“A Case for Professional Liability Reform in Hong Kong”

Three Important Proposals from the Hong Kong Institute of Certified Public Accountants for Liability Reform That Will Safeguard Hong Kong’s Position as a Global Financial Centre

Hong Kong 14 March 2005
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**Annex I** – Hong Kong Institute of CPAs’ Submission dated 16 April 2002 on Proportionate Liability

**Annex II** – Hong Kong Institute of CPAs’ Submission dated 17 October 2003 on Proportionate Liability and Repeal of section 165 of the Companies Ordinance

**Annex III** – Hong Kong Institute of CPAs’ Submission dated 25 November 2004 on the Introduction of Limited Liability Partnerships in Hong Kong
EXECUTIVE SUMMARY

1. The work of the Hong Kong Institute of Certified Public Accountants (Institute) (formerly the Hong Kong Society of Accountants) in relation to Professional Liability Reform in Hong Kong includes the introduction of corporate practices for CPAs (which became effective since 2 August 1996) and advocating the introduction of proportionate liability, the repeal of section 165 of the Companies Ordinance and the introduction of Limited Liability Partnerships (LLPs).

2. The case for Proportionate Liability and Repeal of section 165 of the Companies Ordinance

a. The Institute made a submission “Proposal for an Equitable System of Liability” to the Government on 16 April 2002 (Annex I) which advocates a system of proportionate liability to address concerns over the joint & several liability framework. The principles behind joint & several liability framework and proportionate liability framework can be briefly explained as follows:

(i) Joint & several liability framework
The effect of the principle of the joint and several liability is that where two or more parties are negligent in performing their role in a transaction which causes loss to a plaintiff, the plaintiff can recover his loss in full from any one defendant without reference to the actual share of the fault of each defendant.

(ii) Proportionate liability framework
Under a system of proportionate liability, the liability of a defendant is limited to that proportion of the damages suffered by a plaintiff which is directly referable to that person’s degree of fault. Courts would then decide on the respective responsibility of various defendants with just and fair regard to all the relevant circumstances.
b. A follow-up submission was made by the Institute on 17 October 2003 (Annex II) in response to the Government’s Standing Committee on Company Law Reform’s (SCCLR) Consultation Paper of its Corporate Governance Review on “Auditors’ Liability”. The SCCLR has considered the Institute’s submission and concluded that the issue of proportionate liability had wide implications which were beyond its remit. The SCCLR therefore stated in its twentieth annual report that the matter should be referred to the Law Reform Commission for further study and consideration in the context of civil liability reform. The Institute has recently written to the Secretary for Justice and the Chief Justice requesting them to make an “official” referral to the Law Reform Commission to undertake a study on proportionate liability.

c. Furthermore, indications are strong in the United Kingdom that proportionate liability by contract will appear in a companies bill, hinging on the profession providing certain guarantees.

d. The key aspects of the two Institute’s submissions are:

**The case for Proportionate Liability**

(i) Joint and several liability is no longer appropriate in the recent and current commercial and business environment, as it results in liability wholly disproportionate to the contribution of any particular defendant to the overall loss, although it is still appropriate where a defendant seeking to restrict liability has been found by the Court to have caused the damage or loss as a result of fraud, dishonesty or wilful default and for personal injury actions.

(ii) The consequence of joint and several liability is that a plaintiff will target defendants with “deep pockets” rather than pursue those primarily to blame for the loss suffered.

- Professionals should take responsibility for their breaches of duty.

  The concern is to avoid the unfairness of professionals having to
pay more than their fair share of loss suffered when they only have partial responsibility for that loss.

- Professionals will be accountable for their conduct and will be responsible for the financial consequences. They should not, however, bear the financial consequences of others’ shortcomings.

(iii) For auditors in particular, the amount of damages claimed against them in some cases is so huge that neither the professionals nor their insurers could cover them.

(iv) The profession needs talented people at a time when the financial complexity of business is increasing. Experienced qualified accountants must be encouraged to stay in the profession to make a career. They should not be scared away by the potential catastrophic claims against their employers or own practices.

The case for a repeal of section 165 of the Companies Ordinance

(i) To implement liability reform to repeal that part of section 165 of the Companies Ordinance which prohibits auditors from contractually limiting liability with clients in respect of audit work.

(ii) This is already standard practice for a number of other professions and businesses, including accountancy firms in their non-audit business activities.

(iii) The position of the company and its shareholders will not be prejudiced as a result provided that it is a condition that the limit on liability is approved by the company at its Annual General Meeting.

(iv) The repeal of the relevant part of section 165 of the Companies Ordinance will be beneficial but cannot be the total answer as it will not address an auditor’s liability in respect of claims by third parties.
3. **The case for Limited Liability Partnerships (LLPs)**

a. The Institute also made a submission to the Government on 25 November 2004 (Annex III) advocating the introduction of LLPs in Hong Kong, in addition to incorporation, to address the issue of joint and several liability faced by general partnerships. The Institute has worked closely with the Law Society of Hong Kong in this regard and the Institute’s submission is intended to supplement the Law Society Working Party Report on LLPs submitted to the Registrar of Companies and the Solicitor General in August 2004.

b. Furthermore, it should be noted that in Singapore, after extensive public consultation, the Government has decided to accept the private sector-led Company Legislative and Regulatory Framework Committee’s recommendation to introduce LLPs in Singapore.

c. The key aspects of the Institute’s submission are:

   (i) LLPs remove the risk for the innocent partners but leave the claimant with a remedy against the LLP and the individual partner or partners responsible for the alleged breach of duty.

   (ii) This results in a fairer distribution of the risks inherent in the current business climate.

   (iii) Professionals play a vital role in the operation of capital markets and in helping to promote confidence in good corporate governance generally in Hong Kong. It is not in the interests of anyone involved in the capital markets for professionals to conduct their duties in a defensive way.
(iv) The introduction of LLPs will at least reduce some concerns of the bigger accounting firms which consider that incorporation is not appropriate for them.

(v) If Hong Kong is to maintain its position as a global financial centre, it needs to have a sufficient pool of high quality professionals including, auditors. It is not in the public interest where the risk stakes are disproportionately high which will discourage “the best and the brightest” from entering and remaining in the accounting profession.

(vi) The world has also grown more litigious. Whilst Hong Kong may consider itself lucky to date, there is no room for any complacency.

(vii) Over the past 10 years, Hong Kong accounting firms have been taking on an increasing amount of work which has an extraterritorial element to it, such as cross border listings of companies on the Hong Kong Stock Exchange as well as the stock exchanges in US, UK or Singapore. Such work carries additional risks, such as class action law suits by shareholders in the US.

(viii) Litigation as a common way for plaintiffs to obtain redress reflects the growing sophistication of the community and is becoming an acceptable part of how business is conducted in many jurisdictions.

(ix) Auditors, as an important part of the business fabric of Hong Kong, have to accept this new business reality, but seek the alternative business structure of a LLP so that they can participate on a level playing field compared with other jurisdictions. LLPs exist in many jurisdictions, including those in which major financial centres are situated.
4. **Developments in major overseas jurisdictions**

Other jurisdictions have made or are making considerable progress on liability reform while Hong Kong stands still.

a. **Australia**
Based on our findings, Australia has:
- Proportionate liability
- Ability to limit liability contractually
- Corporate practices
- Statutory liability cap

b. **Canada**
Based on our findings, Canada has:
- Proportionate liability
- LLPs

c. **UK**
Based on our findings, UK has/will have:
- Proportionate liability by contract
- LLPs
- Corporate practices

d. **Other European Union countries**
Based on our findings, a number of the European Union countries have:
- Proportionate liability
- Ability to limit liability contractually
- LLPs
- Corporate practices
- Statutory liability cap
Based on our findings, the USA has:

- Proportionate liability
- Ability to limit liability contractually
- LLPs

**In contrast, Hong Kong currently only allows corporate practices.**

5. **Consumer interests**

The Institute has considered whether its liability reform proposals are in the interests of consumers.

a. The Institute’s proposal for proportionate liability does not entail the wholesale displacement or exclusion of the principle of joint and several liability. To protect consumer interests, the Institute is proposing that proportionate liability should be introduced with exceptions. These exceptions would recognize that there are areas in which the principle of joint and several liability should continue to operate with normal consequences such as:

- Where the defendant seeking to restrict liability has been found by the Court to have caused the damage or loss as a result of his fraud, dishonesty or wilful default; and
- Personal injury actions.

b. The repeal of that part of section 165 of the Companies Ordinance which prohibits auditors from contractually limiting liability in respect of audit work would allow auditors to agree with the company on contractual limits for the auditor’s liability to it. To protect investors’ interests, such reform should have a condition such that the limit on liability should be approved by the company at its Annual General Meeting and disclosed in the company’s annual report and accounts.
c. In relation to the introduction of LLPs, the fact that accounting firms are allowed to practise through corporate practices suggests that Hong Kong has satisfied itself that a limitation on liability of auditors via LLPs is not inconsistent with consumer interests.

6. **The Public Interest**

The Institute is Hong Kong’s only statutory licensing body for accountants. It has more than 24,000 members and close to 10,000 registered students. The Institute operates under the Professional Accountants Ordinance and in the public interest. It has wide ranging responsibilities that include maintenance of the quality of entry to the profession through its postgraduate Qualification Programme, promulgation of first class financial reporting, auditing and ethical standards in Hong Kong and development of the accounting and auditing professions. It has responsibility for regulating and promoting high quality and efficient accounting practices to safeguard Hong Kong’s role as a global financial centre.

However, the Institute adamantly believes that Hong Kong’s liability framework has not evolved in step with developments in the economic, financial and litigious environment in which its members are currently practising and is no longer appropriate to the nature of work performed by professionals in Hong Kong. The imperatives which have driven the need for change are:

- Hong Kong has transformed itself over the last ten years from a local financial centre to a global financial centre.
- Globalization results in the need for an appropriate liability framework for the business and other risks arising from cross border transactions.
- The increased internationalization of commerce has resulted in the development of an increasingly litigious environment while Hong Kong does not provide the legal protections available in other similar jurisdictions.
- Hong Kong is the focus of fund raising for mainland enterprises, creating an increase in the volume and scale of assurance work whilst the liability framework remains unchanged.
• Adequate insurance cover is becoming increasingly scarce and the collapse of one or more of the major accounting firms, which Enron/Andersen graphically demonstrated can happen, would have an extremely damaging effect on everyone with an interest in a healthy financial market.

• Most sophisticated jurisdictions have or are introducing liability reforms. If Hong Kong is left behind, Hong Kong will be less attractive to talented individuals which will inevitably reduce its competitiveness as a global financial centre.

• Uncertainties regarding the future of the profession will make recruitment and retention of the best people more difficult.

PROFESSIONAL LIABILITY REFORM IS NOW VITAL FOR HONG KONG
1 Introduction

1.1 Background

It is quite right that professionals should be accountable for their actions and should bear losses which they cause to others through their own negligence. The accounting profession globally and in Hong Kong is making a significant contribution to reduce the risk of losses arising through the actions of its members by supporting various initiatives to improve audit quality and financial reporting. However, the Institute believes that Hong Kong’s liability framework has not evolved in step with developments in the economic, financial and litigious environment in which its members are currently practising and is no longer appropriate to the nature of work performed by professionals in Hong Kong.

The work of the Institute in relation to liability reform in Hong Kong includes having introduced corporate practices for accounting firms, advocating that the Government introduce proportionate liability for professionals, proposing the repeal of that part of section 165 of the Companies Ordinance which prohibits auditors from contractually limiting liability with clients in respect of audit work and supporting the introduction of LLPs for practising professionals.

The Institute has previously made the following submissions on liability reform to the Government:


This document, entitled “A Case for Professional Liability Reform in Hong Kong”, sets out a comprehensive summary of why the Institute’s three liability reform proposals should be introduced in Hong Kong to safeguard its position as a global financial centre. In short, the proposals, which are necessary to ensure a level playing field with our international counterparts, are:
1. Introduction of Proportionate Liability in Hong Kong

2. Repeal of that part of section 165 of the Companies Ordinance which prohibits auditors from contractually limiting liability with clients in respect of audit work

3. Introduction of LLPs in Hong Kong for professionals

For ease of explanation, the rest of this document refers specifically to the accounting profession, although the arguments set forth may equally apply to other professions. In addition, the Institute would like to emphasize at the outset that it is its belief that accountants in Hong Kong are willing to and do take responsibility for their actions or breaches of duty.

The existing liability framework, however, potentially places an unfair burden on firms where they are only partially responsible for a loss which could, in certain circumstances have dire consequences for a firm, resulting in significant adverse consequences on the stability of the financial markets, the interest of the public at large and Hong Kong’s position as a global financial centre. It is important to be clear that what is being proposed does not amount to preferential treatment for professionals. The Institute’s three proposals are already available elsewhere in other major financial centres.

1.2 Steps being taken to improve quality of auditing

The Institute is already working with the Government to introduce a bill to the LegCo in the current session to establish the Financial Reporting Council, the umbrella for the Audit Investigation Board (AIB) and the Financial Reporting Review Panel (FRRP). The AIB and FRRP will take on the regulatory role now carried out by the Institute in relation to the accounts of listed entities and their audits. The Institute supports the view that the AIB will strengthen the regulatory oversight of auditors and the quality of auditing and the FRRP will strengthen the quality of financial reporting. The Institute and its members will be providing significant financial support for these initiatives. Furthermore, the Institute is currently reviewing its practice review programme to enhance the methodology and approach, including the setting up of a new Practice Review Steering Board. Together, these initiatives will enhance Hong Kong’s reputation as a global financial centre. In this connection, the Institute now
feels that it is also the right time for professional liability reform to be introduced to support this framework of enhanced standards and increased regulation.
2 Case for reform

2.1 Transformation of Hong Kong from a regional financial centre to a global financial centre

Hong Kong has transformed itself over the last ten years from a regional financial centre to a global financial centre. It was the world’s third largest market in terms of funds raised last year and this trend is continuing. Accounting firms have been taking on an increasing amount of work with extraterritorial elements, such as cross border listings of Mainland companies on the Hong Kong Stock Exchange, as well as the Stock Exchanges in the US, UK and Singapore. In addition, an increased level of risk arises from assurance work such as:

- the audits of subsidiaries of US SEC registrants;
- compliance evaluations in relation to internal controls brought about by the US Sarbanes-Oxley Act;
- compliance evaluations in relation to internal controls requested by directors of Hong Kong listed companies due to new Corporate Governance requirements;
- requests to reporting accountants by sponsors of listing companies to produce “Long Form” reports due to changes in Listing Rules; and
- assisting in the extraction of financial information for publication in the public interest.

Such work carries a high risk, not only through the increase in scale of the potential risks (both in terms of volume and financial amounts involved) but through exposures of a different nature such as class action suits by shareholders in the US. Furthermore, in jurisdictions such as the US where the legal system allows lawyers to act on a contingency fee basis, there may be a greater incentive for plaintiffs to initiate lawsuits even for frivolous claims. The absence of costs awards means that there are no downside risks for initiating such claims. Furthermore, with joint and several liability still in place, there may be an incentive under the contingency fee system to initiate claims and inflate the damages being claimed resulting in defendants to these claims, however frivolous they may be, having to incur substantial sums in legal costs just to defend themselves.
Liability reforms have not been introduced in Hong Kong in tandem with its growth in status as a global financial centre despite the increasing growth of a “compensation culture” around the world and are therefore long overdue. In this connection, it should also be noted that the US Securities Act of 1933 provides greater clarity as to the responsibilities of participants in the capital market. Hong Kong does not have a similar Securities Act clarifying the rights and obligations of the participants in the capital market and therefore liability reforms are all the more crucial.

2.2 Availability of adequate insurance

Hong Kong has a strong accounting profession where failures are rare but it is vital that this is not allowed to disguise the threat inherent in a failure to introduce liability reforms before it is too late.

At present under the law of joint and several liability, auditors are accountable not only for their own actions or failings, but also for those of other parties who as a result of their actions are responsible for, but do not have the money to, meet claims awarded against them. Auditors’ potential liability is unlimited even for events which are not necessarily under their control, but that liability is not capable of being matched by appropriate financial resources. The ability of even the largest accounting firms to meet catastrophic claims is severely limited by the lack of adequate professional indemnity insurance. As in the UK, there is no market for insurance which transfers this risk and none is likely to arise. Unlike auditors in other jurisdictions the liability of Hong Kong auditors is not subject to proportionate liability nor do auditors have the ability to limit liability contractually in respect of audit work. Instead, firms have to rely on their limited capital resources and in-house captive insurance vehicles which are unable to spread the risk. Given the scale of capital available to accounting firms relative to the market capitalization of the businesses audited, in particular Mainland state-owned enterprises, it will not be possible for accounting firms to build up sufficient reserves to provide the scale of cover which would be necessary to match the market capitalization of one, let alone all, of the largest companies. It is wholly unrealistic, and was not the intention when statutory auditing requirements were introduced to expect accounting firms to act as insurers of last resort.
The dangers of relying on insurance cover were clearly demonstrated recently in Australia where there was a serious market failure in the professional indemnity insurance market, after the collapse of HIH Casualty & General Insurance Company. This resulted in a significant risk that services would be carried out by uninsured persons or, as happened in practice, certain suppliers refusing to provide services for fear of the sheer scale of the legal damages that could follow a claim against them. This was the catalyst that triggered Australia to introduce reforms and explains why Australia is now ahead of a number of jurisdictions in liability reform.

2.3 A level playing field with major jurisdictions

The following sets out the position in other jurisdictions on liability reform which shows that Hong Kong is indeed falling very much behind:

(i) Australia

- The Australian Federal and State governments have taken major steps to advance liability reform through implementation of measures for proportionate liability; a nationally consistent regime of Professional Standards Legislation providing a statutory liability cap, while not prohibiting limiting liability by contract; incorporation of auditors; and reforms to the Federal Trade Practices Act (to give complete effect to proportionate liability and the ability for auditors to limit liability contractually).
- Legislation has been passed at the Federal level in Australia, permitting incorporation of audit practices, introducing proportionate liability between concurrent wrongdoers, and extending the operation of State professional standards schemes to cover liability arising from breach of specified Federal laws.
- Five States and/or Territories have introduced proportionate liability bills – the remaining three (Northern Territory, Southern Australia and Tasmania) have stated publicly their intention to do so (Southern Australia), released draft legislation (Northern Territory) or introduced a Bill to Parliament (Tasmania).
- Professional standards legislation has been enacted now in seven of the eight States or Territories. The remaining State has publicly committed to do so and has released a draft of its legislation for public consultation.
In summary, Australia has:
- Proportionate liability
- Ability to limit liability contractually
- Corporate practices
- Statutory liability cap

(ii) Canada
- At the Federal level, a modified proportionate liability regime came into force under the Canada Business Corporations Act and the Canada Cooperatives Act on 24 November 2001.
- LLPs are now available in British Columbia, Alberta, Saskatchewan, Manitoba, Ontario, Quebec, New Brunswick and Nova Scotia.
- In summary, Canada has:
  - Proportionate liability
  - LLPs

(iii) UK
- The Department of Trade and Industry indicated that the UK Government remains committed to improving the operation of the capital market and will consider any proposals, including the possibility of limiting liability on a proportionate basis by contract, which can be demonstrated to significantly enhance competition and to improve quality in the audit market.
- In summary, if the proposals become law, UK has/will have:
  - Proportionate liability by contract
  - LLPs
  - Corporate practices
- It is also worth noting that one of the larger accounting firms incorporated as a corporate practice when it had the opportunity to do so and has now left the corporate practice more or less dormant by transferring the business to an LLP once LLPs became available in 2000. Clearly, this shows that LLP is a better operating vehicle for a large accounting firm than incorporation for the reasons mentioned in the Institute’s Paper on LLPs.
(iv) Other European Union (EU) countries

- The 8th Directive of the EU provides that all member states should introduce liability reform provisions in their member states.

- Ten member states permit some form of limitation of an auditor’s liability (e.g. Germany has a cap of four million Euros). This can be by way of a limitation imposed by law (e.g. Austria, Germany, Greece and Slovenia), permitting auditors to limit their liability on a contractual basis (e.g. Denmark, Latvia, Lithuania and Poland) or having a liability regime that assesses an auditor’s responsibility on a proportionate basis (e.g. France and Malta). In addition Finland and the Netherlands have liability regimes which involve an element of proportionality, and limiting liability is common in the Dutch audit market for unlisted companies.

- Belgium and Italy have been or are currently considering a legal limit on auditors’ liability based on a multiple of audit fees. In Italy, a limit based on a multiple of ten times fees has been included in a draft law, whilst in Belgium (where the corporate sector is smaller than in Italy) a multiple of fifty times fees is being discussed. In Portugal, there is a proposed draft law that would introduce liability reform if enacted as drafted.

- In summary, the major countries in the EU have/will have:
  - Proportionate liability
  - Ability to limit liability contractually
  - LLPs
  - Corporate practices
  - Statutory liability cap

(v) USA

- There has been no significant liability reform in the USA since the profession led legislation in 1995, which introduced proportionate liability protection in certain circumstances.

- LLPs were introduced in the USA in 1991.

- In summary, some states in the USA have:
  - Proportionate liability
  - Ability to limit liability contractually
  - LLPs
In contrast, Hong Kong currently only allows corporate practices.

Graphically, this can be illustrated as follows:

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<th>Other EU Countries</th>
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<tr>
<td><strong>Proportionate Liability</strong></td>
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<td><strong>Ability to limit liability contractually</strong></td>
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<td><strong>Limited Liability Partnerships</strong></td>
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<td><strong>Corporate practices</strong></td>
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<td><strong>Statutory liability cap</strong></td>
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2.4 **Concept of joint and several liability requires modification in the current business environment**

Joint and several liability came into being many years ago when businesses were fairly small and straightforward. The current business environment is completely different. There are many participants in the current business environment all of whom knowingly participate with their "eyes open" being fully aware of the risks involve. In this context having one person bearing all the consequences without reference to the actual share of the fault of each defendant is unfair and unreasonable.
3 Benefits of reform

3.1 Sustaining Hong Kong’s role as a global financial centre

With appropriate liability reforms in line with other major jurisdictions, the Hong Kong audit profession will continue to attract some of our brightest and most talented young people to join, train and remain in a profession able to offer an excellent career. The quality of assurance work and therefore the ability of the investing public to have confidence in the financial statements is dependent on the ability of accounting firms to maintain the quality of new professional recruits, and having trained them, to keep these skilled and highly employable professionals within the audit sector.

An environment where the risks are disproportionately high will discourage the best and the brightest from entering and remaining in the audit profession. There is already evidence overseas suggesting that liability risks are deterring some from remaining within the audit profession. Our proposals will help to overcome this threat.

In addition, the increasing demand for trained Hong Kong accountants from Mainland enterprises is a strong incentive for graduates to enter the profession and will improve the financial reporting of Mainland enterprises, many of which will go on to raise capital in Hong Kong and other capital markets. This is clearly important for the credibility of the enterprises concerned and for that of Hong Kong itself. Therefore, the territory needs a sufficient pool of high quality professionals to ensure that Hong Kong maintains its position as a major global financial centre and the best place to raise funds for Mainland companies. Furthermore, the need to have a sufficient pool of high quality professionals is exacerbated by new regulatory changes such as provisions in International Financial Reporting Standards, the US Sarbanes-Oxley Act and the new Basel Capital Accord, as well as anti-money laundering and privacy-protection laws. Accordingly more high quality professionals are needed to provide services in these areas in an increasingly sophisticated and competitive environment.

3.2 Improvement in financial reporting to meet market demands

It is the view of the Institute that liability reforms would facilitate improvements in financial information reporting and the assurance thereon, through auditors taking on
a more meaningful role in relation to the governance and financial reporting of listed companies, in line with international trends. Auditors would be more willing to take on the demand for additional assurance services outside that of the statutory audit. All international developments in these areas, for which the Institute believes appropriate liability reforms must be a pre-requisite, will benefit shareholders and support the growth of capital markets. Examples in this regard are:

- the recent changes in Listing Rules governing sponsors such that sponsors are now requesting reporting accountants to give comfort in the form of “Long Form” reports on listing companies;
- reporting on internal controls to regulators and shareholders;
- reporting on directors’ remuneration schedules; and
- assisting in the extraction of financial information for publication in the public interest.

### 3.3 Proportionate liability provides a more equitable result

Under proportionate liability, auditors would still be responsible for the consequences of their actions. The courts would award damages against a negligent auditor for that proportion of the company’s loss that reflects the extent of the auditor’s responsibility for the damage suffered. The proposals would mean only that the auditor would not have to pay for the actions of others who are responsible for, but do not have the resources to meet damages awarded against them. It is not economically efficient or equitable for a market to operate on the expectation that all financial deficiencies will be compensated by one party (in this case, the auditors who may have performed only a limited role). Proportionate liability provides an equitable result.
4 Recommendations

4.1 The Institute’s three proposals

The Institute recommends that all three proposals be considered now. This is because each of the three liability reform proposals is designed to meet a different risk.

1. The introduction of proportionate liability protects the market by significantly reducing the increasingly real risk that one of the larger audit firms could collapse as a result of a catastrophic claim, for which the audit firm might have a relatively small share of the responsibility.

2. Repeal of that part of section 165 of the Companies Ordinance, which prohibits auditors from contractually limiting liability with clients in respect of audit work, would allow auditors to agree on contractual limits for the auditors’ liability to clients. Such reform would not be against the public interest particularly if it is a condition that the limit on liability should be approved by the company at its Annual General Meeting and disclosed in the company’s annual report and accounts.

Contractually limiting liability with clients is already standard practice for other professions and businesses, including accountancy firms in their non-audit business activities. However, it should be noted that the repeal of the relevant part of section 165 of the Companies Ordinance will be beneficial, but cannot be the total answer as it will not address an auditor’s liability in respect of claims by third parties.

3. The introduction of LLPs would protect innocent individual partners, other than those directly involved in the audit in question, from losing their personal assets (other than those invested in the firm) in the event of a large damages award against the firm. Accordingly, limited liability status protects individual partners. However, LLPs do not protect the firms themselves, just as limited company status does not prevent companies becoming bankrupt.
4.2 **Where does Hong Kong stand in comparison with other capital markets?**

Hong Kong is a global player in the international capital markets for fund raising. Hong Kong’s Accounting Standards, Auditing Standards, Ethical Standards and others are largely in line with those adopted internationally. Client engagement letters of the International accounting firms necessarily follow international trends which are generally established within a liability framework in major jurisdictions that already have liability reform measures in place. Regulatory authorities now have zero tolerance for errors. The Institute understands that this is part of the business environment in which auditors operate save that when it comes to catastrophic claims, global international firms operating in other jurisdictions are doing business under a reformed liability regime. That does not apply to firms operating in Hong Kong. Hong Kong will fail its capital markets and as a consequence, the public interest, in the absence of appropriate liability reform as proposed by the Institute.

Hong Kong accounting firms are already registered with the US Public Company Accounting Oversight Board which was set up to monitor the auditors of SEC listed companies after the accounting scandals in the US. Liability reforms have been introduced elsewhere which do not apply in Hong Kong, which makes it imperative for Hong Kong to adopt liability reforms similar to those adopted elsewhere.
5 Threats if no reform

5.1 Probable life threatening scenario for Hong Kong

Let us imagine the impact on the Hong Kong capital markets if one of the large Hong Kong based accounting firms were forced to exit from the Hong Kong market due to a catastrophic claim because of the delay in liability reform in Hong Kong. The Institute believes that the impact on the Hong Kong capital markets would be enormous affecting the livelihoods of many in Hong Kong.

Apart from the loss of jobs from a firm’s failure and the direct effect on their families, the timetables of audits in progress for listed and other companies would be disrupted, initial public offerings of local and Mainland enterprises would be delayed or cancelled and other tax and consultancy projects would be seriously affected. The disruption to the daily activities of corporate and government bodies cannot be overestimated. This is in addition to the damage Hong Kong would sustain to its reputation and credibility.

In the aftermath of another firm’s failure, the entire accounting profession would suffer. The profession would lose its ability to attract and retain the best recruits and professionals because of the risk attached to the profession. Since a respected accounting profession is the backbone of any important financial centre, if the accounting profession suffers, Hong Kong’s hard-earned status will suffer.

The Institute is therefore urging the Government and the LegCo to address the issue responsibly now. Otherwise, the Government and the LegCo might be forced to introduce changes hastily in response to a crisis, which is what happened in Australia. The Institute believes that the lack of liability reform has now reached a potentially life threatening stage which will not only affect the accounting profession in Hong Kong but all stakeholders with an interest in a healthy capital market and Hong Kong’s entire economic environment.

Some have argued that reputation threat is a greater threat to accounting firms’ continued existence than catastrophic claim litigation, and that liability reform is therefore pointless. This argument fails to recognize that accounting firms can take
action to protect their reputation. However, these firms cannot control the risks imposed by joint and several liability where exposure can arise or be greatly increased by the acts of others. Removing the threat posed by joint and several liability will significantly reduce the chances of an accounting firm collapsing as a result of the actions of others, with damages to Hong Kong.

### 5.2 Consequences of one large firm failing in Hong Kong

If one of the large accounting firms were to fail, choice will be greatly limited, especially in areas where specialized skills are required, such as mergers and acquisitions. Limiting choice in this way is not in the public interest and would be detrimental to the Hong Kong capital markets. Many leading mid-tier accountancy firms may be reluctant to move into the large firms’ current market. Under this plausible scenario, it is conceivable that some companies would not be able to find an independent auditor.

### 5.3 Limited Liability Partnerships to be introduced in Singapore

The Government in Singapore, after extensive public consultation, has decided to accept the private-sector led Company Legislative and Regulatory Framework Committee’s recommendation to introduce LLPs in Singapore. Hong Kong should not be left behind.
6 Conclusion

The Institute adamantly believes that Hong Kong’s current liability framework no longer fits the nature of the work expected of professionals in Hong Kong, the scale of the funds involved and the cross border responsibilities and liabilities now being faced. Hong Kong desperately needs the liability reforms outlined in this paper to stay alive as a major global financial centre.

PROFESSIONAL LIABILITY REFORM IS NOW VITAL FOR HONG KONG