

# **MEMBERS, COUNCIL AGREE ON REFORMS**

## While there is broad consensus on a proposed audit regulatory framework, European Commission equivalence and monetary penalties are among more contentious issues after Institute reviews member feedback

Illustrations by Matt Burchell

**M**embers of the Hong Kong Institute of CPAs have indicated strong support for the Council's position on the proposed audit regulation reforms, a review of written submissions received during the consultation period and a statistical analysis of responses to a recent online survey indicate.

The Institute received 15 written responses from firms and 27 from individual members, and more than 4,500 online responses from individual members during the consultation period. Of the 27 written responses from individual members, 15 requested that their responses not be published.

"We agree on establishing an independent auditing regulation body so that the regulatory system in Hong Kong meets international benchmarks," Barry Ip, Managing Partner of ShineWing (HK) CPA, wrote in his firm's submission, reflecting general approval of the overall framework.

Both written responses and survey results indicated a general concern over the lack of detail in some of the framework proposals resulting in a lack of confidence that the powers and functions of the independent oversight body would be exercised fairly and through due process.

The areas of particular concern expressed include:

- The extent and exercise of reserve powers;
- Composition and governance of the independent oversight body;
- "Fit and proper" criteria for firms and individuals; and
- The disciplinary mechanism and sanctioning guidance.

Following the receipt of the submissions, the Institute has identified a number of areas of concern that should be the subjects of a post-consultation focus.

### EC equivalence

In relation to European Commission convergence as an objective of reform, respondents were mixed in their opinion – ranging from support on the basis of international benchmarking to views that it is irrelevant to Hong Kong.

"We believe that obtaining EC equivalence should and must be an objective," PricewaterhouseCoopers noted in its submission, while Stephen Weatherseed, Managing Director of Mazars, wrote: "We see no or very little benefits in attaining the EC equivalence status."

The Institute's position remains that EC equivalence is mainly about reputation and

the status of Hong Kong as an international financial market. There will be little immediate benefit to most audit practices or their clients. "We support EC equivalence as a policy objective as long as the price the profession needs to pay in terms of reduced authority and influence is fair," says Institute Executive Director Chris Joy.

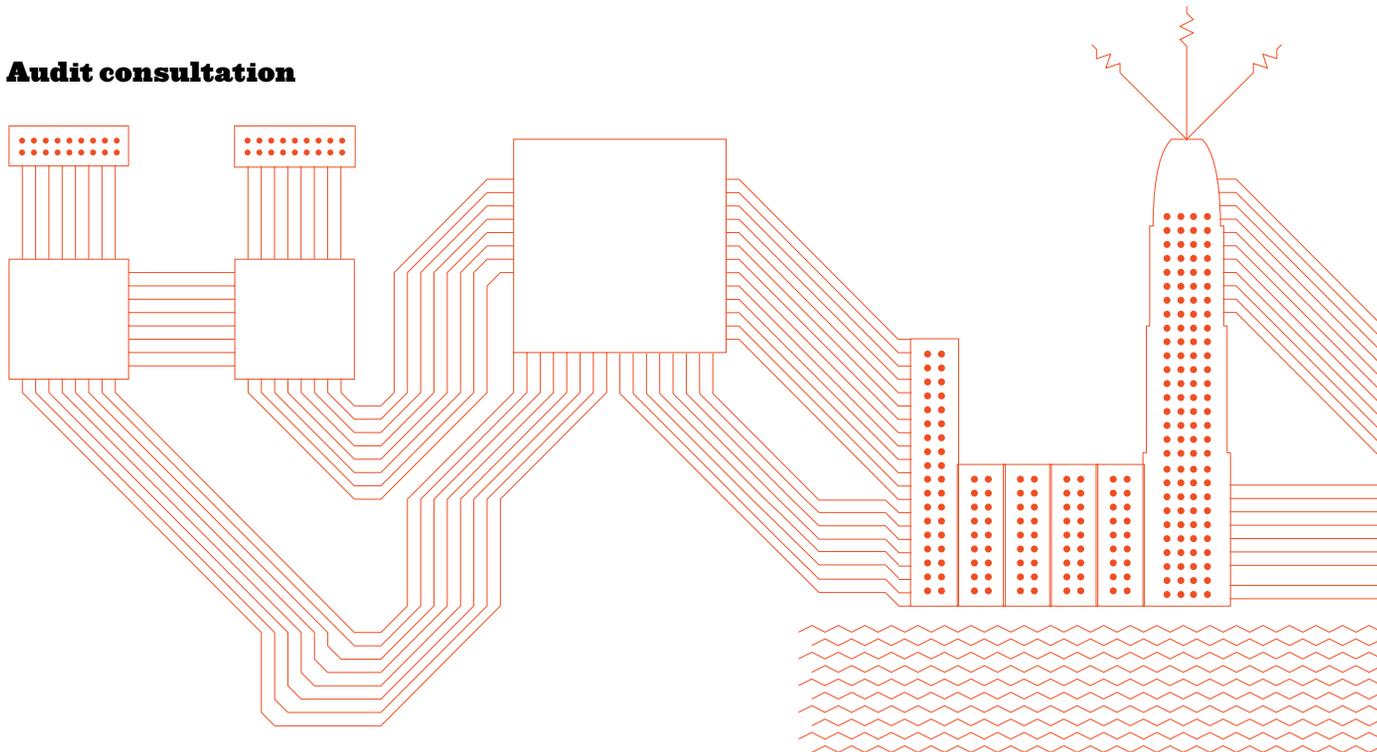
EC equivalence should not result in an independent body's oversight of registration, continuing professional development and standard setting exceeding the necessary minimum, Joy adds.

### Oversight and reserve powers

The consensus from submissions is that the establishment of an independent oversight body should not remove statutory responsibilities from the Institute. "[There] is no evidence to indicate that the [Institute] is not meeting [the] public interest... or public expectations," Derek Chan, Director of HLM CPA, wrote in his submission.

Indeed, there was concern expressed that any removal of statutory responsibilities might erode the Institute's standing and reputation. "A broad principle for the reform should consider where there is an option of oversight by [the independent oversight body] of [Institute] responsibilities to

## Audit consultation



satisfy and secure Hong Kong's membership in the International Forum of Independent Audit Regulators, this should be adopted," suggested Albert Au, Chairman of BDO, in his firm's submission.

There should be further clarification that oversight will be an after-the-event review of process and operations and that the independent oversight body will not be involved in operational activities, several respondents concluded.

"While we agree that the [independent

**"It is not clear to us why the body would need such explicit power to refuse renewal of registration of auditors."**

oversight body] should have reserve powers, it is unclear from the proposed framework how such reserve powers will be exercised," EY wrote in its submission. "More clarification on the use of reserve powers is needed."

More details were sought in terms of the

checks and balances that will operate over the exercise of reserve powers and confirmation that the use of reserve powers will only be considered in extreme circumstances. "[It] is normally assumed that such reserve powers should only be exercised in rare circumstances," EY added.

### Registration

Respondents expressed concern over a suggestion in the framework that the independent oversight body might take direct action and make its own decisions in the registration of auditors based on information other than established registration criteria. "It is not clear to us why the body would need such explicit power to refuse renewal of registration of auditors," Deloitte noted in its submission.

The term "fit and proper" constituted "vague" and "subjective" criteria for registration, according to some submissions. "Current criteria for membership admission, including the consideration of any conviction and civil liability, are objective and should be used in the annual renewal of registration," Charles Chan, Chairman and Chief Executive Officer of Crowe Horwath (HK) CPA, wrote.

Concerns have been raised over the proposal to include, as a category of registration, an individual or individuals responsible for a firm's system of quality control as

this requirement does not feature in auditor regulatory systems in other major jurisdictions. "The Institute is also unconvinced that a single individual should be held responsible for systemic failures," says Joy.

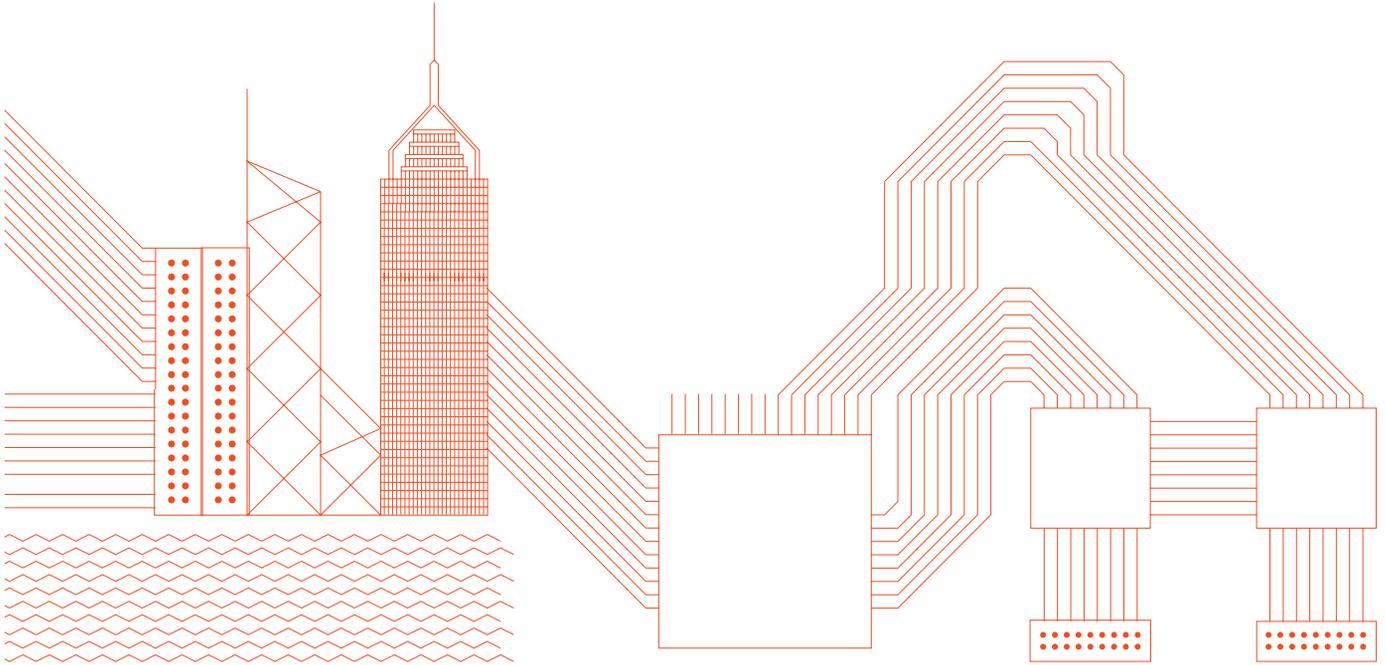
### Enforcement and disciplinary action

Most respondents were of the opinion that the tasks of enforcement and disciplinary action should be kept separate from those of investigation and inspection. Respondents indicated concern over any proposal that the independent oversight body carry out enforcement internally.

The fear is that firms would be denied appropriate hearings or due process. "We are concerned by the proposed mechanism for the [independent oversight body] to play the role of investigator, prosecutor and judge under one roof," wrote Patrick Ng, Managing Director of Pan-China (H.K.) CPA.

There needs to be a lot more detail of how the enforcement and sanctioning process will operate, what checks and balances will be in place to ensure fairness, transparency provisions and sentencing guidelines. "We are of the opinion that firms should have unrestricted right to appeal to the Court of Appeal," Daniel Lin, Managing Partner of Grant Thornton, wrote in his firm's submission.

There seems to be fairly general agree-



ment that a multiple of “profit or loss” is not a relevant penalty cap in respect of audit deficiencies. “A more certain measure might be with reference to the quantum of audit fees,” Deloitte posited.

Consultation responses on the appropriateness of HK\$10 million as a cap were very mixed. “The proposed penalty of HK\$10 million per case uninsurable posed a risk, which is far too excessive for many mid-tier CPA firms to bear,” Raymond Cheng, Managing Director of HLB Hodgson Impey Cheng, wrote. However, some respondents suggested that the cap should be significantly higher if penalties were to be effective.

Other respondents questioned the need for any financial penalties at all. “We disagree in principle with the use of financial penalties as a punishment as the reputational damage to an auditor or a firm is, in itself, a sufficient deterrent,” Mabel Chan & Co. submitted.

The Institute will focus on developing sanctioning guidance based on key principles of fairness and proportionality.

### Standard setting

There was general agreement that the Institute should remain the setter of auditing standards and the code of ethics in Hong Kong, and that authority should be assigned directly in law.

“Hong Kong must continue the Institute’s practice of maintaining convergence with

international standards promulgated by the International Auditing and Assurance Standards Board and the International Ethics Standards Board for Accountants,” KPMG wrote in its submission.

Respondents believe the independent oversight body should not have to endorse standards, or express no objection thereto, before they become effective. The Institute should be subject to “appropriate oversight” in this matter, suggested Thomas Wong, Managing Partner of Nexia Charles Mar Fan & Co.

### Online responses

More than 4,500 responses to the online survey, conducted from 23 December 2013 to 17 January this year, were received. The consensus was broad agreement with the major points of the Council’s proposals.

The major points of contention were, as in the case of the written responses received by the Institute, whether (i) the reform should pursue EC equivalence in addition to membership of the IFIAR and (ii) whether HK\$10 million was a suitable cap for monetary penalties.

More than 82 percent of respondents agreed with the proposal that more independence should be introduced to the listed company auditor regulation system to maintain the international reputation of Hong Kong’s capital markets and the auditing profession.

Similar numbers – more than 81 percent

– agreed that the proposed oversight should not be constructed to go beyond the EC minimum and give the independent oversight body responsibility for registration, CPD and standard setting.

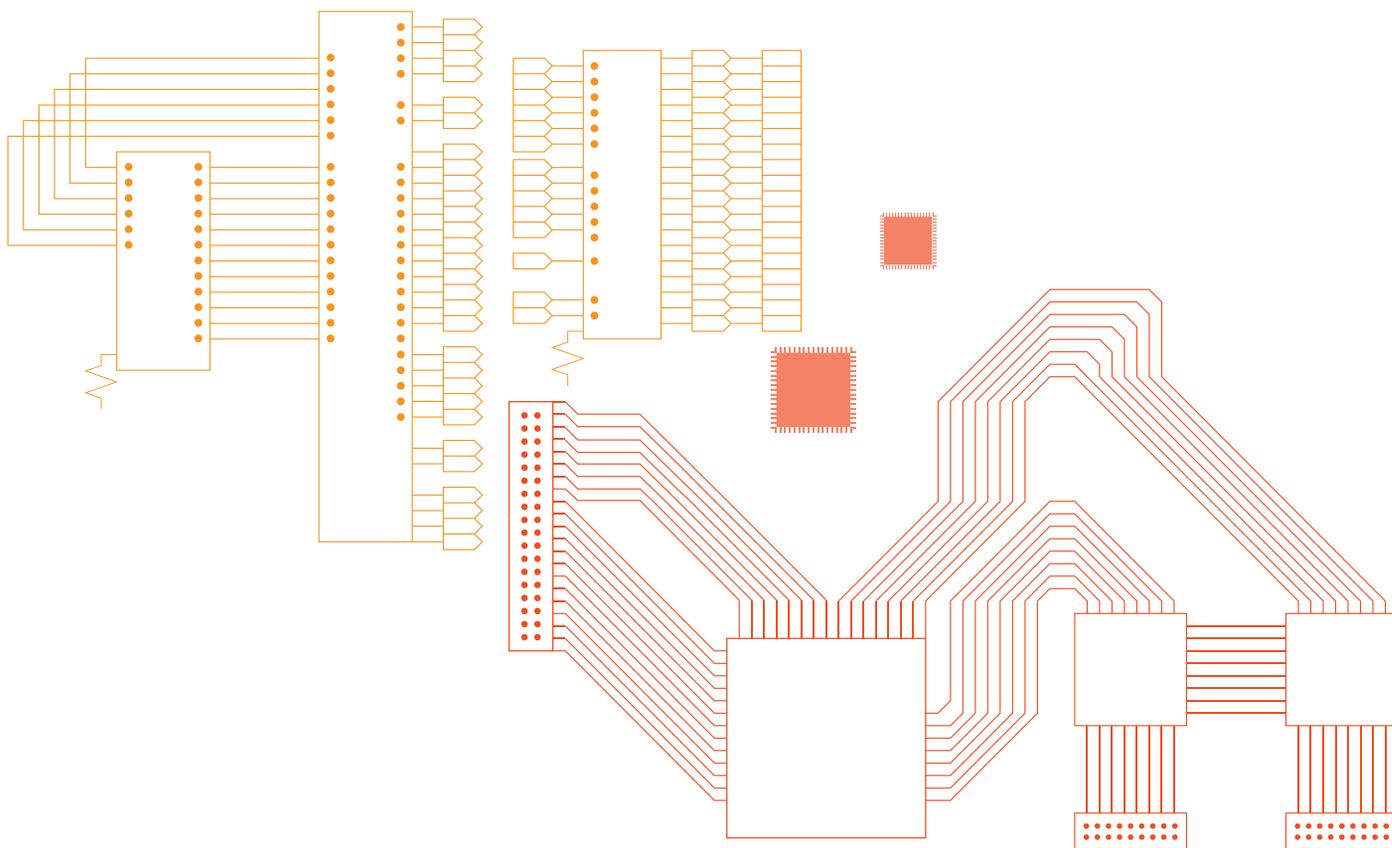
Indeed, responding members were lukewarm when it came to EC equivalence as a key objective of reform: Only 37 percent agreed with the proposal that obtaining EC equivalence should be an objective of the reform exercise.

More than 77 percent agreed with the Institute that the responsibilities for registration, CPD and standard setting should remain with the Institute and be derived from direct assignment in law and not delegated from the independent oversight body.

Nearly 70 percent said they did not feel comfortable with the idea of the independent oversight body having the power to approve

**“We are of the opinion that firms should have unrestricted right to appeal to the Court of Appeal.”**

POLICY	FRAMEWORK PROPOSAL	POST-CONSULTATION VIEWS
<b>European Commission equivalence</b>	Attain regulatory equivalence status with the EC	<ul style="list-style-type: none"> <li>• Reputational issue with little additional benefits</li> <li>• Support only if price for profession is fair</li> </ul>
<b>Oversight and reserve powers</b>	Two options for oversight of registration, continuing professional development and standard setting not carried out directly by independent oversight body: (a) Oversight exercised by delegation of powers from independent oversight body (b) Oversight by express assignment in law (Institute's preferred outcome)	<ul style="list-style-type: none"> <li>• Oversight will be an after-the-event review of process and operations and independent oversight body will not be involved in operational activities</li> <li>• More details sought in terms of checks and balances</li> </ul>
<b>Registration</b>	Set and administer criteria for Hong Kong auditors of Hong Kong-listed companies	<ul style="list-style-type: none"> <li>• No additional criteria for registration beyond what is already set</li> <li>• Concern about independent oversight body taking direct action and making decisions on registration of auditors</li> </ul>
<b>Enforcement and disciplinary action</b>	Three options: (a) Direct decision and sanctioning by independent oversight body (b) Oversight body sends cases to a fully independent disciplinary committee for decisions and sanctioning (Institute's preferred outcome) (c) Cases sent to disciplinary committee chaired by senior executive of independent oversight body	<ul style="list-style-type: none"> <li>• Enforcement and disciplinary action should be kept separate from investigation and inspection</li> <li>• Right to appeal to the Court of Appeal should be unrestricted</li> <li>• Maximum penalty expressed as multiple of "profit or loss" not a relevant measure</li> <li>• Proposed maximum penalty of HK\$10 million per case is excessive and may restrict competition</li> <li>• Institute to develop sanctioning guidance based on key principles of fairness and proportionality</li> </ul>
<b>Standard setting</b>	Institute sets standards and code of ethics in accordance with existing due process	Independent oversight body should not have to endorse standards, or express no objection, before they become effective



or refuse registrations and renewals. Nearly 84 percent believe that there should not be additional criteria for registration beyond the “fit and proper” criteria currently set.

The reform framework proposes that in addition to firms, three categories of individuals should also be subject to registration: public-interest entity engagement partners, engagement quality control reviewers and persons with overall responsibility for firm quality control.

However, more than 78 percent agreed with the Institute’s position opposing the third category – that one individual should not be held responsible for firm-wide responsibilities that should be the collective responsibility of the firm.

More than 90 percent agreed with the Institute’s position that there should be a clear separation of responsibility between “inspection and investigation” and “subsequent disciplinary action.”

Nearly 80 percent agreed with the Institute’s preferred option for the structure of

enforcement and disciplinary proceedings: that cases arising from inspection and investigation be sent to a fully independent disciplinary committee for decision and sanctioning.

More than two-thirds agreed with the Institute’s proposal for an option that would allow for disciplinary action with the consent of both parties without a formal disciplinary hearing.

A majority of respondents – 64 percent – agreed that monetary fines are not necessary if the independent oversight body has the power to mete out potentially more serious consequences, such as suspension or withdrawal of registration.

Nearly half of respondents (48 percent) agreed with the framework proposal that monetary penalties be capped at a maximum of HK\$10 million or three times the profit or loss from the engagement, with a similar number disagreeing or providing no comment. More than 72 percent agreed with the Institute’s belief that determining penal-

ties as a multiple of profit is not appropriate.

In other issues, more than 81 percent of respondents agreed with the Institute’s position that the independent oversight body does not need to endorse auditing and ethical standards.

More than 85 percent agreed that the independent oversight body should be funded from sources independent of the audit profession, and that the Institute should not be involved in collecting fees, levies or other funding for the independent oversight body.

Slightly less than 80 percent agreed with the Institute’s position that the future composition of the independent oversight body’s governing and decision-making bodies should include individuals with substantial knowledge and experience of auditing. **A**

*All consultation materials, including events and responses, are available on the Institute website at: [www.hkicpa.org.hk/en/communications/regulatory-framework/](http://www.hkicpa.org.hk/en/communications/regulatory-framework/)*