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## **PROPOSALS TO IMPROVE THE REGULATORY REGIME FOR LISTED ENTITY AUDITORS**

Dear Sir/Madam,

The International Federation of Accountants (IFAC) values the opportunity to comment on the Financial Services and the Treasury Bureau (FSTB)'s consultation paper, *Proposals to improve the regulatory regime for listed entity auditors*.

Through its current membership of 179 professional accountancy organizations in 130 countries and jurisdictions, IFAC represents approximately 2.5 million accountants in public practice, industry and commerce, government, and education.

### **General Comments**

IFAC commends the FSTB on issuing what is a very thorough and thoughtful consultation paper that addresses a range of matters that aims to improve the regulatory regime for listed entity auditors in Hong Kong.

IFAC recognizes the importance of high-quality auditing and acts to promote and enhance audit quality around the globe. This includes supporting the development, adoption, and implementation of high-quality, internationally accepted auditing and quality control standards, promoting the need for global regulatory convergence where appropriate, and supporting the development of strong professional accountancy organizations and accountancy firms.

Given the critical role that auditing plays in the economy—in terms of being a mandated service that aims to enhance the credibility of financial reporting and providing benefits to the broader public well beyond those who are directly involved in the process—IFAC believes that the primary focus of regulatory reforms to auditing should be to enhance audit quality.

In an increasingly global and inter-connected economy, the need for globally recognized and consistent regulatory arrangements, where appropriate, is becoming more important. Global adoption and implementation of high-quality, internationally recognized, professional standards—such as International



Standards on Auditing (ISAs)<sup>1</sup> and the Code of Ethics for Professional Accountants (the “Code of Ethics”)<sup>2</sup>—are an example of the importance of achieving such global consistency.

Organizations such as the International Forum of Independent Audit Regulators (IFIAR) also play a key role in promoting global consistency for audit regulation. IFAC recognizes, however, that although IFIAR has issued a set of core principles for independent audit regulators that enhance consistency, the way IFIAR members and others implement these principles differs among jurisdictions. That is, there is no “one best model.” Regulatory arrangements differ by jurisdiction, according to a range of legal, economic, cultural, and environmental factors; they also differ among jurisdictions with well-developed, robust arrangements that are mutually recognized.

IFAC is encouraged that the FSTB appears to have drawn on examples from a range of different jurisdictions in developing this consultation paper. IFAC believes this is the right approach, one that ensures that the regulatory arrangements introduced into Hong Kong are fit-for-purpose and appropriate for the Hong Kong environment.

It is important to keep in mind that, when structuring regulatory arrangements appropriate for the environment, it is necessary to consider existing arrangements and the extent to which they have proven to be effective. As well, the costs and benefits of making changes need to be carefully analyzed to ensure that systems and processes that have worked well are not inappropriately discarded.

It is with this in mind that IFAC highlights the obligations and responsibilities of the Hong Kong Institute of Certified Public Accountants (HKICPA) as a member of IFAC. The HKICPA is required to comply with, and to report on its compliance with, [Statements of Membership Obligations](#) (SMOs) as part of IFAC’s compliance program. These SMOs include requirements for IFAC member bodies to use their best endeavors to ensure that international standards for auditing and assurance, ethics, and accounting education are adopted and implemented in their jurisdictions. Member bodies—such as the HKICPA—that are the standard-setting body within a jurisdiction are obliged to use these international standards. Therefore, IFAC is strongly of the view that it is appropriate for the HKICPA to retain responsibility for standard setting and setting continuing professional development requirements (refer specific comments in the sections that follow.)

## **Questions**

In the following sections of this letter, IFAC provides its general views, from an international perspective, on the topics identified, rather than address each question separately. IFAC recognizes that several questions are jurisdictionally specific, and IFAC does not have the depth of knowledge about the Hong Kong environment to provide detailed comments.

We hope that our comments will provide useful input into your further deliberations.

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<sup>1</sup> Issued by the International Auditing and Assurance Standards Board (IAASB).

<sup>2</sup> Issued by the International Ethics Standards Board for Accountants (IESBA).



## ***Basic Parameters of Reform***

### Objective of the Reform

IFAC recognizes the importance for jurisdictions to have regulatory regimes for auditors of listed entities that are recognized by other jurisdictions. This permits enhanced global consistency, fewer chances for organizations to seek out regulatory arbitrage opportunities, and reduced costs and enhanced efficiency of doing business internationally.

While IFAC is conscious that perceptions of the independence of the regulatory regime from the profession are important, it is of the view that the primary driver of regulatory reform should be the enhancement of audit quality. It is important that regulatory regimes are appropriate for the local jurisdictional context, which influences the critical role that the profession continues to play. IFAC considers that, generally, the FSTB has appeared to strike the correct balance in these proposals, but recognizes that when any significant reforms are implemented, they need to be assessed periodically for their effectiveness—and potentially revised—in the future.

Furthermore, IFAC notes that the FSTB proposals are aimed at enhancing the perceived independence of the regime rather than being driven by the need to correct any major shortcomings or failings with the current arrangements.

### Coverage

It is appropriate that the proposed regulatory regime should cover only auditors of public interest entities. IFAC notes that a definition of a public interest entity is jurisdictionally based, and has no comment on the proposed definition. In the interests of promoting and enhancing audit quality more generally within a jurisdiction, however, IFAC believes it is important for regulators to have ongoing communication with the local professional accountancy organization(s). Through qualification, continuing development, and quality assurance programs, local professional accountancy organizations have a key role to play in enhancing audit quality.

### Audit Oversight Body

In determining the most appropriate organization in Hong Kong to become the independent audit regulator, the government should consider a number of key criteria: (i) the ability of the organization to conduct its oversight activities in the public interest, free from political and sectorial influences; (ii) the necessary expertise and skills to undertake the task; (iii) transparency and accountability; (iv) a means of funding that is free from inappropriate undue influence or conflicts; and (v) the ability to cooperate internationally on audit oversight matters.

IFAC is of the view that it is important to consider audit in the broader context of financial reporting; that is, as being only one part of a complex set of interactions and components that comprise the financial reporting supply chain. The benefits of having a regulatory structure that aims to provide a coordinated approach to enhancing financial reporting quality and recognizes that there are many different people involved in producing high-quality financial reporting—for example, financial statements preparers, boards and audit committees, investors and analysts, and, of course, the auditor—cannot be overstated. IFAC notes,



however, that regulatory arrangements differ among jurisdictions. In some jurisdictions, one market regulator may be responsible for all market participants, while others have a separate audit oversight body.

### **Registration**

#### Fit and Proper Person

IFAC agrees that, for an application for registration as a listed entity auditor to be approved, the individuals performing the roles of audit engagement authorized persons, and that of the engagement quality control reviewer, should be fit and proper persons to perform such roles.

While IFAC believes that the individual responsible for a firm's quality control systems need not be separately registered, it agrees that, if this were to occur, the individual responsible for the firm's quality control systems should be a fit and proper person to perform such a role. As noted in International Standard on Quality Control 1, the "person or persons assigned operational responsibility for the firm's system of quality control by the firm's chief executive officer or managing board of partners has sufficient and appropriate experience and ability, and the necessary authority, to assume that responsibility" (refer to paragraph 19).

#### Need for Registration

IFAC supports the requirement for an individual, partnership, or body corporate who wishes to enter into an audit engagement with a listed entity in Hong Kong to register as a listed entity auditor. IFAC does not provide a view on whether it should be a criminal offence for an unregistered person to enter into an audit engagement with a listed entity, but recognizes that there could be a range of sanctions available for use against both that unregistered person and the listed entity.

#### Registrar

As noted previously in the general comments, IFAC recognizes that oversight arrangements differ among jurisdictions. Each jurisdiction needs to consider the most appropriate arrangements for its own circumstances. It needs to determine if there is an existing well-developed, proven, and strong system for auditor registration, and whether there is a need to propose to change it or develop alternatives.

With respect to the oversight arrangements proposed for the FRC, IFAC broadly agrees with the proposals outlined in paragraph 3.24 that the FRC not be involved in the day-to-day operations of the HKICPA. IFAC supports the requirement for periodic reports by the HKICPA Registrar, and quality reviews of the HKICPA Registrar, although it is not clear what such quality reviews shall entail. For both the quality reviews and the FRC's provision of written directions to the HKICPA Registrar, IFAC believes that greater clarity is needed about the operation of these arrangements (e.g., circumstances that the FRC defines as being in the public interest and requiring written directions).

As noted previously, IFAC highlights transparency and accountability as key criterion for audit oversight. With this in mind, IFAC supports the publication of periodic reports, the results of quality reviews, and the FRC's written directions to the HKICPA Registrar.



### Appealing Decisions

As a general principle, IFAC supports the notion that aggrieved parties should have access to independent appeals mechanisms with respect to key decisions, such as auditor registration. More detailed comments about the proposed appeals mechanisms are provided later in the section titled “Appeal Mechanism.”

### Different Registration Systems

It is somewhat unusual for auditors to have several ways to become recognized as an auditor of a listed entity. It is not clear to IFAC why there would need to be separate processes for recognizing overseas auditors from those for auditors located within Hong Kong. IFAC anticipates that there may be situations where different processes could lead to inconsistencies—recognizing that different criteria might need to be applied.

A review of the regulatory regime would seem to be an appropriate time to consolidate the recognition and registration arrangements into one system.

### Overseas Auditors

Recognition as an overseas auditor of an overseas entity listed in Hong Kong is not straightforward, as there is no one global model for audit regulation (including auditor registration). For example, IFAC is aware that registration requirements differ across jurisdictions, and while audit firms may be members of professional accountancy organizations in some jurisdictions, in others they may not. Instead, it would be the individuals in an audit firm who might separately be members of the professional accountancy organization. In some jurisdictions, the auditor does not need to be a member of a professional accountancy organization at all.

One of the criteria listed in the consultation paper for recognition as an overseas auditor is that there be an agreement in force for a mutual or reciprocal cooperation arrangement between the overseas regulator of the auditor and the FRC. Presumably, when the FRC enters into such arrangements, it will assess a range of matters relevant to audit regulation and oversight in that other jurisdiction, including the registration requirements. The FRC might consider how it ensures that there is transparency around the process of recognizing overseas auditors by ensuring that details of the mutual or reciprocal cooperation arrangements are made publicly available.

### ***Setting of Continuing Professional Development (CPD) Requirements***

IFAC agrees that the HKICPA should continue to perform its statutory functions and exercise its statutory powers for setting CPD requirements for listed entity auditors. As noted earlier, the HKICPA has an obligation to comply with international standards on accounting education as part of its membership requirements for IFAC.

Furthermore, IFAC recognizes that oversight arrangements differ among jurisdictions. Each jurisdiction needs to consider the most appropriate arrangements for its own circumstances. It needs to determine if there is an existing, well-developed, proven, and strong system in place, and whether there is a need to propose to change it or develop alternatives.



With respect to the oversight arrangements proposed for the FRC, IFAC broadly agrees with the proposals outlined in paragraph 4.6 and supports the requirement for periodic reports by the HKICPA Council and quality reviews of the HKICPA Council, although it is not clear what such quality reviews shall entail.

However, for both the quality reviews and the FRC's provision of written directions to the HKICPA Council, IFAC believes that the operation of these arrangements (e.g., circumstances that the FRC defines as being in the public interest and requiring of written directions) are not clearly described.

As noted previously, IFAC highlights transparency and accountability as a key criterion for audit oversight. With this in mind, IFAC supports the publication of periodic reports, the results of quality reviews, and the FRC's written directions to the HKICPA Council.

### ***Setting of Standards on Professional Ethics, Auditing, and Assurance***

IFAC agrees that the HKICPA should continue to perform its statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing, and assurance, maintained or otherwise applied by CPAs (practicing). As noted earlier, the HKICPA has an obligation to comply with international standards on ethics, auditing, and assurance as part of its membership requirements for IFAC.

Furthermore, IFAC recognizes that oversight arrangements differ among jurisdictions. Each jurisdiction needs to consider the most appropriate arrangements for its own circumstances and, where there is an existing, well-developed, proven, and strong standard-setting process, there would seem to be little reason to propose to change it or develop alternatives.

With respect to the oversight arrangements proposed for the FRC, IFAC broadly agrees with the proposals outlined in paragraph 5.8, and supports the requirement for periodic reports by the HKICPA Council and quality reviews of the HKICPA Registrar, although it is not clear what such quality reviews shall entail. Greater clarity is needed about how such reviews will be performed.

As for the provision of written directions to the HKICPA Council on its performance as a standard setter, it must be recognized that the HKICPA utilizes ISAs and the international Code of Ethics as the basis for the standards issued in Hong Kong. These standards are issued by the International Auditing and Assurance Standards Board and the International Ethics Standards Board for Accountants, respectively, and represent high-quality global standards that are adopted and implemented across the world. In the interests of promoting global regulatory consistency, IFAC considers it important that standards issued locally do not include deletions from, or additions to, the international standards, other than what might be necessary by law.

The development of international standards, such as ISAs and the international Code of Ethics, are subject to stringent due process and public interest oversight. The due process involves extensive consultation with an advisory group that includes many from the regulatory community, as well as oversight by public interest oversight bodies comprising primarily the same types of people.

An important aspect of strong standard-setting arrangements is the performance of the standard-setting board, and the necessity for, when developing standards, listening and responding appropriately to concerns by all key stakeholders and others affected by the standard-setting process. Regulators are, of



course, one of those key stakeholders, but there are also others who have important views (e.g., investors, companies, auditors, the profession, etc.) that also need to be considered. In balancing different views, it is important for the standard-setting board to adhere to a robust due process and to be transparent and accountable.

Therefore, procedures should be in place to ensure that the HKICPA Council duly takes into account all key stakeholder views, including those of the FRC, during the development of, and before finalizing, standards on professional ethics, auditing, and assurance for listed entity auditors. IFAC recognizes that, in certain circumstances, the procedures may differ for different stakeholders.

As noted previously, IFAC highlights transparency and accountability as a key criterion for audit oversight. With this in mind, IFAC supports the publication of periodic reports, the results of quality reviews, and the written directions the FRC provides to the HKICPA Council.

### ***Inspection***

#### Function and Power

IFAC agrees with the proposal to transfer from the HKICPA to the FRC the statutory functions for conducting recurring inspections of listed entity auditors' performance in their listed entity audit engagements. These powers would be similar to those the HKICPA now has, assuming that the FRC were to be established as the independent audit regulator, having considered the criteria outlined earlier in this response.

IFAC generally agrees that the FRC's inspection program should adopt the statutory procedures as set out in the consultation paper, and with reference to the existing arrangements for HKICPA's practice review program.

IFAC believes, however, that there should be a separation of powers between the organization that undertakes the inspection and the organization that has disciplinary powers. While IFAC considers it acceptable for the same persons from the same group, committee, or organization to perform inspection and investigation activities, it believes that, in the interest of transparency and accountability, and in adhering to the basic principles of natural justice, the disciplinary process should be separated from inspection and investigation.

With this in mind, IFAC recommends revising paragraph 6.14, point (d) to indicate that the FRC may initiate investigation processes and determine whether there is a disciplinary case to be answered and then refer it to an independent disciplinary process.

#### Use of Committees

On the basis that the committees formed under the auspices of the FRC are appropriately resourced and have the relevant technical experience and skill to undertake the assigned tasks, IFAC agrees that the FRC should be able to delegate its inspection functions and relevant powers to committees.

#### Delegation to HKICPA

While IFAC recognizes that inspection programs should be designed on a risk basis—that is, developing and implementing an inspection program that focuses on higher risk areas, whether, for example, they be



the companies themselves, the industries within which the companies operate, the regions from which they originate, or the auditor having previously received negative comments from a previous inspection. Delegating part of the inspection program to HKICPA—under the oversight of the FRC—may allow the FRC to cover a greater number of listed company auditors with its inspection program.

Furthermore, maintaining a close dialogue and liaison between the FRC and HKICPA would have certain benefits. It enables FRC inspection staff to observe and learn from experienced persons who have previously performed inspections, and would potentially allow the FRC and HKICPA to maintain more consistent inspection arrangements. This, in turn, would permit more consistent treatment of auditors, whether they perform audits of listed entities or other entities.

Checks and balances that should be considered in the situation where the FRC delegates its functions and powers to inspect listed entity auditors should focus on matters such as: (i) clarity of delegation and responsibilities; (ii) consistency of approach to inspections; (iii) transparency of work performed and reporting; and (iv) specific performance measures, deadlines, etc. One thing that should be guarded against is the possibility of establishing processes that see the FRC essentially “re-performing” an inspection delegated to the HKICPA.

IFAC believes there are benefits to the FRC and HKICPA coordinating their inspection programs. Consistent with this view, IFAC agrees that the secrecy provisions in the Professional Accountants Ordinance (PAO) and the Financial Reporting Council Ordinance (FRCO) should be suitably amended to provide that both HKICPA and FRC could share their inspection results with each other.

### ***Investigation and Disciplinary Proceedings***

IFAC agrees:

- that the FRC should continue to be responsible for conducting independent investigations into relevant irregularities by listed entity auditors;
- with the proposal that a disciplinary action may be imposed on a listed entity auditor, a person approved to be its audit engagement authorized 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; and
- 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.

### **Individuals Ultimately Responsible for the System of Quality Control**

Conceptually, it is appealing to introduce arrangements whereby 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 a system. From the perspective of promoting the importance of having appropriate resources and attention devoted to developing and maintaining robust quality control systems



within an audit firm, reinforcing the need for accountability for the system, and providing regulators with the ability to enforce such responsibility, the proposal could be seen as being appropriate.

IFAC believes, however, that greater clarity is needed around how accountability will be determined, That is, under what circumstances is it likely that regulatory powers will be exercised to hold an individual to account. It does not appear to be clear cut. For example, while an individual might be able to be held accountable for the existence of a code of conduct and a training program to reinforce that code, it is not clear that an individual could be held accountable for quality failures relating to the internal culture or the “tone at the top.” The potential difficulty then becomes the possibility of the regulatory powers extending to every individual in an audit practice.

#### Disciplinary Powers

Fairness and due process are important elements of any investigation and disciplinary process. With this in mind, IFAC is of the view that the disciplinary process should be separated from the inspection and investigation process.

While IFAC notes that the proposals indicate that the FRC intends to have arrangements in place to ensure that its investigative staff will not be involved in the disciplinary process and the determination of disciplinary sanctions, it is unclear that this will provide the necessary separation and perception of independence (for the disciplinary process) that will instill the necessary confidence in those who are subject to it.

Additionally, IFAC believes that the process for determining disciplinary decisions should involve the person(s) against whom a disciplinary action is being taken, rather than—as outlined in paragraph 7.21—the disciplinary decision being made and communicated to the person(s), who in turn then has/have the opportunity to respond and comment (“be heard”) after the event, but before the exercise of the disciplinary power. From IFAC’s experience, typically, the involvement of the person (s) against whom a disciplinary action is being taken would be the way disciplinary decisions are made in most jurisdictions.

The person(s) against whom a disciplinary action is being taken should have the ability to be heard as part of the process for determining a disciplinary decision. This is a particularly important point for the auditing profession, given—as noted in paragraph 7.22—the complexity of auditing standards, and the fact that the basis of many investigative and disciplinary actions is the exercise of professional judgment.

An independent appeals mechanism is also seen as an important feature of a well-functioning investigation and discipline process.

#### Range of Powers

IFAC recognizes the importance of having a range of disciplinary powers, so that any actions taken are appropriate for the circumstances of the case being considered. It broadly agrees that the FRC should be empowered to exercise the range of disciplinary powers on a person subject to disciplinary action outlined in the consultation paper.

IFAC notes, however, the discussion in paragraph 7.29 on concerns expressed about the proposed maximum amount for the pecuniary penalty and supports the FRC’s position to consider the principles of



fairness and proportionality, taking into account the circumstances of the case. IFAC supports the development of guidelines on this matter.

#### Resolution

IFAC agrees that the FRC should be able to enter into a resolution with the person(s) subject to disciplinary action at any time it is contemplating exercising its disciplinary power and, when exercising such power, that it must consider it appropriate to do so in the interest of the investing public or in the public interest.

Adopting this approach reinforces IFAC's view, expressed earlier, that the process for determining disciplinary decisions should involve the person(s) against whom a disciplinary action is being taken. That is, it would seem that the chances of reaching a resolution would be heightened where the person(s) is/are heard before a disciplinary decision is made.

#### ***Appeal Mechanism***

IFAC supports the establishment of an independent appeals tribunal for hearing appeals of registration decisions made by the HKICPA Registrar and disciplinary decisions made by FRC. An appeals tribunal is common in many jurisdictions.

It is difficult to assess whether 21 days is a sufficient period of time for aggrieved person(s) to apply to an independent appeals tribunal for a review of a registration or disciplinary decision. The circumstances of the decision will dictate whether the aggrieved person(s) need(s) to undertake certain actions, engage third parties, or undertake further work or research before being able to make an application for an appeal.

Therefore, IFAC recognizes the importance of the proposal to grant extensions on a case-by-case basis, where good cause exists, regardless of the time period that is chosen.

#### Chair of Appeals Tribunal

IFAC supports the proposal that the chair of the independent appeals tribunal should be a person qualified for appointment as a judge of the High Court. IFAC recommends that consideration be given to the types of people who are considered appropriate for appointment to the tribunal as members. That is, rather than indicating the type of person who they may not be (i.e., a public officer), it might be preferable to describe the types of people who are considered appropriate (e.g., an eminent academic or a practicing solicitor.)

#### Tribunal Powers

IFAC broadly supports that the independent appeals tribunal may exercise the proposed powers as outlined in the consultation paper in the review proceedings. IFAC is not sufficiently familiar with laws applicable to civil proceedings in Hong Kong, however, to provide an opinion on whether paragraph 8.7(b) is appropriate.

#### Public Hearings

Assuming that a decision not to register a person as an auditor, or a disciplinary decision made against a person(s), has been made public, it would seem appropriate for the hearings of the independent appeals tribunal to be held in public unless in the interests of justice it determines otherwise.



### ***Funding Mechanism***

As noted previously, an important consideration in establishing independent audit oversight is access to a means of funding that is free from inappropriate undue influence or conflicts and is also sustainable. Therefore, it is not clear that a levy imposed on those who are subject to the regulatory regime—i.e., listed entity auditors and indirectly listed entities—demonstrates a funding arrangement clearly free from undue influence or conflicts. At the very least, it will be necessary to structure the arrangements in such a way as to ensure that perceptions are appropriately managed.

### ***Governance of the Financial Reporting Council***

IFAC broadly agrees with the proposed new composition of FRC membership. It assumes that, to ensure that the most competent and appropriate person(s) are appointed to the FRC, it may need to receive nominations for membership from the HKICPA, Hong Kong Exchanges and Clearing Limited (HKEx), and Securities and Futures Commission (SFC).

IFAC strongly believes that it is necessary for there to be sufficient members of the oversight body with the knowledge of and experience in the auditing of Hong Kong-listed entities. The requirement for there to be at least two persons with relevant knowledge and experience would appear to provide the flexibility for a greater number of such persons to be appointed, as required.

IFAC supports the proposal to maintain the present requirement for the FRC to have a chairman and a majority of members who are independent of the audit profession. It agrees with the proposed change from describing people who are independent from the profession as “lay people” to “non-practitioners.” IFAC also supports the definition proposed for non-practitioners.

Please do not hesitate to get in touch if you have any questions about the comments in this letter, or if you require any further clarification.

Sincerely,

A handwritten signature in black ink, appearing to read "Faye Choudhury", written over a light blue horizontal line.

Faye Choudhury  
Chief Executive Officer