is therefore appropriate or necessary the normal approach to determining the sanction should be to:

    a. Assess the nature and seriousness of the failure;
    b. Identify sanctions that are potentially appropriate or necessary;
    c. Consider any relevant aggravating or mitigating circumstances and how these affect the level of sanction;
    d. Consider any further adjustment necessary to achieve the appropriate deterrent effect;
    e. Consider whether a discount for admission or settlement is appropriate; and
    f. Decide which sanction to apply and the level/duration of the sanction where appropriate.

Determination of sanctions

3. The full circumstances of each case should be considered to determine which sanction should be imposed. The following factors may be relevant to the committee or tribunal's consideration but there may be other factors and not all listed factors will apply to all cases. The relative weight of factors must also be considered by the committee or tribunal.

4. Nature and seriousness of the failure will be determined by a number of factors. The extent to which intent, recklessness, knowledge of risk or consequences, negligence or incompetence will vary from case to case. Factors which are likely to be relevant, but are not necessarily exhaustive, are:

    a. Whether the failure was intentional or deliberate;
    b. Whether the failure occurred as a result of recklessness;
    c. Nature, extent or importance of the standards or regulations breached;
    d. How far short of the standards the auditor fell;
    e. Whether the failure adversely affected or potentially adversely affected a number of people (the client, the public, investors, consumers, employees, pensioners etc.);

f. Whether the failure could undermine confidence in the standards of auditors generally;
g. Whether the failure involved ethical issues;
h. Whether the failure was isolated, repeated or ongoing and if repeated or ongoing the length of time over which the failures occurred;
i. Whether similar failures have been identified in previous inspections and if so what steps had been taken to address them;
j. Whether the auditor had failed to comply with a previous written undertaking that is relevant to the failure;
k. Whether senior management foresaw that a failure would occur or allowed it to occur;
l. Whether senior management took or allowed action knowing that they or others were acting outside their field of competence;
m. Effectiveness of internal procedures, systems and guidance;
n. Whether it is likely the same type of failing will recur;
o. Arrangements for supervision and management of the performance of audits;
p. Financial benefit derived or loss avoided, for or by the auditor or others, as a result of the failure; and
q. Whether the failure caused actual or potential loss of significant sums of money.

5. Having assessed the nature and seriousness of the failure and determined an appropriate sanction the committee or tribunal will consider whether to adjust the sanction to reflect any aggravating or mitigating factors.

6. Events or behavior that could be considered aggravating factors may include:

a. The auditor failed to co-operate with or hindered the inspection;
b. Senior management were aware of the failure or that failure was likely but took no steps to prevent it;
c. Senior management or an engagement partner sought to conceal or reduce the risk that the failure would be discovered;
d. Similar findings were identified in a previous inspection;
e. No remedial steps taken to address previous inspection findings;
f. Failings repeated and/or occurred over an extended period of time;
g. The auditor has failed to comply with previous written undertakings; and
h. The auditor has previously been sanctioned.

7. Events or behavior that could be considered mitigating factors may include:

a. Co-operation during the inspection and with the committee or tribunal considering the report;
b. The auditor had taken steps to stop or prevent the failing;
c. The auditor has proper policies and structures in place;
d. The auditor has shown awareness of relevant standards;

e. Appropriate remedial action was taken promptly when the failing was identified;
f. The auditor brought the failure to the attention of the regulator;
g. The auditor was misled by a third party;
h. The failing was an isolated event that is unlikely to be repeated;
i. The auditor did not stand to profit or gain any benefit from the failure;
j. The auditor has a good compliance history; and
k. The auditor has shown contrition.

8. If the committee or tribunal, after determining the sanction and adjusting for any aggravating or mitigating factors, consider that the sanction is insufficient to deter the auditor from making similar or further failings it may adjust the sanction to achieve the intended deterrent effect.

9. In the event of a settlement or admission the committee or tribunal may consider discounting the determined sanction.

Specific sanctions

10. **Directions and/or conditions** might be the most appropriate sanctions when the shortcoming is identified in a particular area of the practice or there have been relatively minor or inadvertent breaches of standards. Directions and/or conditions should be appropriate, proportionate, workable and measurable and not amount to an inability to practice.

11. An order imposing directions and/or conditions will be accompanied by provisions addressing:

a. The period for which a direction not to undertake a specified type of engagements remains in effect;
b. The period for which a condition remains in effect;
c. Any timescale within which a condition must be fulfilled; and
d. Procedures to apply for variation or discharge of an order.

12. **Monetary penalties** can be used alone or in combination with other sanctions but only used alone if there are no concerns that continued registration without directions or conditions could adversely affect an audit client or other person and it is sufficient to ensure that audits are undertaken, supervised and managed effectively.

13. Determination of whether a monetary penalty is an appropriate sanction would normally involve considering whether:

a. Other sanctions (directions, conditions, suspension or withdrawal of registration) alone would not be sufficient to address the concerns of the committee or tribunal;
b. The auditor has derived financial gain or benefit;

c. The shortcoming identified involved or caused or put at risk the loss of substantial amounts of money; and
d. A monetary penalty was imposed in similar cases.

14. Having arrived at a figure for the penalty based on the nature and seriousness of the case the committee or tribunal should consider the financial circumstances of the auditor and whether it should be adjusted with reference to the factors in paragraphs 3 to 9 above.

15. **Suspension of registration** would be considered only when directions and /or conditions or monetary penalty or both are not sufficient to address the committee or tribunal's concerns. It is a far reaching and serious sanction that should be reserved for cases where concerns about the about the auditors competence and/or ability to comply with standards are so serious that the auditor should be prevented from carrying out audits for a period of time. It may also be used where the failure was so serious that it undermines public confidence in listed company auditors in general. The committee or tribunal must also be satisfied that the failures are capable of being rectified within a reasonable period of time.

16. The period of suspension must be necessary and proportionate and should be determined by considering the nature and seriousness of the failure.

17. **Withdrawal of registration** is the most serious sanction and should be reserved for fundamental breaches of standards and regulations where continued registration would be so damaging to the public, the public interest and market confidence that withdrawal of registration is the only appropriate sanction.

18. Withdrawal of registration may be appropriate where the tribunal considers that there is a lack of willingness to comply with standards and regulation such that the auditor is unlikely to improve and serious failings are likely to continue. Considerations that may be taken into account include:

    a. Previous sanctions in relation to similar failings have not resulted in improvements;
    b. Failings took place over a long period of time with the knowledge or complicity of senior management; or
    c. Conduct that was fundamentally incompatible with continued registration.

19. All other available sanctions must be considered before withdrawing registration to ensure it is the only appropriate sanction and it is proportionate in the circumstances of the case.

Other matters to be considered by committee or tribunal

20. Having regard to further information or representations received from the auditor or inspection team the committee may decide that an **amended or lesser sanction** is appropriate, provided it is still proportionate to the failings and the reasons for imposing the sanction and is sufficient to protect the public and the public interest.

21. Factors which may be relevant to a decision to agree a lesser penalty include:

    a. Further mitigation provided by the auditor;
    b. More detailed explanation about how the failings occurred; and
    c. Other information received after the sanction was initially determined that lessens the seriousness of the failing.

22. **Written undertakings from an auditor** may be accepted by the committee or tribunal when this is sufficient to address the concerns of the committee or tribunal, to prevent an adverse effect on a listed company audit client and to ensure that audits are undertaken, supervised and managed effectively.

23. If written undertakings are accepted the regulator will monitor compliance with the undertakings. Failure to comply will result in the case being re-opened and reconsidered by the committee.

24. By way of example written undertakings may include:

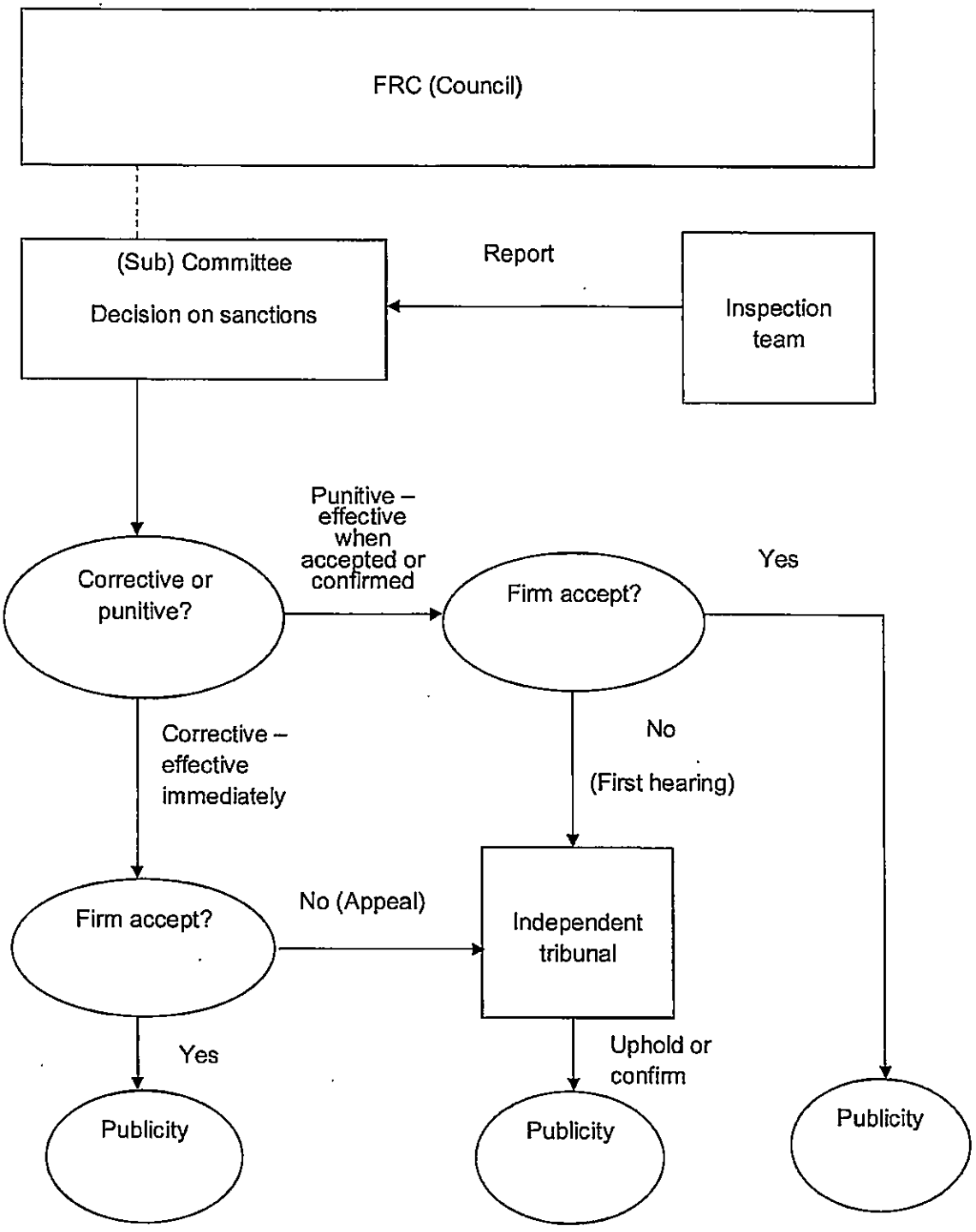
    a. A commitment to impose mandatory audit training on staff;
    b. An agreement not to undertake certain types of audit work; or
    c. A proposal to introduce new policies and procedures to address and prevent further or future failings.

25. The committee may at any time, with the agreement of the auditor vary or revoke a direction, condition or period of suspension. **Variation or revocation of a sanction** will only happen after considering whether:

    a. The auditor has taken steps to ensure the failure will not be repeated;
    b. The auditor has complied with directions, conditions or suggestions made by the committee in connection with a period of suspension;
    c. The sanction in the case of variation or any sanction in the case of revocation, is no longer required; and
    d. The varied sanction is sufficient to protect the public and the public interest.

Annex 3

Sanctioning process flowchart



Annex 4

Regulatory decisions and actions

Decision/action	When effective	Publicity
Initial registration refused	Immediate, may be reversed on appeal to independent tribunal.	None. No public interest element until registration achieved. Publicity may affect future applications.
Regulatory decision – corrective action	Immediate, may be reversed on appeal to independent tribunal. The auditor can apply to the tribunal for sanctions to be stayed for the duration of the appeal process.	Publicity through normal channels immediately after acceptance by the audit firm or decision is upheld by the independent tribunal.
Regulatory decision – punitive action	When accepted by the audit firm or confirmed by decision of the independent tribunal	Publicity through normal channels immediately after acceptance by the audit firm or confirmation by the independent tribunal.

Attachment 2

CONSULTATION CONCLUSIONS

ON ACCEPTANCE OF MAINLAND ACCOUNTING AND AUDITING STANDARDS AND MAINLAND AUDIT FIRMS FOR MAINLAND INCORPORATED COMPANIES LISTED IN HONG KONG

December 2010

Hong Kong Exchanges and Clearing Limited
香港交易及結算所有限公司

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Summary of Abbreviations used

CASBE	China Accounting Standards for Business Enterprises
CIRC	China Insurance Regulatory Commission
CSQC5101	China Standards on Quality Control
CSRC	China Securities Regulatory Commission
Exchange	The Stock Exchange of Hong Kong Limited
FRC	Financial Reporting Council
GEM	Growth Enterprise Market
HKEx	Hong Kong Exchanges and Clearing Limited
HKFRS	Hong Kong Financial Reporting Standards
HKICPA	Hong Kong Institute of Certified Public Accountants
HKSA	Hong Kong Standards on Auditing
HKSQC1	Hong Kong Standards on Quality Control
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
MOU	Memorandum of Understanding
MOF	Ministry of Finance
Rules	Main Board Listing Rules and GEM Listing Rules
SFC	Securities and Futures Commission

EXECUTIVE SUMMARY

1. This paper presents the results of the public consultation on our proposals to accept Mainland accounting and auditing standards and Mainland audit firms for Mainland incorporated companies listed in Hong Kong.

2. An overwhelming majority of the respondents supported our proposals. They agreed that the proposed framework should be introduced as Mainland accounting and auditing standards are substantially converged with Hong Kong accounting and auditing standards and the proposed framework will reduce compliance costs for Mainland incorporated issuers and increase efficiency in preparing financial statements.

3. Having considered the responses, we have decided to implement the proposals as set out in the Consultation Paper, which are:-

   (a) to allow Mainland incorporated Main Board and Growth Enterprise Market ("GEM") issuers to prepare their financial statements using Mainland accounting standards;

   (b) to allow Mainland audit firms approved by the Ministry of Finance ("MOF") of China and the China Securities Regulatory Commission ("CSRC") to service these issuers using Mainland auditing standards; and

   (c) to provide for a reciprocal arrangement to allow companies incorporated or registered in Hong Kong and listed in the Mainland to prepare their financial statements using Hong Kong Financial Reporting Standards ("HKFRS") / International Financial Reporting Standards ("IFRS") and audited by Hong Kong audit firms registered with the Hong Kong Institute of Certified Public Accountants ("HKICPA") using Hong Kong Standards on Auditing ("HKSA") or International Standards on Auditing ("ISA").

4. We have finalized the Rule amendments to implement the proposals. They have been approved by the Board of The Stock Exchange of Hong Kong Limited ("the Exchange") and the Securities and Futures Commission ("SFC"), and come into effect on 15 December 2010.

CHAPTER 1 INTRODUCTION

5. On 28 August 2009, the Exchange, a wholly-owned subsidiary of the Hong Kong Exchanges and Clearing Limited ("HKEx"), published a Consultation Paper on Acceptance of Mainland Accounting and Auditing Standards and Mainland Audit Firms for Mainland Incorporated Companies Listed in Hong Kong. The Consultation Paper sought views and comments on proposals to accept financial statements prepared under Mainland accounting standards and audited by Mainland auditors using Mainland auditing standards for Mainland incorporated companies listed in Hong Kong.

6. The consultation period ended on 23 October 2009. We received a total of thirty submissions from listed issuers, professional and industry associations, market practitioners and individuals. A list of respondents is provided at **Appendix 1** and the respondents are grouped into broad categories as follows:-

Category	**Number of respondents**
Main Board issuers	13
A+H share companies	*9*
H share companies	*3*
Others	*1*
GEM issuers	1
Professional and trade associations	6
Market practitioners	6
Retail investors	4
	30

7. The full text of all the submissions is available on the HKEx website at: http://www.hkex.com.hk/eng/newsconsul/mktconsul/responses/cp200908r.htm.

8. Of the thirty respondents, a majority expressed general support to our proposals. Chapter 2 summarises the major comments made by the respondents as well as our responses to these comments and our conclusions. This paper should be read in conjunction with the Consultation Paper, a copy of which is posted on the HKEx website at: http://www.hkex.com.hk/eng/newsconsul/mktconsul/documents/cp200908_e.pdf.

9. We have finalised the Rule amendments to implement the proposals which are available on the HKEx website at: http://www.hkex.com.hk/eng/rulesreg/listrules/mbrulesup/mb_ruleupdate.htm and at: http://www.hkex.com.hk/eng/rulesreg/listrules/gemrulesup/gemrule_update.htm. They have been approved by the Board of the Exchange and the SFC, and come into effect on 15 December 2010. For further details see paragraphs 71 and 72 below.

10. We would like to thank all those who shared their views with us during the consultation process.

CHAPTER 2 MARKET FEEDBACK AND CONCLUSIONS

11. We set out below the proposals, major comments made by the respondents as well as our responses to these comments and our conclusions on how we will proceed with the proposals.

Framework for Acceptance of Mainland Accounting and Auditing Standards and Mainland Audit Firms

12. We proposed a framework to provide Mainland incorporated companies listed in Hong Kong with a choice to prepare their financial statements using China Accounting Standards for Business Enterprises ("CASBE") and audited with Mainland auditing standards, and to accept Mainland audit firms approved by MOF and CSRC to act as auditors and reporting accountants of Mainland incorporated companies listed in Hong Kong. The framework also provides for a reciprocal arrangement to allow companies incorporated or registered in Hong Kong and listed in the Mainland to prepare their financial statements using HKFRS/IFRS and audited by Hong Kong audit firms registered with the HKICPA using HKSA or ISA. We set out below the major comments made by the respondents.

Overall response

13. Out of the thirty submissions received, twenty-four supported the proposal. One submission also provided the views and comments from the board secretaries of 14 Mainland companies. The supporting respondents provided the following reasons for their views:-

- Mainland accounting and auditing standards are substantially converged with Hong Kong and international standards and it is appropriate to accept Mainland accounting and auditing standards and Mainland audit firms.
- Consistent with the direction of global convergence.
- Reduce the cost of preparing financial statements and hence increase cost effectiveness.
- Encourage more timely disclosure of financial information to the market.
- Provide flexibility in the choice of auditors and reporting accountants.
- Create new opportunities for auditing and accounting professions in Hong Kong and the Mainland.
- Encourage more Mainland company listings in Hong Kong.

14. Five respondents disagreed with the proposed framework and their concerns included:-

- Mainland accounting standards are not fully converged with the HKFRS/IFRS.
- Hong Kong investors do not have a clear understanding of the regulatory regime over Mainland audit firms and this may have an impact on investors' confidence and the quality of the capital market in Hong Kong.
- Reduced regulatory power of Hong Kong regulators.
- The proposed framework will adversely affect the accounting profession in Hong Kong.

15. Respondents who supported the proposal also raised questions relating to:-

- On-going convergence of Mainland accounting standards with the Hong Kong and international standards and Hong Kong investors may not be familiar with CASBE
- Overall equivalence of practice review systems in Hong Kong and the Mainland
- Qualification requirements for Mainland audit firms to service Hong Kong listed companies
- Compliance with standards issued by the HKICPA in relation to investment circulars by Mainland audit firms
- Reciprocal arrangements
- Disclosures in the financial statements of the transition to CASBE
- Costs incurred by Hong Kong regulators and cost reduction effect of listed issuers
- Publicity of details of Hong Kong and Mainland regulatory systems over audit firms
- Sponsors' reliance on information provided by Mainland audit firms
- Comments on Rule amendments

16. One submission from a professional body presented the views based on a survey of its members. Of the hundred members of this professional body who completed the survey half of them supported the proposed framework and half did not.

17. We agree with the reasons provided by the supporting respondents and our responses to the concerns and questions received from respondents referred in paragraphs 14 and 15 are addressed below.

Convergence and continued convergence between Mainland accounting standards and Hong Kong and international standards

Comments received

18. Some respondents emphasized that there must be a mechanism to ensure the on-going convergence of Mainland accounting standards with HKFRS/IFRS as convergence was a basic condition on which the framework was developed. Any difference between the Mainland accounting standards and HKFRS/IFRS would make financial statements less comparable. One respondent pointed out that there were differences in the treatment of intangible assets, the treatment of a number of notes to the accounts and the recognition of financial instruments but did not give any examples of these differences.

Our response

19. We agree with the observation that there should be a mechanism to ensure on-going convergence and that mechanism has been put into place. The HKICPA and the China Accounting Standards Committee signed a Joint Declaration on 6 December 2007 which is available on the HKICPA's website at http://www.hkicpa.org.hk/en/standards-and-regulations/technical-resources/mainland-standards-convergence/financial-reporting-standards/. The Joint Declaration declared that there was substantial convergence between CASBE and HKFRS and included details of a mechanism for ensuring on-going convergence of CASBE and HKFRS. This mechanism has been in operation since December 2007 and regular meetings (at least twice yearly) are held by HKICPA, MOF and the International Accounting Standards Board on on-going convergence of CASBE and HKFRS/IFRS.

20. The Joint Declaration identified two remaining accounting differences at the time the declaration was signed. They related to the accounting standard on "related parties" and reversal of "impairment charges". In November 2009, a revised International Accounting Standard 24 "Related Party Disclosures" was released to remove the "related party" difference. On the latter issue, we understand that the Mainland accounting rules which disallow reversal of impairment charges are primarily applicable to property, plant and equipment and believe that such reversals should be rare. We believe the Mainland rules are in substance more prudent and are directed at preventing the manipulation of profits. We consider that although the CASBE rule on reversal of impairment charges is more restrictive, it is still consistent with HKFRS/IFRS.

21. The Joint Declaration did not indicate that there were differences in the treatment of intangible assets and the recognition of financial instruments. In the preparation of the financial statements of issuers that are listed in both the Mainland and Hong Kong, the accounting policies adopted on measurement and recognition of assets and liabilities should be the same given that such companies are managed by the same board and management. In respect of the fair value of intangible assets, we note that CASBE 6 "Intangible Assets" allows the cost model only while Hong Kong Accounting Standard 38/International Accounting Standard 38 "Intangible Assets" allows the cost model and as an alternative the revaluation model, where fair value can be determined by reference to a price quoted in an active market. We believe that an active market for intangibles and use of the revaluation model should be rare. Again, although the CASBE rule on measurement of intangible assets is more restrictive, we consider that it is still consistent with HKFRS/IFRS. In respect of recognition of financial instruments, no significant difference in this area between CASBE and HKFRS/IFRS was noted. In addition, financial statements should include disclosures of material and relevant information to meet the overall objective of providing a true and fair view of the issuer's results and financial position.

22. Based on the Joint Declaration and subsequent developments since the declaration was signed, we believe that CASBE is substantially converged with HKFRS/IFRS and there will be continued convergence. The difference concerning reversal of impairment charges is not a significant difference. We appreciate that Hong Kong investors who choose to read CASBE statements may have initial concerns in familiarizing themselves with Mainland accounting standards which are normally in Chinese. However, there are English translations available and familiarity will develop over time. As required under the Rules, investors may elect to receive an English version of annual reports which should clearly describe the principal accounting policies adopted.

Hong Kong investors do not have a clear understanding of the regulatory regime over Mainland audit firms and this may have an impact on investors' confidence and the quality of the capital market in Hong Kong

Comments received

23. Some respondents were concerned that Mainland audit firms lack the necessary knowledge and experience of Hong Kong rules and regulations and the quality of audits performed by Mainland audit firms may not be guaranteed. Some suggested that it is important to ensure that the proposed framework will not lead to a decline in financial reporting in Hong Kong which may downgrade the position of Hong Kong as an international financial centre.

Our response

24. Issuers have the primary responsibility to produce accurate financial information and independent external auditors act as an additional safeguard. Investors in making investment decisions should consider the risks they wish to accept and whether they are confident with the issuers' management as well as the degree of reliance they place on external auditors.

25. We explained in paragraph 71 of the Consultation Paper that Mainland auditors are required to comply with China Standards on Quality Control ("CSQC5101") which requires them to be knowledgeable of any relevant local rules, regulations and practices concerning their clients. Moreover, Mainland auditors are governed by the Law of the People's Republic of China on Certified Public Accountants and are subject to a system of practice review by the MOF and the China Institute of Certified Public Accountants to monitor and ensure audit quality. We concluded from the findings of the practice review comparison exercise conducted for HKEx by the HKICPA that the practice review systems in Hong Kong and the Mainland are similar (see paragraph 37 below).

26. In addition, the memoranda of understanding and co-operation agreements between the Hong Kong and Mainland regulators will enable efficient and effective monitoring and investigation of Mainland audit firms. With these safeguards, we believe that investors' confidence and the quality of capital market in Hong Kong would be maintained.

Reduced regulatory power of Hong Kong regulators

Comments received

27. Some respondents were concerned that the regulation of Mainland audit firms relies heavily on Mainland regulators and they felt that Hong Kong regulators did not possess adequate monitoring and oversight power.

28. A respondent suggested that Hong Kong regulators should adopt a similar system to that established in the United States, namely, the creation of an independent regulatory body such as The Public Company Accounting Oversight Board. Some respondents were unclear as to how liquidators or shareholders could pursue actions against Mainland audit firms and how preparers of financial information will be regulated. One respondent also commented that extreme sanctions such as removal of the license of an audit firm should only be exercised as a final and extreme option.

Our response

29. The framework was developed on the basis of the existing legislation and on the basis that there would be no change in legislation including the establishment of additional regulatory bodies. We believe the memoranda of understanding and co-operation agreements between Hong Kong and Mainland regulators will enable efficient and effective monitoring and investigation of Mainland audit firms by the regulators best positioned to do so.

30. The framework does not change the rights of investors as a body and liquidators to take legal actions against the company, its directors and its auditors.

31. In relation to preparers of financial information, i.e. issuers, there is no change in their position. The same rules and regulations currently available to take legal actions against issuers remain. Preparers of financial information are required to comply with the Rules and relevant accounting standards. The Financial Reporting Council ("FRC") was established to effectively regulate this area and the Exchange and the FRC have a memorandum of understanding in place for co-operation and cross-referrals. In addition to implement the proposals, the FRC has signed a new separate memorandum of understanding with the Mainland regulators.

32. If an issuer fails to produce financial statements as required under the Rules, the Exchange is able to suspend the share trading of the issuer and ultimately, if appropriate, to delist the issuer.

33. As discussed in paragraphs 80 to 82 of the Consultation Paper, any suspicion of possible misconduct by Mainland audit firms may be reported to the FRC who may seek assistance, as appropriate, from MOF to expeditiously investigate the matter.

Impact on the accounting profession in Hong Kong

Comments received

34. Some respondents raised concerns over the future employment of accountants or auditors in Hong Kong.

Our response

35. We accept that there would be an impact on the future employment of Hong Kong accounting firms but we believe that the choice of audit firms is a commercial matter to be decided between the listed issuer and the audit firm. The reciprocal arrangement to allow companies incorporated or registered in Hong Kong and listed in the Mainland to prepare their financial statements using HKFRS/IFRS and audited by Hong Kong audit firms registered with the HKICPA using HKSA or ISA should alleviate these concerns. The reciprocal arrangement would provide Hong Kong audit firms and accountants with possible business and employment opportunities in the Mainland and we note that some respondents indicated that this will likely happen as they move to place more focus on the Mainland market.

Overall equivalence of practice review systems in Hong Kong and the Mainland

Comments received

36. Certain respondents were concerned that at the time the Consultation Paper was released the HKICPA had not yet completed its comparison exercise and queried whether the Mainland's quality assurance and practice review system is similar to that in Hong Kong.

Our response

37. In late October 2009, the HKICPA completed the comparison exercise of the Hong Kong and Mainland practice review systems and provided its findings to the Exchange. The Hong Kong regulators, including the FRC, SFC, HKICPA, Financial Services and the Treasury Bureau and the Exchange have reviewed HKICPA's findings. The Exchange believes that although the two systems are not identical there are no substantive differences between the practice review systems in Hong Kong and the Mainland. We believe the Hong Kong system is more timely and efficient whereas the Mainland system is more thorough as the Mainland regulators take more time to complete their practice reviews and carry out surprise visits of audit firms and their work also involves re-performance of audit tests undertaken by the audit firms. Findings of HKICPA's comparison exercise are provided at **Appendix 2**.

Qualification requirements for Mainland audit firms to service Hong Kong listed companies

Comments received

38. Some respondents felt that the qualification requirements for Mainland audit firms should be made more transparent to enhance investors' confidence. Some suggested that qualification requirements should include considerations such as a minimum number of certified public accountants employed by the audit firm, experience in auditing listed companies and "H-share" companies and history of any disciplinary action against the audit firm. One respondent questioned whether Mainland audit firms should have a minimum professional indemnity insurance coverage and whether Hong Kong audit firms would be required to create a "professional risk fund" and make contributions to the fund, as required by the MOF for Mainland audit firms.

Our response

39. The qualification requirements suggested by respondents have already been considered by MOF and CSRC. MOF and CSRC intend to restrict Mainland audit firms that will be approved to service Hong Kong listed companies to the larger practices and in September 2009 it consulted 58 Mainland audit firms. Full details of the qualification requirements will also be available when a Mainland audit firm applies for registration with the MOF and CSRC.

40. HKICPA has no separate licensing regime for auditors eligible to service listed companies and does not propose to introduce any new requirements for auditors of Hong Kong companies seeking to list in the Mainland. The qualification criteria required by the HKICPA are available on its website and can be obtained when an audit firm applies for registration with the HKICPA.

41. The framework was developed based on mutual recognition. Audit firms only need to comply with the professional indemnity insurance and/or professional risk fund requirements imposed by their home registration jurisdiction.

42. We understand that in the Mainland the MOF requires that the sum of the accumulated professional indemnity insurance coverage and the accumulated "professional risk fund" of a Mainland audit firm that services listed companies should not be less than RMB6 million. The professional risk fund is determined at 5% of the practice's annual fee income from auditing services.

43. The HKICPA, under its statement No.1.103 "Corporate Practices (Professional Indemnity) Rules", has requirements for corporate practices. Such practices are required to have minimum professional indemnity insurance coverage of at least HK$5 million but this increases depending on the practice's fee income and the number of partners.

Compliance with standards issued by HKICPA in relation to investment circulars by Mainland audit firms

Comments received

44. A respondent questioned whether Mainland auditors would be required to comply with two specific HKICPA standards in relation to investment circulars, namely, Auditing Guideline 3.340 "Prospectuses and the Reporting Accountant" and Auditing Guideline 3.341 "Accountants' Report on Profit Forecasts".

Our response

45. Under the existing Rules, compliance with Auditing Guideline 3.340 "Prospectuses and the Reporting Accountant" has been retained under Main Board Rule 4.08(3) and GEM Rule 7.08(3). Auditing Guideline 3.341 "Accountants' Report on Profit Forecasts" deals with profit forecasts which are not mandatory. Moreover, China Standards on Quality Control ("CSQC5101") which is similar to Hong Kong Standards on Quality Control ("HKSQC1") requires that audit firms should be knowledgeable of any relevant local rules, regulations and practices concerning their clients. Breach of these standards may result in disciplinary actions taken by the relevant audit firm licensing body.

46. In addition, the Exchange has the power to reject documents. It pre-vets listed companies' / listing applicants' documents prior to their release (e.g. prospectuses) and has the power to reject documents that are not prepared properly.

Reciprocal arrangements

Comments received

47. A respondent suggested that Mainland regulators accept certain international audit firms who have affiliated firms registered with HKICPA and accepted by the Exchange on a case-by-case basis under Main Board Rule 19.20(2) for the purpose of their Hong Kong and Mainland listings, so that these audit firms need not be subject to further levels of audit and regulatory supervision for the purpose of their Mainland listing clients. Another respondent suggested that Mainland regulators should recognize audit firms registered with the equivalent bodies to HKICPA within the United Kingdom and the United States. Another respondent suggested that Mainland regulators should allow Hong Kong accountants to provide Mainland accounting, taxation and valuation services. A respondent also requested clarification of whether the reciprocal arrangements would apply to companies registered under Part XI of the Companies Ordinance.

Our response

48. We believe extending the services that may be provided by Hong Kong accounting firms beyond auditing and assurance services are decisions that can only be made by the Mainland regulatory authorities. The framework deals with reciprocal arrangements on auditing and assurance services only and the scope of the reciprocal arrangements on audit firms that may service relevant Hong Kong sourced Mainland listings are restricted to audit firms registered with HKICPA.

49. We would also clarify that the reciprocal arrangements apply to Mainland listings of companies incorporated or registered in Hong Kong. The reference to "registered in Hong Kong" covers non-Hong Kong incorporated companies registered under Part XI of the Companies Ordinance.

Disclosures in the financial statements of the transition to CASBE

Comments received

50. Certain respondents suggested that there should be specific disclosure requirements on the transition from one set of accounting standards to another and a reconciliation statement should be included in financial statements to reconcile the net profit or loss under CASBE to the figure under HKFRS/IFRS. Another respondent commented that once a listed issuer decides to change and prepare its financial statements under CASBE, the issuer should not be permitted to change back and if there is any change, reasons should be disclosed in the annual report.

Our response

51. We believe we addressed these issues in paragraph 47 of the Consultation Paper. An issuer who decides to change and prepare its financial statements under CASBE should release an announcement on the change and explain the reasons and show the financial impact, if any, of the change. We agree that an issuer should not normally change back once it decides to change to CASBE. Listed issuers should decide which set of accounting standards is most suitable to them and adopt that set of accounting standards continuously. There should not normally be any significant impact on the issuers' results or financial position on the adoption of CASBE.

Costs incurred by Hong Kong regulators and cost reduction effect of listed issuers

Comments received

52. A few respondents considered that costs incurred by regulatory authorities would increase and were concerned that these costs may be passed to listed issuers. One respondent commented that the cost savings expected may not be significant as A+H share companies would still have to produce and print two sets of annual reports for the Mainland and Hong Kong.

Our response

53. Although regulatory authorities would incur some additional costs to implement the framework, the cost will be borne by the Hong Kong regulators and not listed issuers.

54. We believe that printing costs would be significantly reduced as well as accounting and auditing costs. This view was also given by some respondents who supported the proposed framework. To reduce printing costs "A+H share" issuers that choose to adopt CASBE may consider printing one report rather than two separate annual reports so long as they comply with all the regulatory disclosure requirements in Hong Kong and the Mainland.

Publicity of details of Hong Kong and Mainland regulatory systems over audit firms

Comments received

55. One respondent suggested that a detailed analysis should be made public on (a) acceptance criteria for endorsing audit firms; (b) practice review systems; (c) investigation procedures; (d) extent of information sharing; and (e) sanction structures of both markets.

Our response

56. We understand that some aspects of these areas are currently available on the websites of relevant regulatory bodies in Hong Kong. The HKICPA has certain aspects of point (a), (b), (c) and (e) available on its website. The FRC also has some aspects of (c) and (d) on its website.

57. The extent of details regarding the regulation of audit firms made publicly available depends on that permitted by law and the decisions of the relevant regulatory bodies.

Sponsors' reliance on information provided by Mainland audit firms

Comments received

58. A respondent commented that sponsors may not feel comfortable to rely on the information provided by an audit firm registered in a jurisdiction that they are not familiar with.

Our response

59. We consider that whether a sponsor feels comfortable with a specific audit firm will be determined on a case-by-case basis and is a commercial matter that would need to be considered by a sponsor before accepting an engagement. If a sponsor does not feel comfortable with a specific audit firm, the sponsor can discuss the matter with the listing applicant to change the audit firm or alternatively to withdraw from the engagement.

Comments on Rule amendments

Comments received

60. A respondent commented that the reference to "business segments" in Notes 2(b) and 2(c) to Main Board Rule 14.04 in the Rule amendments included in the Consultation Paper is out of date and suggested the word "business" be removed. A respondent suggested amending Main Board Rules 19A.33 and 19A.35 and GEM Rules 25.26 and 25.29 to require the audit firms to report on whether the financial statements "...give a true and fair view or to present fairly in all material respects..." of the results and financial position of the issuer.

Our response

61. We agree with the comment in relation to the reference to "business segments" and have amended the Rule to delete the word "business".

62. On the latter point relating to adding the phrase "present fairly in all material respects" we note that paragraph 35 of HKSA 700 (Clarified)/ISA 700 "Forming an Opinion and Reporting on Financial Statements" states that the phrases "present fairly in all material respects" and "give a true and fair view" are regarded as being equivalent. On this basis, we consider that adding the phrase "present fairly in all material respects" to the relevant Main Board and GEM Rules is not necessary.

63. After taking into consideration the above matters set out in paragraphs 12 to 62, we have decided to adopt the proposed framework to accept Mainland accounting and auditing standards and Mainland audit firms for Mainland incorporated companies listed in Hong Kong and a reciprocal arrangement for Mainland listings of companies incorporated or registered in Hong Kong.

Effective commencement date

64. In our Consultation Paper, we suggested that if the proposed framework is adopted, the proposed effective commencement date for the new rules would be 1 January 2010 and would apply to annual accounting periods beginning on or after 1 January 2010.

Overall response

65. A majority of the respondents supported the proposed effective commencement date of 1 January 2010. Out of the thirty submissions received, eighteen agreed to our proposal and eight did not agree.

Comments received

66. Some of the respondents who did not agree to the proposed effective commencement date suggested that the commencement date should be delayed at least three to five years. They considered that the timeframe was too short for the Mainland and Hong Kong regulators to complete the preparation work necessary to implement the framework. Some respondents from the insurance industry also suggested deferring the commencement date until the China Insurance Regulatory Commission ("CIRC") has finalised the timetable for the proposed new computation method for insurance reserves, which they indicated may have a significant impact on the financial statements of insurance companies.

67. Some respondents commented that it was not clear how the effective commencement date of 1 January 2010 should be applied in prospectuses and circulars where financial information presented is required to cover more than one financial year.

Our response

68. The framework provides Mainland incorporated companies listed in Hong Kong with a choice of accounting standards and audit firms. The proposed amendments to the Rules are enablers rather than requirements and the changes do not automatically require any immediate actions to be taken by issuers. As mentioned in the Consultation Paper, if an issuer is considering a change it should carefully study the possible impact before deciding on a change.

69. The original timetable to introduce the framework on 1 January 2010 was agreed between the Hong Kong and Mainland regulators and a majority of respondents to the public consultation agreed with the proposed commencement date. Another year has lapsed. All the preparation work including the practice review comparison and all the memoranda of understanding are now in place.

70. In relation to the request for a delay until the new computation method for insurance reserves is released by the CIRC, we consider that issuers whose business is in a regulated industry, such as banks and insurance companies, would need to comply with any specific additional requirements which are imposed by their industry regulators. As mentioned above our proposals are enablers to facilitate a choice and issuers have the freedom to decide whether they wish to change and if so, the appropriate timing for the change.

71. After taking into consideration the matters noted in paragraphs 65 to 70 above, we have decided to adopt the new rules with a commencement date of 15 December 2010. CASBE may be used for the preparation of periodic financial reports commencing from annual accounting periods ending on or after 15 December 2010.

72. If a Mainland incorporated listing applicant or issuer has decided to adopt CASBE for its annual accounting periods ending on or after 15 December 2010, in the preparation of financial information to be included in a prospectus or a circular issued on or after 15 December 2010, the financial information for all periods presented in the prospectuses or circular should also be prepared under CASBE.

CONSULTATION CONCLUSIONS

73. We have adopted the proposals as proposed in the Consultation Paper. We have finalised the revised Rules to implement the proposals which are available on HKEx's website.

APPENDIX 1 LIST OF RESPONDENTS

Main Board issuers

1 HSBC Holdings plc
2 PICC Property and Casualty Company Limited
3 Main Board issuer 1 (name not disclosed at the respondent's request)
4 Main Board issuer 2 (name not disclosed at the respondent's request)
5 Main Board issuer 3 (name not disclosed at the respondent's request)
6 Main Board issuer 4 (name not disclosed at the respondent's request)
7 Main Board issuer 5 (name not disclosed at the respondent's request)
8 Main Board issuer 6 (name not disclosed at the respondent's request)
9 Main Board issuer 7 (name not disclosed at the respondent's request)
10 Main Board issuer 8 (name not disclosed at the respondent's request)
11 Main Board issuer 9 (name not disclosed at the respondent's request)
12 Main Board issuer 10 (name not disclosed at the respondent's request)
13 Main Board issuer 11 (name not disclosed at the respondent's request)

GEM issuer

14 GEM issuer (name not disclosed at the respondent's request)

Professional and trade associations

15 ACCA Hong Kong
16 CPA Australia – Hong Kong China Division
17 The Chamber of Hong Kong Listed Companies
18 The Hong Kong Institute of Certified Public Accountants
19 The Hong Kong Institute of Chartered Secretaries
20 The Hong Kong Society of Financial Analysts

Market practitioners

21 Hermes Equity Ownership Services Limited
22 KPMG
23 Latham & Watkins
24 Linklaters
25 PricewaterhouseCoopers
26 The Professional Commons

Retail investors

27 Paul Mok
28 Suen Chi Wai
29 Fanny Wong
30 Retail investor (name not disclosed at the respondent's request)

APPENDIX 2 COMPARISON BETWEEN HKICPA PRACTICE REVIEW PROGRAMME AND THE MAINLAND AUDITOR MONITORING PROGRAMMES

		Hong Kong Institute of Certified Public Accountants ("HKICPA")	**Ministry of Finance ("MOF")**	**Chinese Institute of Certified Public Accountants ("CICPA")**
1)	Regulator			
2)	Responsible department	Quality Assurance Department ("QAD")	Supervision and Inspection Department	Supervision Department
3)	Source of authority	Professional Accountants Ordinance Section 32C	PRC accounting law and PRC CPA law	Section 37 of PRC CPA law and Section 3 of the Articles of CICPA
4)	Targets	Approximately 2,400 practice units in Hong Kong	Approximately 60 Licensed (for listed company audits) CPA firms in the PRC and other CPA firms with focus areas of inspection	Approximately 7,000 CPA firms in the PRC
5)	Selection basis	Risk-based approach: Big 4 are subject to review on annual basis; 3-year cycle for practices with listed companies; priority is given to practices with other public interest clients. Random selection of practices to ensure that all practices have a reasonable chance of being selected.	3-year cycle for Licensed CPA firms and random inspection on other CPA firms with focus areas, e.g, referral by other department, being complained; suspected violations of laws and regulations during daily supervision, etc.	3-year cycle for Licensed CPA firms and 5-year cycle for all other CPA firms in the form of random selection, focusing on special nature of issues or industry, e.g., public interest entities or accepting clients who frequently changes auditors, etc.
6)	Timing of review	Throughout the year	The bulk of the inspections are carried out in the period May to October each year, after the annual reports of listed entities are published. If MOF receives a complaint MOF will initiate an investigation immediately.	Usually from May to October each year, avoiding the peak season of the CPA firms
7)	Qualifications and experience of reviewers / inspectors	Full-time staff of HKICPA with a recognised university degree in accounting / finance / business and CPAs with a minimum of 5 years' post qualification experience gained in CPA firms	The review team should have 2 or more full-time personnel from the MOF or finance department and a number of professionals. The professionals should have the following qualifications: qualified CPA practising in CPA firms for 5 or more consecutive years; have strong operational skills and good professional ethics; not being penalized in the latest 3 years and do not have any relationships with the CPA firms under inspection	Inspectors should be engagement-in-charge in a CPA firm; have more than 5 years audit experiences; familiar with accounting and auditing standards and their applications and not being penalized in the latest 3 years
8)	Time spent on each review	1 day to 3 weeks	Approximately 3 - 4 months. Usually 1 - 2 months spent on site visit to the CPA firm and the other 1 - 2 months spent on the direct inspection of listed clients	Approximately 10 days for the licensed CPA firm's headoffice and 4 - 5 days on their branch offices

		HKICPA	MOF	CICPA
9)	Number of reviewer for each review	1 to 4 reviewers lead by a team leader	At least 2 full-time staff from MOF and a number of professionals depending on the workload. Lead by personnel from MOF	At least 3 inspectors and lead by a team leader from CICPA
10)	Scope of review	1) Review of system of quality control as required by HKSQC 1 and 2) review of completed engagement files to reach a conclusion on compliance with professional standards.	1) Quality of work performed by the CPA firm - must extend the inspection work to two listed clients of the CPA firm in order to verify the work performed; 2) Conditions required for setting up a CPA firm and other matters stipulated by laws and regulations	1) Review of system of quality control according to 5101 Standard on Quality Control for CPA firms and Engagements Quality Control and Guidance on Internal Management of CPA firm 2) Review of engagements files to assess engagement quality; 3) Inspection of compliance with professional ethical requirements.
11)	Review process	1) Notification letter sent to PU at least 6-week in advance of review; 2) Planning and on site review and enquiries with relevant personnel; 3) Exit meeting to agree findings; 4) Dated draft report for practice unit; 5) Practice unit response on dated draft report within 21 days; 6) Issuance of reviewer's report, incorporating the responses from practice unit, if necessary; 7) Quality Assurance Department submit recommendations for Practice Review Committee considerations; 8) Practice Review Committee issue decision letters to PU; 9) Follow-up on Practice Review Committee's decision.	1) MOF lead the overall inspection program and set out the planning; 2) Notification letters will be sent to CPA firms 3-days in advance of the inspection; 3) The CPA firm may be required to perform a self-inspection before the MOF inspection, though not compulsory; 4) Performance of on-site inspection by way of enquiries, review of documentation and other necessary procedures; 5) Team leader to draw a conclusion on the case and the non-compliance matters. Written response should be obtained from the CPA firm; 6) Inspection team consider the written response and prepare a written inspection report to MOF (within 10 working days after the field work and can be extended to 30 working days at maximum for special cases); 7) Hearing by a committee set up by MOF ; 8)The committee make a decision on the case and inform the CPA firm; 9) MOF will penalise the firms if necessary. MOF will also inform the CPA firm that it has the rights to conduct a hearing to explain the case further.	1) Preparation work - planning for the overall inspection program; sending out inspection notifications 5-day in advance of inspection, by way of enquiries and review of documentation. The CPA firm may be required to perform a self-inspection and make the necessary arrangement to accommodate the inspection; 2) Planning of the inspection field work 3) Performance of inspection field work covering the 3 areas mentioned in scope of review above; 4) Team discussions on inspection results and consolidation of inspection findings to a report. Obtain written response from the CPA firm on the inspection findings; 5) Drafting of final inspection report which incorporates the response from the CPA firm; 6) Assembly of inspection working paper files and submit to CICPA; 7) Expert panel to discuss the inspection case; 8) Actions for improvements provided to CPA firms 9) Penalties determined by the Disciplinary Committee will be imposed on CPA firm with serious non-compliances.

	HKICPA	MOF	CICPA
12) Outcome of review	1) Practice Review Committee issue instructions and recommendations to PU to act upon 2) follow-up on the practice unit's proposed action plan 3) follow-up visit 4) raise complaint against the PU	1) instruct the CPA firm to carry out remedial actions; 2) continuous monitoring / follow-up visits 3) advises / reminders to CPA firm by interviews or refer to CICPA for disciplinary actions within the profession 4) To pay a large sum penalty 5) Suspension of practising license 6) Cancellation of CPA qualification 7) Cancellation of CPA firm registration	1) Advise for improvements 2) Criticism within the profession 3) Public reprimand 4) Grading from Outstanding to Bad assigned to CPA firm
13) Review / Inspection manual	HKICPA practice review programme (with reviewer's manual and working paper templates and checklists)	The MOF has a set of rules for supervision and inspection of CPA firms <會計師事務所監督檢查工作規程> and the existing inspection manual <檢查工作指引> is in the process of revision to provide additional detailed guidance	Practice quality inspection system inspection manual (with inspection guides and 7 categories of working paper templates and questionnaires) <會計師事務所執業質量檢查手冊>