

Hong Kong Institute of CPAs
Update on Campaign for Reforming Auditors' Liability Regime

1. Our Proposition

The Hong Kong Institute of CPAs (“the Institute”) firmly believes that liability reform is in the best interests of a healthy and stable capital market in Hong Kong and, equally importantly, is in the interests of a healthy and sustainable auditing profession. It is, therefore, an essential element of Hong Kong’s long-term economic development.

The growth in capital markets internationally, which has been faster in Hong Kong than in most other developed markets, has increased the number of companies with a huge market capitalisation. This has also resulted in a substantial increase in the risks faced by auditors, especially to firms performing audits for listed companies in Hong Kong, who still face an unlimited liability environment.

There exists a gap between the perceived financial strength of large audit firms and the size of existing and potential claims against such firms. There is also a mistaken belief that such audit firms have adequate insurance cover available in the event of a mega claim. This is incorrect, as the insurance market has completely evaporated for what the market considers to be an uninsurable risk.

Some of the “mega” claims that are now being made are of a size that could bankrupt a major audit firm in Hong Kong, which could in turn have a catastrophic impact on capital markets. The knock-on effects of the failure of a major auditor in one of the world’s few global financial markets would potentially be highly destabilising. In a volatile environment, similar to the situation over the past 18 months, a substantial loss of confidence could occur very quickly and be extensive, with its impact being felt both domestically and internationally. If reasonable steps can be taken that would significantly reduce the likelihood of such a scenario happening, and help to safeguard Hong Kong’s reputation as a highly liquid, orderly and well-run market, then they should be seriously considered.

During the past year, the Institute has held a series of meeting with stakeholders, and other activities which reflect our ongoing and determined efforts to close expectation gaps, address misconceptions and outline the need for reform in Hong Kong (see Appendix 1 for a summary of initiatives). The Institute has explained to stakeholders our proposition, that introducing a statutory cap on auditors' liability, which would help to provide additional stability to capital markets and better protection for the investments of the public, would be advantageous to all interested parties: the markets, market participants, and the wider community of Hong Kong.

While the Institute’s main intention has been to explain our position and to listen to stakeholders’ views on any challenges they foresee, our experience has been that, once they are apprised of the actual circumstances of auditors in Hong Kong, including the common misconceptions, and of the benefits of introducing liability reform, our proposition has received a generally favourable response. The Institute will continue work to strengthen the case for reform. We propose to carry out a robust, independent study on the impact of auditors’ liability in Hong Kong, based on a similar study undertaken by the European Commission, and to conduct further engagement with stakeholders, with a view to presenting a more detailed and specific reform proposal to the Hong Kong SAR Government.

2. The Global Trend for Reform of Auditors' Liability Regimes

There is little doubt that Hong Kong is lagging behind other major financial markets and competitors in introducing reforms to the auditors' liability regime. An overview of the liability regimes in other jurisdictions is at Appendix 2. This makes Hong Kong more vulnerable to the occurrence of the kind of event that would lead to major instability in the capital market, result in a loss of reputation from which it could take years to recover and, potentially, permanent damage to our competitive position. The longer the current situation persists, the greater the risk that such an event will occur. Other financial centres have recognised this risk in their own markets and taken steps to eliminate or reduce it.

2.1. European Union

Global liability reforms reached a milestone internationally in June 2008 when the European Commission (EC) issued a recommendation to all European Union (EU) member states to address the issue of limiting auditors' civil liability.

The EC recognised, after in-depth research and extensive consultation, that unlimited liability, combined with insufficient or non-existent insurance cover, was no longer sustainable. The EC recommendation represented a response to the increasing trend of litigation and the inadequacy of commercial insurance cover in this sector. It sought to provide more protection to European capital markets by ensuring that sufficient audit capacity would remain available to serve companies listed in the EU.

Consequently, all EU member states are advised to take steps to implement liability reform in their markets if they have not already done so.

2.2. Australia

Australia is a major common law jurisdiction, which has recently introduced extensive auditor liability reforms and its experience is being seen internationally as a valuable model. Australia introduced proportionate liability (i.e. apportionment of liability between defendants according to their responsibility for the loss suffered) and a legal cap for auditors and other professions. This was in answer to the collapse of insurance company HIH and the ensuing loss of insurance capacity in the Australian market.

2.3. Mainland China

The Mainland has also implemented liability reforms for auditors. The auditor liability regime in the Mainland combines the following principles:

- (i) Proportionate liability: In cases of negligence, auditors are liable for damages in proportion to the degree of their fault in preparing the financial statements.
- (ii) Liability sequencing: The audited entity should pay all losses of the claimant, including the audit firm's proportionate share, and the audit firm is called on to pay damages only where the audited entity is unable to do so.

- (iii) Capping: The quantum of the cap is to be determined with reference to the amount of misstatement in the financial statements.

2.4. Bermuda

Although relatively small, this jurisdiction is the place of incorporation of many Hong Kong-listed companies. Capping has been introduced to limit auditors' liability and, unlike Hong Kong, the laws in this jurisdiction do not prohibit contractual arrangements between companies and their auditor to limit the latter's liability.

2.5. Hong Kong: current position

Hong Kong is becoming increasingly isolated in not initiating specific action to mitigate the absence of reform for auditors' liability. Currently in Hong Kong, auditors practising in a partnership, which is the legal form commonly adopted by CPA practices, are jointly and severally liable and their liability in relation to statutory audits is unlimited. The Companies Ordinance prohibits any agreements that seek to limit auditors' liability. Proportionate liability and liability capping are also not provided for in the law. There is, therefore, no legal framework for auditors to mitigate their risk in relation to statutory audits. In the event of the collapse of large audit firm as a result of a very large claim for negligence against it succeeding in court, the partners would face individual bankruptcy, as their personal assets are also at stake in an unlimited joint and several liability regime. As a bankrupt, an auditor may not hold a practising certificate or sign an audit report. Therefore, the collapse of a very large firm would result in a significant immediate and ongoing loss of audit capacity.

3. The Urgency of Reforms for Hong Kong

3.1. Enhancing stability and certainty in the market

Clearly, stability of capital markets is a broad issue, in which auditors' liability is only one element. However, the collapse of a major audit firm as a result of a massive claim against it would be a potential trigger for substantial instability in capital markets. In the event of a sudden and dramatic decline in audit capacity following a large audit firm's collapse, many large listed companies could find themselves unable to produce their audited accounts on time, or within a reasonable period thereafter. This could lead to suspension of trading in the shares of the affected companies and, in a volatile market, a rapid and substantial withdrawal of funds. This gap in the auditing market could not be addressed quickly were the partners of the collapsed firm to be made bankrupt. A rapid flight of capital would affect investors large and small, including those investing directly and those holding investments and pensions through banks and insurance companies. Given the speed of communications and the global nature of financial markets, a local crisis could quickly become an international crisis, as has been amply demonstrated in recent years.

Reform of the auditors' liability regime is needed in Hong Kong to put our capital market on a more secure footing, preserve our competitiveness and provide a safeguard against this potential financial "armageddon". In the past, such a scenario might have seemed remote and largely hypothetical.

However, the recent financial crisis has demonstrated plainly that even the unthinkable can become a reality, and that it can happen extremely quickly. It has also shown that we cannot take capital market stability for granted and that preventative steps should be taken to reinforce the framework under which the market operates, and to deal with any potential areas of weakness.

A professional liability cap set at a sufficiently high level would have no impact on the more routine, day-to-day claims, but it would help to prevent systemic failure in the face of massive claims and improve certainty for all players. With a cap in place, it is expected that, for example, commercial insurers would be better able to provide coverage for larger audit firms, as is now the case in Australia and other markets. The process of making claims and settlement arrangements should also become more efficient and expeditious. Investors will benefit from the protection of their remaining portfolios in a more stable market.

3.2. Claims

Auditors' current exposure to claims in Hong Kong, as in other developed markets, is significant and given the rapid growth of our capital market, together with its "internationalisation", this is likely to increase. Auditors are often seen as "deep pockets", a good target for compensation claims, partly because their liability is unlimited, creating a false expectation on the part of some investors that their losses can be recovered by claiming against auditors. However, this is an unrealistic proposition, given the sheer size of actual and potential claims. It is clear from the Institute's meetings with stakeholders that there is also a common misconception that auditors are fully insured. In order to enhance understanding of the real situation, the Institute plans to commission an independent study in 2010, which will present a clearer picture of the current environment and the wider impact of the auditors' liability regime and claims in Hong Kong.

Although as yet we do not have all the available data to illustrate the possible magnitude of claims in Hong Kong, reference to other major markets will give a sense of the size of the problem. For instance, it was estimated in the authoritative study commissioned by the EC, referred to above, that the biggest single claim the largest audit firm in Europe could sustain over a certain period (four or five years) once the firm's captive insurance resources were exhausted, would be less than 0.3% of the market capitalisation, and just under 0.25% of the turnover, of the largest UK company. The situation in Hong Kong is not likely to be very different.

As a further, and more immediate, example, the recent claim in Hong Kong of over a billion US dollars in relation to the failure of Akai is evidence of the risks facing auditors. It should be noted, whatever the specific circumstances of that case may prove to be, it began as a simple claim for negligence. A claim of this magnitude, were it to be upheld in full in court, would be sufficient to bankrupt most of the top ten largest audit firms in Hong Kong. A larger claim, were it to succeed, could wipe out any audit firm, with potentially very major knock-on effects on the capital market and confidence in Hong Kong's financial markets generally.

Under the Institute's proposal, the proposed liability cap would apply only where innocent mistakes have been made. The objective is primarily to

enable the firm involved to survive under such circumstances and the partners not directly involved in the relevant audit to be able to maintain their professional livelihoods. Where any criminal activity has been involved, on the other hand, the liability cap would not apply, and certainly not to any individual who may have engaged in that activity.

3.3. Emerging markets risks

Hong Kong is an international financial marketplace, which attracts foreign investors wishing to invest in this region, particularly the opportunities offered by the rapid growth of the Mainland economy. Some of these investors are from jurisdictions that are commonly regarded as being significantly more litigious than Hong Kong. The stock exchange is also aiming to expand listings from emerging economy issuers, which is likely to further increase international participation in the market and also raise the risk profile. Hong Kong auditors are involved in advising on huge initial public offerings, and subsequent audits, of companies with an investor base that includes large foreign institutional investors and funds, in addition to local funds and large numbers of retail investors. In relation to retail investors, possible future developments, such as the introduction of procedures for class action suits, a proposal currently under discussion, also add to the concern. In short, while the risks for auditors have been increasing substantially, there has been no commensurate change in the scope for auditors to mitigate those risks. As such, the situation is becoming untenable.

3.4. Sustainability of the audit profession

Partly because of the risks involved, major firms find it particularly difficult to retain talented professionals, who should, all things being equal, be expected to achieve partnership in their audit practice. There are increasing instances of high performers declining to become partners in order to avoid having to assume this liability risk. After gaining considerable experience, more talented audit professionals may leave for other, less risky practice areas, or move externally to fill accounting-related positions in the commercial sector. The sustainability of a quality audit profession in Hong Kong is at stake. If the “brain drain” continues, it will, at some stage, have an impact on the effectiveness of the relationship between auditors and company senior management, if, for example, senior management consider that they are not getting the support at the right level, or if the auditors are not able to speak to senior management with the appropriate degree of authority, persuasiveness and knowledge. Ultimately, this may affect the international investment community’s confidence in Hong Kong.

4. Stakeholders’ Views

During the past year, the Institute has engaged with a wide range of stakeholders with a view to enhancing their understanding of the issues and seeking feedback on possible challenges to proposals for reforms that would bolster Hong Kong’s position as a financial centre. We have received useful and constructive views and some positive initial responses. We are confident of being able to respond to the few main potential challenges that stakeholders have identified. A list of the stakeholders that the Institute has met to discuss liability reforms is attached as Appendix 3. Stakeholders’ main suggestions for moving reforms forward can be summarised as follows:

- (i) It is essential to bring public opinion on side by highlighting the overall interests for Hong Kong and investors, big and small, of pursuing liability reform.
- (ii) It is important to explain to the public that audit quality would not be compromised if liability is limited.
- (iii) That Hong Kong's future development as an international centre is at stake is an important rallying point, especially when other major markets and jurisdictions have introduced reforms, leaving Hong Kong as the only major market without any kind of market safeguard in place.
- (iv) It should be explained to the public that little or no commercial insurance is currently available in Hong Kong for large audit firms in respect of listed company audits, and that introducing reforms would be more likely to create an insurable risk, which would improve certainty, as well as benefiting the development of the local insurance market.

It should also be noted that stakeholders are not generally aware of the extent of the problem facing auditors. Regarding point (iv) above, for example, most stakeholders believe, incorrectly, that any liability claims would be covered by commercial insurance.

5. Proposed Reform Directions

The Institute's intention is to minimise the risk of a major audit firm collapsing, leading to instability and a loss of confidence in Hong Kong's capital market and, potentially, a financial "meltdown", with far-reaching consequences in Hong Kong and other markets. The proposed means to achieve this is the introduction of capping of auditors' liability through legislation, together with a system of proportionate liability. The statutory cap would be set at a sufficiently high level, as it would be intended to safeguard against a disaster scenario and not to affect routine claims. While we have explained to stakeholders that the maintenance of audit quality is a function of a raft of regulatory and reputational factors, and not driven by the threat of unlimited liability facing auditors, nevertheless a cap set at a reasonably high level could also be perceived by the public as a sufficient deterrent against any drop in standards.

The capping mechanism could include a variable amount based on a suitable benchmark (e.g., audit fees) subject to an absolute maximum limit. This is the mechanism that has been adopted in Australia, and also other markets. It helps to ensure that the needs and resources of smaller firms are taken on board and that there is no inherent bias towards very large audit firms.

It should be reiterated that the proposed regime would not protect auditors from actions arising from criminal conduct, but would help to ensure the survival of the firm and the livelihoods of partners not involved in the case, when individual auditors made inadvertent negligent mistakes.

In our discussions with stakeholders, some parties have enquired whether existing avenues, such as incorporation of audit firms, or other alternatives, e.g., limited liability partnerships (LLPs), would be enough to provide the stability and the safeguards for the capital market and the audit profession. The Institute is of the view that these measures are, first and foremost alternative modes of practice and, while they may be useful in that regard, they cannot offer an effective solution to the main problem outlined above. Reasons for this include:

- (i) While incorporation and LLPs can help to protect the assets of innocent partners not directly involved in a negligence claim, operating in either of these modes of practice would not prevent a firm from collapsing under the weight of a massive claim, and would not address the risks of capital market instability.

Therefore, while enabling auditors to set up LLPs as an alternative mode of practice, as is currently being considered for law firms, would be a worthwhile measure in itself, it would not address the fundamental problem.

- (ii) Incorporation of audit firms, which has been permitted since 1996, is not practicable for large firms, given that:
 - they may have upwards of 300 partners (so not all partners could become directors and complicated internal arrangements would be needed to adopt a corporate form);
 - maintaining the “partnership ethos” is more suitable for them;
 - they would not be in a position to meet the statutory professional indemnity insurance requirements, due to the unavailability of sufficient commercial insurance, referred to above.

6. Next Steps

The Institute will continue to build the case for introducing liability capping and proportionate liability, including through commissioning an in-depth consultancy study and continuing with stakeholder engagement work. The Institute is planning to undertake the following this year:

- (i) Commission the consultants that undertook the EU research to study the impact of the auditors’ liability regime and claims in Hong Kong.
- (ii) Continue to engage stakeholders on the need for and urgency of reforms.
- (iii) Increase media work to explain the issues and the reform proposal.
- (iv) Produce more detailed and specific proposals to discuss with stakeholders and present to the government.

The Institute hopes to maintain its dialogue with the government on this crucial reform proposal, in the interests of supporting Hong Kong’s long-term development and standing as an international financial centre.

Appendix 1

Initiatives conducted by the Institute in respect of liability reform in 2009/2010

The Institute's reconstituted professional liability reform working group met regularly in 2009 and has continued to do so in 2010, to discuss progress of the liability reform project. The working group comprises of:

Paul F. Winkelmann	Chair
Winnie C.W. Cheung	Deputy Chair
Albert Au Siu Cheung	Member
William Andrew Crowe	Member
Wilson Fung Ying Wai	Member
Richard John Weir George	Member
Alden Leung Kwok Ki	Member
David Smyth	Member
Desmond Yuen Kwok Keung	Member

Major initiatives that have taken place include:

- (i) Visit by Peter Wyman, London-based global leader for public policy and regulatory affairs at PwC, who was closely involved in UK's liability reform. He and Paul F. Winkelmann, the 2009 Institute president (and chair of the professional liability reform working group) conducted a series of meetings and briefings with key stakeholders.
- (ii) Visit by Bill Palmer of the Institute of Chartered Accountants of Australia, who was closely involved in Australia's extensive liability reform, to brief the working group on developments in Australia.
- (iii) Engagement of a public affairs consultant, APCO Asia Ltd., to assist in strategic planning and other key aspects of the campaign.
- (iv) Meeting with the international regulatory working group from the six global accounting networks to discuss the developments in the liability regimes of other jurisdictions and proposals for pursuing reform in Hong Kong.
- (v) Meetings with major stakeholders by the chair and other representatives of the working group, and representatives of the management, to outline the issues and seek feedback. Stakeholders include the government, business associations, financial service sector organisations and regulators, academics, legislators, professional and consumer bodies, capital market participants, media, and Institute member firms and members.
- (vi) Educating the public and increasing awareness in relation to professional liability reform through the media. For example:
 - The discussion on liability reform was renewed early in 2009. It was the main subject when South China Morning Post featured Paul F. Winkelmann in an exclusive interview with him as Institute's president.

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- In the context of the snowballing financial crisis, the possibility of more corporate failures and litigation was quite real, which raised the prospect of investors or creditors potentially seeking enormous sums in compensation from auditors. The news media covered this angle and wrote about the Institute's concern that auditor liability was a pressing problem, particularly in the global economic downturn.
- The fact that Hong Kong does not have any kind of liability reform, while most of the major world capital markets have liability capping, or other mitigation measures, in place in the event of a lawsuit against an auditor, captured the interest of news media and continued the intelligent debate about liability reform on the news pages.
- The subject of the Institute's campaign was covered in all the influential papers as news and in editorial columns for two consecutive days in February 2009 when the Institute held a press briefing during Peter Wyman's visit.
- Liability reform was the topic of discussion in an informal lunch with the president and the media in October 2009. As a consequence, newspaper reports gave the topic substantial coverage.
- Liability reform was the cover feature in the October 2009 issue of the Institute's journal, "A Plus".

The table below summarises the Institute's information on the different regimes in other jurisdictions.

Jurisdictions ¹	Capping		Mode of practice		Proportionate Liability
	Statutory liability cap	Ability to limit liability contractually	Limited liability partnerships	Corporate practices	
Australia	✓		✓ ³	✓	✓
Austria	✓				
Belgium	✓				
Bulgaria	✓				
Bermuda		✓	✓		✓
Canada			✓		✓
Cyprus	✓				
Czech Republic					✓
Denmark					✓
Estonia	✓				
France					✓
Germany	✓				
Greece	✓				
Hungary					✓
Latvia	✓				
Hong Kong				✓	
Mainland China	✓		✓		✓
Poland	✓				
Romania	✓				
Singapore			✓	✓	
Slovakia	✓				
Slovenia	✓				
Sweden	✓ (in draft)				
United Kingdom		✓ ²	✓	✓	
United States of America			✓		✓

¹ In 2008, the European Commission issued a recommendation to all EU member states to implement measures to limit auditors' civil liability. In addition to the existing measures shown in the table, statutory caps are currently being actively considered in Finland, Ireland and Spain.

² The UK is reviewing deficiencies with its previous reforms that allow liability to be limited contractually, and is looking at the option of a statutory cap.

³ We understand that limited liability partnerships are not generally used in Australia and capping removes the need to use such structures.

External

Industry groups

1. Business and Professionals Federation of Hong Kong
2. Federation of Hong Kong Industries
3. Hong Kong General Chamber of Commerce
4. The Chamber of Hong Kong Listed Companies
5. The Chinese General Chamber of Commerce
6. The Hong Kong Institute of Directors
7. The Real Estate Developers Association of Hong Kong

Financial service sector/ capital market participants

8. Asian Corporate Governance Association
9. Hong Kong Investment Funds Association
10. Hong Kong Trustees Association
11. The Hong Kong Association of Banks
12. The Hong Kong Federation of Insurers
13. The Hong Kong Society of Financial Analysts

Regulators

14. Hong Kong Monetary Authority
15. Hong Kong Exchanges and Clearing
16. Office of the Commissioner of Insurance
17. Securities and Futures Commission

Academic

18. Hong Kong Baptist University
19. City University of Hong Kong
20. The Chinese University of Hong Kong
21. The Hong Kong Polytechnic University
22. The Hong Kong University of Science and Technology
23. The University of Hong Kong

Legislators

24. Legislators representing various geographical and functional constituencies

Others

25. Consumer Council

Internal

26. Institute member firms
27. Institute members