

**Proposals to  
Improve the Regulatory Regime for  
Listed Entity Auditors**

**Consultation Paper**

**June 2014**

**Financial Services and the Treasury Bureau**

**[www.fstb.gov.hk](http://www.fstb.gov.hk)**

## ABOUT THIS DOCUMENT

1. This paper is published by the Financial Services and Treasury Bureau (“FSTB”) of the Government of Hong Kong Special Administrative Region to consult the public on the reform proposals to improve the regulatory regime for listed entity auditors.
2. A list of questions for consultation is set out for ease of reference after Chapter 10. Please send your comments to us on or before **19 September 2014** by one of the following means –

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3. This consultation paper is also available on the FSTB’s website [http://www.fstb.gov.hk/fsb/ppr/consult/consult\\_rpirrlea.htm](http://www.fstb.gov.hk/fsb/ppr/consult/consult_rpirrlea.htm).
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## ABBREVIATIONS

CPA	A person registered as a certified public accountant by virtue of section 22 of the PAO
CPA (practising)	A CPA holding a practising certificate issued under section 30 of the PAO
CPD	Continuing professional development
EC	The European Commission
EU	The European Union
FRC	Financial Reporting Council
FRCO	Financial Reporting Council Ordinance (Cap. 588)
HKEx	Hong Kong Exchanges and Clearing Limited
HKICPA	Hong Kong Institute of Certified Public Accountants
HKICPA Registrar	Registrar of HKICPA appointed by the Council of HKICPA in accordance with section 21 of the PAO
IFAC	International Federation of Accountants
IFIAR	International Forum of Independent Audit Regulators
IMF	International Monetary Fund
IOSCO	The International Organisation of Securities Commissions
PAO	Professional Accountants Ordinance (Cap. 50)
SFC	Securities and Futures Commission
UK	The United Kingdom
US	The United States of America

## EXECUTIVE SUMMARY

1. Auditors play the role of a key gatekeeper in assuring the integrity and accuracy of the financial reports of listed entities. Therefore, it is important that there is a robust regime for regulating the conduct and upholding the professional standards of listed entity auditors, in order to safeguard the interests of the investing public and reinforce Hong Kong's status as an international financial centre.
2. The existing regulatory regime for listed entity auditors is not consistent with international standards and practices that the oversight of the regulation of listed entity auditors should be independent of the profession itself. As a result, Hong Kong is not eligible to be represented on IFIAR which is an influential international organisation in the regulation of auditors. We lag behind comparable jurisdictions in being recognised as having an equivalent auditor regulatory system. Besides, the International Monetary Fund has recently published its comprehensive assessment on the overall financial regulatory system of Hong Kong, expressing concerns about the lack of independence of the present regulatory regime for listed entity auditors and the effectiveness of the enforcement framework and has made recommendations for improvement.
3. To address these issues, the Government proposes to enhance the independence of the existing regulatory regime for listed entity auditors from the audit profession, with a view to ensuring that the regime is benchmarked against international standards and continues to be appropriate in the local context. In developing measures to bridge the gaps in our existing regime, we have been engaging HKICPA and FRC and considered their views carefully.
4. For the new regulatory regime for listed entity auditors, we propose that the relevant professional body, namely HKICPA, will perform the statutory functions of registration, setting of CPD requirements and setting of standards on professional ethics, auditing and assurance with respect to listed entity auditors, subject to oversight by the independent auditor oversight body, namely FRC. We further propose to vest in FRC disciplinary and inspection functions and powers with regard to listed entity auditors, in addition to its existing investigatory functions and powers. Based on the "user pays" principle and the principle that the auditor oversight body should be operationally and financially independent of the Government, FRC will in future be funded by levies

coming from three sources, namely listed entities, securities transactions and listed entity auditors on an equal basis.

5. There will be appropriate checks-and-balances to ensure the integrity of the new regulatory regime. For easy reference, a table summarising the respective statutory roles and functions of FRC and HKICPA under the proposed regulatory regime for listed entity auditors is set out in the Appendix.
6. The Government would like to invite comments on the proposals set out in this consultation document to enhance the independence of the regulatory regime for listed entity auditors. We will study carefully the comments received in finalising the proposals. Our plan is to introduce the necessary legislation into the Legislative Council in 2015.

**A summary of the respective statutory roles and functions of FRC and HKICPA under the proposed regulatory regime for listed entity auditors**

	HKICPA	FRC
<p><b>Registration</b> <i>(Details in Chapter 3)</i></p>	<p><u><i>Mechanism for registering listed entity auditors</i></u></p> <ol style="list-style-type: none"> <li>(1) Maintaining a register of listed entity auditors and making it available for public inspection.</li> <li>(2) Receiving applications for registration/renewing registration as a listed entity auditor, and approving/rejecting such applications in accordance with the statutory registration criteria.</li> <li>(3) Removing a listed entity auditor from the register under specified circumstances (e.g. if the auditor is subject to a registration removal order under FRC’s disciplinary proceedings (see (18)).</li> <li>(4) Submitting periodic reports to FRC on the exercise/performance of the above powers/functions (see (5)(a)) and complying with FRC’s written directions in relation to the exercise/performance of any of the above powers and functions (see (5)(c)).</li> </ol> <p><i>(Note: Appeals to HKICPA’s registration decisions will be heard by an independent appeal mechanism (Details in Chapter 8).)</i></p>	<ol style="list-style-type: none"> <li>(5) Exercising oversight powers over HKICPA in relation to the registration of listed entity auditors through the following arrangements –             <ol style="list-style-type: none"> <li>(a) receiving periodic reports from HKICPA on the exercise/performance of its powers/functions;</li> <li>(b) conducting quality review on HKICPA in respect of its exercise/performance of such powers/functions; and</li> <li>(c) upon being satisfied that it is in the public interest to do so, giving HKICPA written directions in relation to its exercise/performance of such powers/functions.</li> </ol> </li> </ol>



	<b>HKICPA</b>	<b>FRC</b>
	<p><u><i>Mechanism for recognising overseas auditors of specific overseas entities listed in Hong Kong</i></u></p> <p>(6) Maintaining a list of overseas auditors recognised by FRC for entering into audit engagements with specific overseas entities listed in Hong Kong under (8), and updating the list having regard to recognition decisions made by FRC.</p> <p>(7) Making available for public inspection the list of overseas auditors who are recognised by FRC under (8).</p>	<p>(8) Receiving applications for recognising/renewing the recognition of an overseas auditor of a specific overseas entity listed in Hong Kong, and approving/rejecting such applications in accordance with statutory requirements.</p>
<p><b>Setting of CPD requirements</b></p> <p><i>(Details in Chapter 4)</i></p>	<p>(9) Setting CPD requirements for the purpose of renewal of registration of listed entity auditors.</p> <p>(10) Subjecting to FRC's oversight powers as in (5) when exercising/performing the power/function in (9).</p>	<p>(11) Exercising oversight powers over the HKICPA in relation to the setting of CPD requirements through the arrangements as set out in (5).</p>
<p><b>Setting of standards on professional ethics, auditing and assurance</b></p> <p><i>(Details in Chapter 5)</i></p>	<p>(12) Issuing or specifying statements of professional ethics required to be observed, maintained or applied by any registered listed entity auditor.</p> <p>(13) Issuing or specifying standards of auditing and assurance required to be observed, maintained or applied by any registered listed entity auditor.</p> <p>(14) Subjecting to FRC's oversight powers as in (5) when exercising/performing the powers/functions in (12) and (13).</p>	<p>(15) Exercising oversight powers over HKICPA in relation to the setting of standards on professional ethics, auditing and assurance through the arrangements as set out in (5).</p>

	<b>HKICPA</b>	<b>FRC</b>
<b>Inspection</b> <i>(Details in Chapter 6)</i>	N/A	(16) Performing/exercising the functions and powers in relation to the inspection of listed entity auditors in respect of their listed entity audit engagements.
<b>Investigation</b> <i>(Details in Chapter 7)</i>	N/A <sup>1</sup>	(17) Conducting an investigation into an auditing/reporting irregularity in relation to a listed entity and carrying out follow-up action as it thinks fit.
<b>Disciplinary</b> <i>(Details in Chapter 7)</i>	N/A	(18) Making decisions on disciplinary cases and exercising disciplinary powers in respect of auditing/reporting irregularities of listed entity auditors subject to fair hearing and due process.  <i>(Note: Appeals to FRC's disciplinary decisions will be heard by an independent appeal mechanism (Details are in Chapter 8).)</i>

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<sup>1</sup> At present, all suspected auditing and reporting irregularities in relation to listed entities identified by HKICPA are referred to FRC for independent investigation.

# Chapter 1

## INTRODUCTION

### Background

- 1.1 In a capital market where companies' shares are traded publicly, auditors of listed companies are required to play the role of an independent "gatekeeper" in providing assurance for the integrity and accuracy of the companies' financial reports. As the financial reports form the basis of investment decisions made by the general public, a robust regime for regulating the conduct and upholding the professional standards of auditors of listed companies is essential not only in underpinning Hong Kong's development as an international financial centre, but also in safeguarding the interests of the investing public.
- 1.2 At present, Hong Kong's regulatory regime for auditors is primarily administered by HKICPA, which is a statutory professional body established by the PAO. HKICPA is empowered under the PAO to set admission and continuing registration criteria for its members including qualified auditors; set accounting, auditing and professional ethical standards; oversee the quality of auditing practices and monitor compliance with relevant standards; and conduct investigations<sup>2</sup> and exercise disciplinary powers where warranted, etc. The management and control of HKICPA is vested in its Council, which comprises predominately accounting and auditing professionals elected from within its membership<sup>3</sup>. HKICPA's revenue mainly comes from fees levied on its members and registered firms and corporate practices.
- 1.3 Over the years, the Government has introduced a number of initiatives to enhance the independence, transparency and accountability of the auditor regulatory regime. In the wake of the major listed company audit failures at Enron and WorldCom in 2001-02 in US, the PAO was

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<sup>2</sup> Excluding investigations into possible auditing and reporting irregularities in relation to listed entities, which are within the purview of FRC (see paragraph 1.3).

<sup>3</sup> Pursuant to section 10 of the PAO, the Council is composed of 14 CPAs elected from within the membership of HKICPA (with not less than six being CPAs in full time practising as CPA (practising) and not less than six being CPAs otherwise than in full time practising as CPA (practising)), the immediate past President of HKICPA, a representative of the Financial Secretary (currently the Registrar of Companies), the Director of Accounting Services, four lay persons appointed by the Chief Executive (see paragraph 1.3) and not more than two CPAs co-opted by the Council.

amended in 2004 to, amongst other things, provide for the Government to appoint four lay persons<sup>4</sup> to the governing Council of HKICPA, and for both the Investigation Committee<sup>5</sup> and the Disciplinary Committee<sup>6</sup> of HKICPA to comprise a majority of lay persons appointed by the Government, one of whom shall be the chairman of the Investigation/Disciplinary Committee. A statutory independent body, namely FRC, was established in 2006 following the enactment of the FRCO to inter alia conduct independent investigations into possible auditing and reporting irregularities in relation to listed entities, which are defined as listed corporations and listed collective investment schemes in the FRCO<sup>7</sup>.

- 1.4 Since the establishment of FRC, all suspected auditing and reporting irregularities in relation to listed entities, including those identified by HKICPA and other financial regulators during their day-to-day activities are referred to FRC for independent investigation. All other regulatory powers with respect to the audit profession continue to be vested with HKICPA under the PAO.

### **International Developments in Recent Years**

- 1.5 In recent years, most jurisdictions with major capital markets have enhanced the independence of their auditor regulatory regimes from the audit profession by establishing independent oversight for the regimes, in line with the principles and standards established by international organisations on the regulation of auditors.

### *IFIAR*

- 1.6 With independent regulators for auditors being set up in more and more jurisdictions, a new multilateral organisation for independent regulators

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<sup>4</sup> Under section 2 of the PAO, a lay person means a person who is not a CPA in Hong Kong or a member of an accountancy body which is a member of IFAC.

<sup>5</sup> Under section 42C of the PAO, the Council of HKICPA may constitute an Investigation Committee where it reasonably suspects or believes that there are justifications to undertake an investigation. An Investigation Committee appointed by the Council is required by law to report the outcome of its investigation to the Council.

<sup>6</sup> Under section 34 of the PAO, the Council of HKICPA may constitute a Disciplinary Committee on the basis of the Investigation Committee's findings. The Disciplinary Committee is empowered to make a number of orders, including an order to pay a penalty not exceeding \$500,000 to HKICPA and an order to remove a CPA from the register of CPAs either permanently or for a period of time, etc.

<sup>7</sup> Besides conducting independent investigation into possible auditing and reporting irregularities, FRC is also charged with the statutory responsibility of enquiring into possible non-compliances with accounting requirements on the part of listed entities.

of auditors, namely IFIAR, was established in September 2006. IFIAR's membership is restricted to regulators that are both (a) independent of the profession and professional bodies; and (b) engaged in audit regulatory functions in the public interest, including ultimately responsible for the system of recurring inspection of audit firms undertaking audits of public interest entities and exercising that responsibility either directly or through independent oversight<sup>8</sup>. Besides, in its Core Principles for Independent Audit Regulators, IFIAR highlighted that regulators of auditors should be "operationally independent in the exercise of its functions and powers.....including not being controlled in its governance by audit practitioners" and that regulators should "ensure that their staff is independent from the profession". At present, IFIAR comprises independent audit regulators from 49 jurisdictions (a list of these jurisdictions is set out in **Annex A**).

- 1.7 IFIAR has become an increasingly influential organisation. In 2011, it became a member of the Monitoring Group, the body that oversees the auditing and assurance related international standard setting activities of IFAC<sup>9</sup>, monitors the activities of the Public Interest Oversight Board<sup>10</sup>, and convenes to discuss issues and share views relating to international audit quality and regulatory and market developments having an impact on auditing.

## *EU*

- 1.8 On the other hand, EU adopted the Statutory Audit Directive<sup>11</sup> in 2006 which, inter alia, requires all EU Member States to subject all statutory auditors and audit firms to public oversight and to organise an effective system of public oversight governed by non-practitioners<sup>12</sup>. EU has also laid down, as part of the Directive, a number of principles concerning the system of public oversight for statutory auditors and audit firms, and EC (EU's executive arm) applies these principles to assess

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<sup>8</sup> Charter of IFIAR.

<sup>9</sup> IFAC is the international organisation for the accountancy profession, and comprises accounting professional bodies of 130 jurisdictions, including Hong Kong.

<sup>10</sup> The Public Interest Oversight Board was established in 2005 as part of the reform undertaken by IFAC to ensure that international standards on auditing and assurance, professional ethics, and education are set in a transparent manner that reflects the public interest. It is a collaborative effort by IFAC and the international financial regulatory community.

<sup>11</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts.

<sup>12</sup> The Directive also applies to three Member States of the European Economic Area which are not EU Member States, namely Norway, Liechtenstein and Iceland. For simplicity, only EU is referred thereafter in this document.

whether the auditor oversight systems of non-EU jurisdictions are “equivalent” to those within EU. If the auditor oversight system of a non-EU jurisdiction is not considered as equivalent by EC, the auditors of these outside jurisdictions who have entered into audit engagements with listed entities in any EU Member State are required to register with the Members States concerned and be subject to their own systems of auditor oversight, quality assurance systems and systems of investigation and penalties.

1.9 Over the years, the EU principles concerning the system of public oversight for statutory auditors and audit firms have gained international recognition and many non-EU jurisdictions including most comparable jurisdictions with major capital markets have attained EU equivalence status. These principles require, inter alia, all statutory auditors and audit firms to be subject to public oversight and that the system of public oversight shall be governed by a majority of non-practitioners who are knowledgeable in the areas relevant to statutory audit. Besides, the system of public oversight shall have the ultimate responsibility for the oversight of –

- (a) the approval and registration of statutory auditors and audit firms;
- (b) the adoption of standards on professional ethics, internal quality control of audit firms and auditing; and
- (c) continuing education, quality assurance and investigative and disciplinary systems.

The principles also require the system of public oversight to have the right to conduct investigations in relation to statutory auditors and audit firms and the right to take appropriate action.

## *IOSCO*

1.10 In 2010, IOSCO<sup>13</sup> published the document “Objectives and Principles of Securities Regulation”. The document sets out 38 principles of securities regulation with the overriding objectives of protecting investors; ensuring that markets are fair, efficient and transparent; and

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<sup>13</sup> IOSCO is an international organisation which brings together the world’s securities regulators and is recognised as the global standard setter for the securities sector. IOSCO develops, implements, and promotes adherence to internationally recognised standards for securities regulation, and works closely with the G20 and the Financial Stability Board on the global regulatory reform agenda.

reducing systemic risk. One of the principles is that listed entity auditors should be subject to adequate levels of independent oversight. According to IOSCO<sup>14</sup>, a key principle for auditor oversight is that a mechanism should exist to provide that a body, acting in the public interest, provides oversight over the quality and implementation of auditing, independence, and ethical standards used in the jurisdiction, as well as audit quality control environments. Such a body must have an adequate charter of responsibilities and powers, and adequate funding that is not under the control of the auditing profession, to carry out those responsibilities.

## **Need for Reform**

1.11 Hong Kong being an international financial and capital market, it is imperative that our auditor regulatory regime with respect to listed entities evolves with changing market needs in the light of international developments and local circumstances. In view of the clear international trend that the oversight of the regulation of auditors should be independent of the profession itself, there is a need to reform our present regulatory regime which is considered by many as largely a self-regulatory regime.

### *IFIAR membership*

1.12 At present, Hong Kong's auditor regulatory regime falls short of the admission requirements of IFIAR and hence Hong Kong is not represented on IFIAR. Our lack of participation in this important forum has rendered us no influence in its discussions and has hindered cooperation between Hong Kong regulators and their counterparts in overseas jurisdictions, which is increasingly important given the rising number of overseas companies being listed in Hong Kong and the expansion of overseas operations of Hong Kong listed companies.

1.13 Some jurisdictions (e.g. Singapore<sup>15</sup>) have stipulated requirements that only auditors who are registered with and/or regulated by a member of IFIAR would be able to audit the financial statements of their listed companies. Therefore, if Hong Kong does not become a member of

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<sup>14</sup> The Principles for Auditor Oversight published by the Technical Committee of IOSCO in October 2002.

<sup>15</sup> Rule 712(2)(b) of the Singapore Listing Manual requires that auditors of entities listed on the Singapore Exchange must be registered with and/or regulated by an independent audit oversight body which is a member of IFIAR.

IFIAR, Hong Kong auditors will lose out on potential market opportunities in these jurisdictions.

### *International recognition of EU Principles*

- 1.14 20 jurisdictions, ranging from major economies such as US, Canada and Australia to smaller-sized economies such as Jersey, Isle of Man and Guernsey, have obtained EC's recognition of equivalence status of their auditor regulatory regimes. Another 7 jurisdictions have also been granted a transitional period for achieving equivalence by EC<sup>16</sup> (a full list of these jurisdictions is set out in **Annex B**). However, Hong Kong has been excluded. We note that some sectors of the audit profession have pointed out the importance of Hong Kong achieving regulatory equivalence with EU's system as the competitiveness of Hong Kong auditors is currently being undermined, noting that there are already some EU-listed entities being audited by Hong Kong auditors. The future prospects of Hong Kong auditors for assisting Hong Kong entities to raise funds through the capital markets in EU will likewise be hampered.
- 1.15 Besides, the need to put in place a robust mechanism for regulatory cooperation between Hong Kong and overseas auditor regulators is gaining in importance with the increasing trend for overseas companies, including those from EU, to use Hong Kong as either a primary or a secondary listing platform. In this regard, we note that the EU Statutory Audit Directive stipulates that regulators of EU Member States may only provide certain regulatory assistance to those which are considered to be "competent authorities" of non-EU jurisdictions.

### *IMF's Financial Sector Assessment Programme*

- 1.16 On the other hand, Hong Kong's auditor regulatory regime with respect to listed entities recently came under the scrutiny of IMF as part of its review of Hong Kong's securities market under the Financial Sector Assessment Programme. When reviewing Hong Kong's regulatory regime for listed entity auditors against the relevant IOSCO principles (paragraph 1.10 refers), IMF noted, in its report released in May 2014, that the current regulatory framework "does not ensure the independence of HKICPA.....nor establish a strong enforcement framework". To

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<sup>16</sup> According to EC's decision of 13 June 2013, while these jurisdictions have established or are in the process of establishing an equivalent regime, information about the functioning and the rules governing such systems is not sufficient to carry out an equivalence assessment.



address these issues, the IMF recommended that Hong Kong should establish a “fully independent authority with responsibility for the oversight of the audit profession and with strong enforcement power” and that such authority “should have jurisdictions over all auditors that audit companies listed in Hong Kong”.

## **The Reform**

- 1.17 To address the above issues, it is necessary to introduce new elements of independence into our existing auditor regulatory regime to bring it in line with international standards and practices. The need to ensure that our auditor regulatory regime is benchmarked against international standards is especially important, given the externally-oriented nature of our financial markets and the need to maintain the confidence of both international and local investors in our overall financial regulatory regime with regard to the capital market. It will be necessary to make reference to IFIAR’s Charter and Core Principles for Independent Audit Regulators, the EU’s Statutory Audit Directive and IOSCO’s Objectives and Principles of Securities Regulation and Principles for Auditor Oversight in considering the scope and extent of the reform.
- 1.18 To this end, the Government has been in close liaison with FRC and HKICPA and engaging different stakeholders as we develop reform proposals to enhance the independence of the existing auditor regulatory regime from the profession. In drawing up the proposals, we have taken into account the findings of a consultancy study commissioned by FRC on the auditor regulatory systems in overseas jurisdictions<sup>17</sup> and the feedback provided to us by HKICPA after its members’ engagement exercise on this subject<sup>18</sup>. Besides, since the proposals will have an impact on Hong Kong’s development as an international capital market, we have also discussed with SFC and HKEx amongst others and taken into account their preliminary feedback. The full package of reform proposals are set out in this consultation document.

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<sup>17</sup> FRC commissioned an independent consultant in March 2013 to examine the auditor regulatory systems in six comparable jurisdictions (viz. the EU, the UK, the US, Canada, Australia and Singapore). The study also took stock of the international standards by reference to the membership admission criteria of IFIAR and the standards adopted by the EU in its Statutory Audit Directive for considering whether non-EU jurisdictions are equivalent. The report was published in October 2013 and can be accessed at [http://frc.org.hk/pdf\\_20131010/Full%20Report.pdf](http://frc.org.hk/pdf_20131010/Full%20Report.pdf).

<sup>18</sup> In October 2013, HKICPA conducted a three-month exercise to solicit views from its members on the reform.

## **Seeking Comments**

- 1.19 The Government would like to invite comments on the reform proposals set out in this consultation document. Please send your comments to us on or before 19 September 2014. The Government will study carefully the comments received in preparing the necessary legislation.
- 1.20 Subject to the outcome of the consultation, the Government plans to introduce a Bill to amend the PAO and the FRCO into the Legislative Council in 2015.

## Chapter 2

### BASIC PARAMETERS OF REFORM

#### Objective

- 2.1 To reinforce Hong Kong's status as an international financial centre and capital market, it is imperative that our auditor regulatory regime evolves with changing market needs in the light of international developments and local circumstances. Having regard to the international trend of establishing independent oversight for auditor regulatory regimes, we **propose** that the objective of the reform is to further enhance the independence of the existing auditor regulatory regime from the auditing profession with a view to ensuring that the regime is benchmarked against international standards and practices and continues to be appropriate in the local context.

#### Basic Parameters of Reform

##### *Focus on the regulatory regime for listed entity auditor*

- 2.2 At present, all companies registered in Hong Kong are required to appoint an auditor to audit its financial statements under the Companies Ordinance (Cap. 622). These companies number more than one million in total, the vast majority of which are small private companies. Currently, all practice units registered with HKICPA (numbering 5915 in total as of 31 March 2014) are qualified to sign on the auditor's report of these companies, and they come under the existing auditor regulatory regime which is primarily administered by HKICPA. Our priority is to address concerns that Hong Kong as an international financial centre, with an increasing number of overseas companies being listed here and the globalised operations of existing listed companies, is lagging behind comparable overseas jurisdictions in terms of the international recognition of the independence of our auditor regulatory regime.
- 2.3 Given the gate-keeping role played by listed entity auditors in providing assurance for the integrity and accuracy of the financial reports of listed entities, an effective and independent regulatory regime for this category of auditors is of paramount importance to safeguarding the interest of the public. It is our policy intention that the current reform should focus on

establishing necessary independent oversight for the audit activities of listed entities. Therefore, we **propose** to confine the remit of the reform to enhancing the independence of the regulatory regime for auditors of listed entities from the profession itself. This is consistent with the policy approach which was taken when defining the present statutory remit of FRC, whose statutory function is to conduct independent investigation into possible auditing and reporting irregularities in relation to listed entities. As of 31 December 2013, 51 audit firms perform audits for such entities.

#### *Reference to international standards and practices*

- 2.4 One of IFIAR's membership criteria as set out in its Charter is that its members are required to engage in auditor regulatory functions in the public interest with respect to auditors undertaking audits of "public interest entities". In order to enable Hong Kong to be eligible for being represented in IFIAR, we **propose** to draft the necessary legislation for the reform in such a way that the new regulatory regime would cover auditors of public interest entities, with public interest entities to be defined to mean listed entities in Hong Kong. Our policy objective is to cover auditors of listed entities only and we have no plan to expand the definition of public interest entities. To alleviate possible concern from the audit profession that the definition of public interest entities would be widened in future to cover certain non-listed entities without due consultation and consideration, we **propose** that the definition of public interest entities should be set out in the main legislation such that any change in future could only be made by way of an amendment bill.
- 2.5 Some in the audit profession have also noted that many comparable overseas jurisdictions have already achieved regulatory equivalence with the EU system. We see the importance of making reference to the relevant EU Principles in designing the new regulatory regime. In this regard, we note that FRC had indicated its full support for Hong Kong to achieve regulatory equivalence with the EU system. Besides, following its members' engagement exercise, HKICPA indicated in its conclusions of March 2014 that it also supported EU equivalence as a policy objective, on the condition that the new regime would not cause unnecessary disturbance to existing systems.

**Question 1**

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

**Question 2**

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

**Question 3**

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

*FRC as the independent auditor oversight body*

- 2.6 Since its establishment in 2006, FRC has been playing an increasingly important role in upholding the quality of financial reporting in Hong Kong in respect of listed entities, especially in conducting independent investigations into possible auditing/reporting irregularities in relation to listed entities. Over the years, it has accumulated strong expertise and invaluable experience in financial reporting regulatory issues.
- 2.7 Besides, FRC meets all relevant international standards in terms of its independence from the auditing profession. Under the FRCO, all members of FRC are appointed by the Government, with a majority being lay persons as required by law. The law also provides for a comprehensive system to ensure avoidance of conflict of interest such that members with material interest will not be able to influence the outcome of FRC's investigations.
- 2.8 In view of the above, we **propose** that FRC should become the independent auditor oversight body with respect to listed entities in Hong Kong under the proposed new regulatory regime by enlarging its regulatory remit as appropriate. This arrangement could synergise the expertise and knowledge gained by FRC in financial reporting regulation and minimise regulatory duplication.

**Question 4**

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

## Chapter 3

### REGISTRATION

#### Present Position

##### *Qualification as an auditor of a listed entity in Hong Kong*

- 3.1 At present, the qualification requirements as an auditor of a listed entity in Hong Kong are the same as those for an auditor of a company registered in Hong Kong, subject to the special arrangements with regard to overseas entities listed in Hong Kong (see paragraphs 3.15 to 3.16 below).
- 3.2 The Companies Ordinance (Cap. 622) stipulates that only a practice unit registered under PAO may sign on an auditor's report of a company registered in Hong Kong. A practice unit includes –
- (a) a CPA (practising) (i.e. a CPA with a practising certificate) practising on his own;
  - (b) a firm of CPAs (practising); and
  - (c) a corporate practice registered with HKICPA.

As of 31 March 2014, there are 5,915 practice units qualified to sign on an auditor's report in Hong Kong, which comprise 4,224 CPAs (practising), 1,259 firms of CPAs (practising) and 432 corporate practices. Amongst them, there are 51 auditors of listed entities in Hong Kong.

- 3.3 The PAO stipulates that a CPA must fulfil the following requirements for obtaining a practising certificate –
- (a) passes examinations in local law and taxation;
  - (b) fulfils relevant auditing experience requirement of having a period of not less than four years of full-time approved accounting experience of which at least one year is acquired after the applicant

becomes qualified as a CPA<sup>19</sup>;

- (c) is ordinarily resident in Hong Kong;
- (d) fulfils HKICPA's requirements for CPD; and
- (e) is not a bankrupt nor has become bankrupt nor has entered into a voluntary arrangement with his creditors within the meaning of the Bankruptcy Ordinance<sup>20</sup>.

The HKICPA Council is the authority for issuing practising certificates to CPAs. Practising certificates are subject to annual renewal.

- 3.4 In situations where a CPA (practising) wishes to practise under a firm name on his own account or in partnership, or to practise as a body corporate (i.e. a corporate practice), he must apply to the HKICPA Council for registration of the firm name or the corporate practice as appropriate<sup>21</sup>. Registration as a registered firm/corporate practice is also subject to annual renewal.
- 3.5 Since an individual has to be a CPA before he is eligible to obtain a practising certificate, he also needs to fulfil the relevant requirements for qualifying as a CPA before he can apply to be an auditor under the current regime. At present, the HKICPA Council is the registration authority for CPAs. Under the PAO, a person applying to become a CPA has to attain the age of 21 and is of good character and a fit and proper person.
- 3.6 HKICPA has laid down specific criteria for considering the fitness and properness of an applicant for registration as a CPA<sup>22</sup>. Regarding "fitness", it relates to the competence and capacity of the applicant to fulfil his or her relevant responsibilities. Criteria to consider include professional qualifications, knowledge, skills, experience and reliability. As for "properness", it relates to the applicant's character and suitability for membership of HKICPA. Criteria to consider include adherence to

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<sup>19</sup> The four-year period may be reduced to 30 months if all the experience is acquired after the applicant becomes qualified as a CPA.

<sup>20</sup> Sections 29A and 30 of the PAO.

<sup>21</sup> Sections 28A and 28D of the PAO.

<sup>22</sup> The specific criteria currently stipulated by HKICPA for considering the fitness and properness of an applicant can be found at [http://www.hkicpa.org.hk/file/media/section3\\_registration/Register%20as%20a%20CPA/pdf-file/info/membership-fit-proper.pdf](http://www.hkicpa.org.hk/file/media/section3_registration/Register%20as%20a%20CPA/pdf-file/info/membership-fit-proper.pdf).



the HKICPA Code of Ethics for Professional Accountants, behaviour in personal as well as professional life, financial integrity, conviction or civil liability and good reputation and character. Besides, the applicant also needs to pass the qualification programme examination conducted by HKICPA and satisfy the practical experience requirements prescribed by the HKICPA Council<sup>23</sup>.

- 3.7 Registration of a person as a CPA is subject to annual renewal. An application for renewal will not be granted unless the applicant has satisfied the HKICPA Council that he has complied with the requirements on CPD<sup>24</sup>.

*Individuals authorised to perform specific roles in an audit engagement – engagement partners, engagement quality control reviewers, and individuals who are ultimately responsible for the system of quality control within a practice unit*

- 3.8 Where an audit engagement in respect of a listed entity is taken up by a firm of CPAs (practising) or a corporate practice, the prevailing Hong Kong auditing standards provide that an “engagement partner” should be responsible for the engagement and its performance, and for the report that is issued on behalf of the practice unit.
- 3.9 According to the prevailing Hong Kong auditing standards, an engagement quality control review is also required for all audits of financial statements of listed entities. Such reviews provide an objective evaluation of the significant judgments made by the engagement team of the practice unit and the conclusions reached in formulating the engagement report. The standards also provide that engagement quality control reviewers should have the technical qualifications, including the necessary experience and authority, to perform the role. An example given in the standards is that “the engagement quality control reviewer for an audit of the financial statements of a listed entity is likely to be an individual with sufficient and appropriate experience and authority to act as an audit engagement partner on audits of financial statements of listed entities”.
- 3.10 Besides, the prevailing auditing standards also contain express stipulation on the leadership responsibilities for quality within a practice unit. In particular, the standards require a practice unit to establish

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<sup>23</sup> Section 24 of the PAO.

<sup>24</sup> Section 28(2)(c) of the PAO.

policies and procedures designed to promote an internal culture recognising that quality is essential in performing engagements<sup>25</sup>. The standards also stipulate that such policies and procedures shall require certain individual(s) within the practice unit viz. the practice unit's chief executive officer (or equivalent) or, if appropriate, the practice unit's managing board of partners (or equivalent) to assume ultimate responsibility for its system of quality control<sup>26</sup>.

### *Maintenance and publication of register*

- 3.11 The HKICPA Registrar is statutorily required to keep a register which includes the names of CPAs (practising), registered firms and corporate practices together with their particulars<sup>27</sup>. For the purposes of enabling any member of the public to ascertain whether he is dealing with a CPA (practising), a firm of CPAs (practising) or a corporate practice, and to ascertain the particulars of registration of such person, the HKICPA Registrar is required to make available the register or a reproduction of the relevant information for public inspection without charge<sup>28</sup>. Besides, the Registrar is also required to publish the lists of CPAs (practising), registered firm names and corporate practices in the Gazette once every year<sup>29</sup>.
- 3.12 In case the application for/renewal of a practising certificate or the application for registration/renewal of registration as a firm/corporate practice is rejected by the HKICPA Council, the applicant may file an appeal to the Court of Appeal against the Council's decision<sup>30</sup>.

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<sup>25</sup> Under paragraph 16 of Hong Kong Standard on Quality Control 1, a practice unit is required to establish and maintain a system of quality control that includes policies and procedures that address each of the following elements –

- (a) leadership responsibilities for quality within the firm;
- (b) relevant ethical requirements;
- (c) acceptance and continuance of client relationships and specific engagements;
- (d) human resources;
- (e) engagement performance; and
- (f) monitoring.

<sup>26</sup> Paragraph 18 of Hong Kong Standard on Quality Control 1.

<sup>27</sup> Under section 22 of the PAO, the HKICPA Registrar shall enter in its register the following particulars of a CPA (practising): (a) his name; (b) his residential address and his registered office; (c) the qualification by virtue of which he is registered; and (d) such other particulars as the Council may direct. Section 28E provides that the HKICPA Registrar shall enter in its register the following particulars of a corporate practice: (a) its name; (b) its registered office; and (c) such other particulars (if any) as specified by the Council.

<sup>28</sup> Section 22 of the PAO.

<sup>29</sup> Section 32 of the PAO.

<sup>30</sup> Section 41 of the PAO.

- 3.13 Under the PAO, the HKICPA Council shall remove the name of a CPA (practising), a registered firm or a corporate practice from the register under certain specified circumstances, e.g. such as when he dies (in the case of an individual), has been registered by mistake, fails to renew his registration or in accordance with an order made by the Disciplinary Committee (relevant background on the Disciplinary Committee set-up and its proceedings are set out in paragraphs 7.3 to 7.8), etc. However, if an appeal is lodged by the registrant to the Court of Appeal against an order made by the HKICPA Disciplinary Committee, he shall not be removed from the register before the appeal is finally determined<sup>31</sup>.
- 3.14 The HKICPA Council may also cancel the practising certificate of a CPA if he fails to commence practice within six months from the date of issue of the practising certificate, is or has become bankrupt or has entered into a voluntary arrangement with his creditors, or fails to comply with HKICPA's requirements for CPD within a specified period.

*Acceptance of overseas auditors for auditing overseas entities listed in Hong Kong*

- 3.15 With reference to other major international capital markets which allow listed entities domiciled outside their jurisdictions to engage auditors based in these outside jurisdictions, and against the background of Hong Kong's development as an international capital formation centre, SFC and HKEx accept certain overseas collective investment schemes listed in Hong Kong and overseas-incorporated companies listed in Hong Kong respectively to engage, apart from a practice unit under the PAO (paragraph 3.1 refers), an overseas auditor which "has an international name and reputation" and "is a member of a recognised body of accountants" to audit their annual accounts<sup>32</sup>.
- 3.16 Under the existing arrangements, SFC will consider whether to accept an overseas auditor as part of its overall process for considering the listing application by the relevant overseas collective investment scheme which is to be audited by the overseas auditor. HKEx applies similar arrangements for considering acceptance of an overseas auditor in

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<sup>31</sup> Section 27 of the PAO.

<sup>32</sup> Main Board Listing Rule 19.20 and Section IV of SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products. Separately, Main Board Listing Rule 19A.31 also provides for a special arrangement for HKEx to accept specified Mainland audit firms to audit relevant Mainland-incorporated listed companies. The number of listed entities involved are set out in footnote 34.

respect of an overseas-incorporated company listed in Hong Kong. In other words, any decision by SFC and HKEx to accept an overseas auditor is linked to the listing of the relevant overseas entity on a listing platform in Hong Kong.

## **International Standards and Practices**

3.17 Most comparable overseas jurisdictions with major financial centres have already put in place independent systems of public oversight which assume the ultimate responsibility for the oversight of the approval and registration of auditors of their listed entities. The EU Statutory Audit Directive also stipulates that the system of public oversight of all EU Member States and third countries which have achieved regulatory equivalence with EU shall have the ultimate responsibility for the oversight of the approval and registration of their listed entity auditors. It is noted that most major jurisdictions (e.g. US, Canada and Australia) require their listed entity auditors to be registered directly with their independent auditor oversight bodies, which are responsible for operating the system for handling registration application and renewal. On the other hand, a few jurisdictions empower their professional bodies by law to administer their systems for registering listed entity auditors under the oversight of their independent auditor oversight bodies (e.g. UK). In these latter cases, to effectively discharge their oversight roles, the oversight bodies have the ultimate responsibility for the oversight of, and are empowered by law to issue directions to, the professional bodies in respect of their registration functions as necessary.

## **Proposals**

### *Criteria for listed entity auditor*

3.18 As the policy objective of this reform is to enhance the independence of the existing regulatory regime, we have no intention to introduce any material change to the existing “entry requirements” to be a listed entity auditor. Our proposals for the new regime for listed entity auditors are made with reference to the relevant criteria under the existing regime.

3.19 We **propose** that a listed entity auditor must be a practice unit as defined under the PAO (i.e. a CPA (practising) practising on his own, a firm or a corporate practice registered with HKICPA). Besides, he has to be a fit and proper person to be registered as a listed entity auditor. In

considering whether a person is fit and proper to be registered as a listed entity auditor, we **propose** no change to the existing qualification and experience requirements for meeting the existing fit and proper test for becoming a CPA (paragraph 3.6 refers), subject to regular reviews in future.

3.20 With reference to the three categories of individuals who perform specific roles in an audit engagement under the existing regime (paragraphs 3.8 to 3.10 refer), we **propose** that an application for registration as a listed entity auditor will only be approved if the individuals who are authorised by the auditor to perform the following three specific roles are fit and proper persons to perform such roles –

- (a) audit engagement authorised persons (i.e. “engagement partners” referred to in paragraph 3.8) – they are individuals who are authorised by the auditor to issue opinions in respect of its audit engagements with listed entities (if the auditor is a firm or a corporate practice);
- (b) engagement quality control reviewers – they are individuals who take responsibility for engagement quality control reviews in respect of the auditor’s audit engagements with listed entities as referred to in paragraph 3.9; and
- (c) quality control system responsible persons – they are individuals who assume ultimate responsibility for the auditor’s system of quality control as referred to in paragraph 3.10.

We also **propose** that there will be no change to the existing qualification and experience requirements for individuals to take up these roles with respect to a registered listed entity auditor when considering whether they are fit and proper to assume these positions. These three categories of individuals, together with all registered listed entity auditors, will be the regulated persons under the new regulatory regime for listed entity auditors.

3.21 Since there will be no material change to the existing entry requirements for a registered listed entity auditor, pre-existing listed entity auditors and practice units who are qualified to be listed entity auditors under the present regime will continue to be eligible to be a registered listed entity auditor upon the coming into effect of the new regime.

### **Question 5**

- (a) Do you agree that a listed entity auditor must be a practice unit as defined under the existing PAO and a fit and proper person to be registered as a listed entity auditor?
- (b) If yes, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for considering whether a person is fit and proper to be registered as a listed entity auditor, i.e. by reference to the existing fit and proper test for becoming a CPA?

### **Question 6**

- (a) Do you agree that in order for an application for registration as a listed entity auditor to be approved, the individuals who are authorised by the auditor to perform the roles of an audit engagement authorised person, an engagement quality control reviewer or a quality control system responsible person should be fit and proper persons to perform such roles?
- (b) If so, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for individuals taking up such roles with respect to a registered listed entity auditor when considering whether they are fit and proper to perform those roles?

### *Register of listed entity auditors*

- 3.22 We **propose** that an individual, partnership or body corporate who wishes to enter into an audit engagement<sup>33</sup> with a listed entity in Hong Kong should be required to register with a Registrar of Listed Entity Auditors, and it shall be a criminal offence if an unregistered auditor entered into an audit engagement with a listed entity. In addition, a new register of listed entity auditors should be established.
- 3.23 Considering that HKICPA is equipped with the necessary infrastructure and experience in discharging associated registration functions and as it has been performing the statutory functions of registering CPAs, firms and corporate practices as well as granting practising certificates to CPAs under the PAO, we **propose** that HKICPA shall be assigned the role of the Registrar of Listed Entity Auditors, with its registration functions discharged through the HKICPA Registrar. As the Registrar

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<sup>33</sup> “Audit engagements” will be deemed to cover all assurance engagements required to be undertaken by auditors under the Listing Rules (c.f. Rules 4.03 and 19.20).

of Listed Entity Auditors, the HKICPA Registrar shall be responsible for –

- (a) maintaining the register of listed entity auditors;
- (b) the custody of the said register;
- (c) receiving applications for and making decisions on registration in accordance with the statutory registration criteria and requirements as set out in paragraphs 3.19 and 3.20;
- (d) receiving applications for and making decisions on renewal of registration in accordance with the statutory registration criteria and requirements as well as the requirements for CPD (details are set out in Chapter 4);
- (e) removing the name of a registered listed entity auditor from the register under certain specified circumstances, such as when he dies (if the auditor is an individual), has been registered by mistake, fails to renew his registration, ceases to be qualified for such registration, or in accordance with a disciplinary decision made under the new disciplinary mechanism for listed entity auditors (details are set out in Chapter 7);
- (f) making available the register of listed entity auditors or a reproduction of the information for public inspection without charge; and
- (g) publishing the list of listed entity auditor in the Gazette once every year and, as far as practicable, making the register available to the public through the internet.

3.24 We **propose** that FRC, as Hong Kong’s independent auditor oversight body under the proposed new regulatory regime, should be responsible for independent oversight of the registration of listed entity auditors. We **propose** that FRC’s oversight powers over the HKICPA Registrar should be exercised through the following arrangements –

- (a) receiving periodic reports from the HKICPA Registrar on the performance of its functions and exercise of its powers in relation to the registration of listed entity auditors;

- (b) conducting quality review on the HKICPA Registrar in respect of its performance of such functions and exercise of such powers; and
- (c) upon being satisfied that it is in the public interest to do so, giving written directions to the HKICPA Registrar in relation to the latter's performance of such functions and exercise of such powers, and the HKICPA Registrar would be required to act accordingly upon receipt of such written directions.

FRC will not be involved in HKICPA's day-to-day operation when the latter performs such functions and exercises such powers. To enhance transparency of the exercising of the said oversight powers by FRC, we **propose** that FRC should publish the said periodic reports on its website, and provide information on the results of its quality review and the written directions given by it in its annual report.

#### **Question 7**

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

#### **Question 8**

- (a) Do you agree that HKICPA Registrar should be assigned the role of Registrar of Listed Entity Auditors and be vested with the registration functions and powers as outlined in paragraph 3.23, and FRC should exercise oversight through arrangements as proposed in paragraph 3.24?
- (b) Do you agree that FRC should publish the periodic reports received by the HKICPA Registrar as mentioned in paragraph 3.24(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?

### *Appeal mechanism*

3.25 As a measure of check-and-balance, we **propose** that any person subject to a registration decision by the HKICPA Registrar may appeal against the decision, and any such appeal should be handled by an appeal mechanism which is independent of both the HKICPA Registrar and FRC. A registration decision will not come into effect until the appeal is determined. Details on the proposed appeal mechanism are set out in Chapter 8.



**Question 9**

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

*Other registration provisions*

- 3.26 Following existing arrangements under the current regime, we **propose** that registration shall remain in force until 1 January in the year following the year in which the auditor was so registered, and each registration is subject to annual renewal.
- 3.27 Modelling on the existing arrangement with respect to the information required to be included in the HKICPA register at present, we **propose** that the register of listed entity auditors should contain the following information about each registered listed entity auditor –
- (a) the full name of the registered listed entity auditor;
  - (b) the start and expiry date of each registration;
  - (c) any conditions placed on the registered listed entity auditor (see Chapter 7) ;
  - (d) the name of individuals authorised by the registered listed entity auditor to perform the roles as described in paragraph 3.20, namely the audit engagement authorised person(s), the engagement quality control reviewer(s) and the quality control system responsible person(s), and their relevant particulars; and
  - (e) any other prescribed information, including the business address of the listed entity auditor.

**Question 10**

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

**Question 11**

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

*Recognition of overseas auditors of specific overseas entities listed in Hong Kong on an exceptional basis*

- 3.28 As the regulation of listed entity auditors would in future be subject to independent oversight by FRC, we propose to take the opportunity of the reform to bring the mechanism for the acceptance of overseas auditors to audit overseas entities listed in Hong Kong (paragraphs 3.15 and 3.16 refer) under the new regulatory regime for listed entity auditors.
- 3.29 We **propose** that FRC be vested with the statutory powers to receive and make decisions on applications for recognising overseas auditors of specific overseas entities which have been approved for listing in Hong Kong, noting that it will be best placed to make such decisions in an independent and unbiased manner. Overseas auditors who wish to enter into audit engagements with specific overseas entities approved for listing in Hong Kong shall apply to FRC for recognition in respect of such engagements in lieu of applying to be registered in accordance with paragraph 3.22.
- 3.30 We **propose** that an applicant for recognition as an overseas auditor of a specific overseas entity listed in Hong Kong must meet the following criteria –
- (a) the auditor is a member of a body of accountants recognised by FRC;
  - (b) there is in force an agreement of mutual or reciprocal cooperation arrangement between the overseas regulator of the auditor and FRC; and

(c) he must demonstrate to the satisfaction of FRC that he has adequate resources and possesses the capability to perform the audit of the relevant overseas entity listed in Hong Kong.

3.31 Criterion (a) is modelled on a similar requirement in the existing Listing Rules. Criteria (b) and (c) replace the existing requirement in the Listing Rules that the overseas auditor needs to have “an international name and reputation”. Criterion (b) ensures that the applicant must be regulated by an overseas regulator which can be relied upon by FRC to provide regulatory assistance, such as performing direct supervision and regulation of the overseas auditors concerned. This would also enable FRC to follow through on any issues concerning the recognised overseas auditors of listed entities by referring such cases to the relevant overseas regulators. Criterion (c) sets out more objective factors to be taken into account by FRC in assessing the suitability of the overseas auditor to take up the audit engagement in question. These criteria should not affect the eligibility of overseas auditors which have already been accepted by SFC/HKEx<sup>34</sup> for continuing to be recognised as overseas auditors for auditing specific overseas entities listed in Hong Kong under the new mechanism.

3.32 FRC’s assessment on whether an applicant is able to fulfil the said criteria will be specific to the relevant overseas entity listed in Hong Kong. A decision by FRC to recognise an overseas auditor will only apply to the audit engagement with the specific overseas entity listed in Hong Kong as set out in the application. The overseas auditor in question will not be allowed to enter into an audit engagement with any other overseas entity listed in Hong Kong, unless it makes a fresh application to FRC, which is to be considered by FRC on a case-by-case basis. Such application will not be approved unless FRC is satisfied that the overseas auditor fulfils the criteria as mentioned in paragraph 3.30 above. This arrangement is similar to the existing practice of SFC and HKEx in handling applications from overseas auditors for acceptance.

3.33 We **propose** that the recognition of an overseas auditor of an overseas entity listed in Hong Kong shall remain in force until –

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<sup>34</sup> As of 31 March 2014, HKEx has accepted 18 overseas auditors for auditing the annual accounts of 24 overseas-incorporated listed companies in accordance with paragraph 19.20 of the Listing Rules while 11 Mainland auditors have also been accepted for auditing the annual accounts of 41 Mainland-incorporated listed companies in accordance with paragraph 19A.31 of the Listing Rules. Besides, SFC has accepted 4 overseas auditors for auditing the annual accounts of 38 overseas collective investment schemes listed in Hong Kong.

- (a) 1 January in the year following the year in which the overseas auditor was so recognised, which is consistent with the arrangement for the registration of a listed entity auditor; or
- (b) the time when the overseas auditor ceases to be the auditor of the overseas entity in question,

whichever is earlier. In case of (a), the registrant may apply for renewal of his recognition and FRC shall consider the application having regard to the relevant criteria as mentioned in paragraph 3.30 above.

- 3.34 We **propose** that the HKICPA Registrar shall maintain and update a list of the overseas auditors who were recognised by FRC for entering into audit engagements with specific overseas entities listed in Hong Kong. FRC and the HKICPA Registrar shall enter into an arrangement to ensure that the list of recognised overseas auditors will be updated in a timely manner to reflect recognition decisions made by FRC.
- 3.35 To enhance transparency, we **propose** that the HKICPA Registrar should make available for public inspection/publish on its website a list of the overseas auditors which were recognised by FRC for entering into audit engagements with specific overseas entities listed in Hong Kong.

**Question 12**

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

**Question 13**

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

**Question 14**

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

**Question 15**

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

## Chapter 4

### SETTING OF CONTINUING PROFESSIONAL DEVELOPMENT REQUIREMENTS

#### Present Position

- 4.1 At present, a listed entity auditor is required to comply with relevant CPD requirements. Under the PAO, the HKICPA Council may refuse to issue a practising certificate to a CPA (thereby disqualifying him as a listed entity auditor) if he has failed to satisfy the Council that he has complied with the CPD requirements stipulated by the Council<sup>35</sup>. Similarly, an application for renewal of registration as a CPA shall only be granted if the applicant has satisfied the HKICPA Council that he has complied with the requirements prescribed by the Council for CPD<sup>36</sup>.
- 4.2 In practice, the HKICPA Council has prescribed one set of CPD requirements which applies to all CPAs, including listed entity auditors.
- 4.3 Besides setting CPD requirements, HKICPA also organises training programmes, attendance of which will be counted towards the fulfilment of CPD requirements by a listed entity auditor.

#### International Standards and Practices

- 4.4 In most comparable overseas jurisdictions with major financial centres, the independent auditor oversight bodies assume ultimate responsibility for setting the CPD requirements of their listed entity auditors. The EU Statutory Audit Directive also stipulates that the system of public oversight of all EU Member States and third countries which have achieved regulatory equivalence with EU should have the ultimate responsibility for the oversight of continuing education of auditors. In particular, the independent auditor oversight bodies of some jurisdictions (e.g. US and Singapore) assume direct responsibility over the setting of CPD requirements, whereas in other jurisdictions (e.g. UK), their independent auditor oversight bodies exercise oversight of their professional bodies' work in setting CPD requirements.

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<sup>35</sup> Section 30(8) of the PAO.

<sup>36</sup> Section 28(2)(c) of the PAO.

## Proposals

4.5 With reference to the prevailing international practices with regard to the setting of CPD requirements for listed entity auditors, we **propose** that in future, HKICPA should continue to perform the statutory functions and exercise the powers of setting CPD requirements for listed entity auditors, subject to independent oversight by FRC as follows –

- (a) subject to (b) below, the HKICPA Council be vested with statutory functions and powers to prescribe CPD requirements for listed entity auditors for the purpose of renewing the registration of listed entity auditors; and
- (b) FRC would be empowered by law to oversee the discharge of the HKICPA Council’s statutory functions and powers in relation to the setting of CPD requirements for listed entity auditors.

4.6 Specifically, we **propose** that FRC’s oversight should be exercised through the following arrangements –

- (a) receiving periodic reports from the HKICPA Council on the performance of its functions and exercise of its powers in relation to prescribing CPD requirements for listed entity auditors for the purpose of renewing their registration;
- (b) conducting quality review on the HKICPA Council in respect of its performance of such functions and exercise of such powers; and
- (c) upon being satisfied that it is in the public interest to do so, giving the HKICPA Council written directions in relation to the latter’s performance of such functions and exercise of such powers, and the HKICPA Council would be required to act accordingly upon receipt of such written directions.

To enhance transparency of the exercising of the said oversight powers by FRC, we **propose** that FRC will publish the said periodic reports on its website, and provide information on the results of its quality review and the written directions given by it in its annual report. The proposed oversight powers are the same as those which would be exercised by FRC in terms of the registration of listed entity auditors (see Chapter 3).

**Question 16**

- (a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers with regard to setting CPD requirements for listed entity auditors, subject to independent oversight by FRC in accordance with paragraph 4.6?
- (b) Do you agree that FRC should publish the periodic reports received by it as mentioned in paragraph 4.6(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?



## Chapter 5

### SETTING OF STANDARDS ON PROFESSIONAL ETHICS, AUDITING AND ASSURANCE

#### Present position

- 5.1 At present, a listed entity auditor is required to observe, maintain or apply relevant standards of auditing and assurance practices as well as statements of professional ethics. Under the PAO, the HKICPA Council is empowered to specify such standards and statements which are required to be observed, maintained or applied by CPAs (practising), including listed entity auditors (“standards on professional ethics, auditing and assurance”)<sup>37</sup>.
- 5.2 Since 2005, the HKICPA Council has adopted international standards promulgated by the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA)<sup>38</sup> when specifying standards on professional ethics, auditing and assurance in Hong Kong.
- 5.3 Before adopting any new or revised standards on professional ethics, auditing and assurance, the HKICPA Council consults other relevant stakeholders, including regulatory bodies (such as FRC), its members, listed companies in Hong Kong, HKEx, academics and other relevant organisations.
- 5.4 The HKICPA Council has also established two committees to oversee the process for setting standards on professional ethics, auditing and assurance. The Audit and Assurance Standards Committee is responsible for the auditing and assurance standards and comprises HKICPA members and representatives of FRC, HKEx and SFC. The Ethics Committee is responsible for the standards on professional ethics and its members include HKICPA members and representatives of SFC and the Independent Commission Against Corruption (but not FRC). The two committees also issue practice notes to provide information

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<sup>37</sup> Section 18A of the PAO.

<sup>38</sup> IAASB and IESBA are both independent standard-setting bodies supported by IFAC. The standard-setting activities of IAASB and IESBA are subject to oversight by the Public Interest Oversight Board and the Monitoring Group (whose members include the Basel Committee on Banking Supervision, EC, Financial Stability Board, International Association of Insurance Supervisors, IFIAR, IOSCO, and the World Bank).

and/or guidance on issues concerning professional ethics, auditing and assurance, and prepares HKICPA's submissions to IAASB and IESBA on their consultation papers and exposure drafts on new and revised standards.

- 5.5 As a member of IFAC, HKICPA has indicated that it is committed to maintaining the convergence of its standards on professional ethics, auditing and assurance with international standards promulgated by IAASB and IESBA.

### **International Standards and Practices**

- 5.6 In most comparable overseas jurisdictions with major financial centres, the independent auditor oversight bodies have direct or oversight powers for the setting of standards on professional ethics, auditing and assurance. The EU Statutory Audit Directive also stipulates that the system of public oversight of all EU Member States and third countries which have achieved regulatory equivalence with EU should have the ultimate responsibility for the oversight of the adoption of standards on auditing, professional ethics and internal quality control of audit firms. In many jurisdictions, such standards are directly specified by the independent auditor oversight bodies or other bodies independent from the audit profession (e.g. US and UK) while in a few others, the independent auditor oversight bodies exercise oversight of the setting of standards by their professional bodies (e.g. Canada).

### **Proposals**

- 5.7 With reference to the prevailing international standards and practices, and taking into account the local circumstances as described in paragraphs 5.1 to 5.5 and the fact that the existing international standards on professional ethics, auditing and assurance apply equally to both listed and non-listed entities, we **propose** that the HKICPA Council should continue to perform its present statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing and assurance to be observed, maintained or applied by CPAs (practising), but such functions and powers which are applicable to listed entity auditors would be subject to oversight by FRC.
- 5.8 Specifically, we **propose** that FRC's oversight powers should be specified in law and exercised through the following arrangements –

- (a) receiving periodic reports from the HKICPA Council on the performance of its functions and exercising of its powers relating to the specification of standards on professional ethics, auditing and assurance to be observed, maintained or applied by any listed entity auditor;
- (b) conducting quality review on the HKICPA Council in respect of its performance of such functions and exercise of such powers; and
- (c) upon being satisfied that it is in the public interest to do so, giving the HKICPA Council written directions in relation to the latter's performance of such functions and exercise of such powers, and the HKICPA Council would be required to act accordingly upon receipt of such written directions.

To enhance transparency of the exercising of the said oversight powers by FRC, we **propose** that FRC will publish the said periodic reports on its website, and provide information on the results of its quality review and the written directions given by it in its annual report. The proposed oversight powers are the same as those which would be exercised by FRC in terms of the registration and the setting of CPD requirements of listed entity auditors (see Chapters 3 and 4).

- 5.9 To facilitate smooth operation of this new arrangement for the setting of standards on professional ethics, auditing and assurance in relation to listed entity auditors, we **propose** that HKICPA and FRC should establish procedures to ensure that the HKICPA Council would duly take into account FRC's views before it makes any decision on the setting of such standards. Specifically, a full-time employee of FRC should serve as an observer on both the Audit and Assurance Standards Committee and the Ethics Committee of HKICPA and receive all papers of the two committees.
- 5.10 Under the above proposals, both FRC and the HKICPA Council will perform important statutory roles in the new regime for setting standards on professional ethics, auditing and assurance to be observed, maintained or applied by listed entity auditors.

**Question 17**

- (a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing and assurance to be observed, maintained or otherwise applied by CPAs (practising), and FRC should exercise oversight of the performance of such functions and the exercise of such powers by HKICPA which are applicable to listed entity auditors as proposed in the arrangements set out in paragraph 5.8?
- (b) Do you agree that FRC should publish the periodic reports received by it as mentioned in paragraph 5.8(a) on its website, and provide information on the results of its quality review and the written instructions given by it in its annual report?

**Question 18**

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

## Chapter 6

### INSPECTION

#### Background

- 6.1 To monitor auditors' compliance with applicable professional standards and enhance the quality of auditing, it is necessary for regulators of auditors to put in place a programme for conducting inspections of auditors on a recurring basis. Usually, inspection programmes would include reviewing both the internal quality control system of practice units and their individual audit engagements. The former would address the practice unit's overall quality control system as reflected in its organisation, policies and procedures, while the latter would include reviewing selected audit files in order to assess the application of the practice unit's quality control system and its compliance with applicable laws, rules and professional standards. Regulators of auditors would usually establish a minimum cycle regarding the frequency of inspections of individual practice units having regard to various risk factors.
- 6.2 Recurring inspection of practice units in Hong Kong is currently conducted by HKICPA, which operates a practice review programme pursuant to the authority and powers as set out in the PAO.
- 6.3 Under the PAO, the HKICPA Council is empowered to specify the particular professional standards in relation to which inspections are to be carried out. It may also issue directions requiring an examination or a review, to determine whether the specified professional standards have been observed, maintained or applied by the practice units<sup>39</sup>.
- 6.4 The actual inspections of practice units are conducted by reviewers, who in practice are full-time HKICPA employees with an audit background. The reviewers are provided with specific statutory powers to enable them to carry out the inspections. Under the PAO, the results of the inspections by the reviewers are reported to a statutory Practice Review Committee ("the PRC"), members of which are CPAs appointed by the

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<sup>39</sup> Section 32B of the PAO.

HKICPA Council<sup>40</sup>. The PRC is empowered inter alia to determine the practice and procedure to be observed in relation to the inspections and to issue instructions to any reviewer relating to the inspections<sup>41</sup>.

- 6.5 Before making a report to the PRC, a reviewer will send a draft of the report to the practice unit concerned and any individual named in the draft, who are entitled under the PAO to make submissions or representations in writing to the reviewer<sup>42</sup>. Having regard to the inspection report and any submissions or representations made in respect of the matters raised in the report, the PRC may take any of the following actions –
- (a) to conclude the inspection with no follow up action required;
  - (b) to make recommendations and specific requests to the practice unit concerned regarding the application by it of professional standards;
  - (c) to instruct that another inspection is required; or
  - (d) if PRC is of the opinion that the practice unit may have failed to observe, maintain or apply professional standards, to refer the case to the HKICPA Registrar, who shall submit it to the HKICPA Council. The Council may then at its discretion initiate HKICPA's Disciplinary Committee process (details about the process are set out in Chapter 7).
- 6.6 HKICPA selects practice units for review based on their risk profiles including the public interest profile of audit clients, while the frequency of review varies from different practices. For instance, under HKICPA's current policy, the Big Four audit firms<sup>43</sup> are subject to inspection annually, while other practice units with a significant number of listed clients are subject to a full inspection every three years and an interim inspection during the three-year cycle. The remaining practice units who have listed clients are subject to inspection once every three years.

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<sup>40</sup> The HKICPA Council shall from time to time appoint from among CPAs the members of the PRC. The Committee shall consist of not less than five members, and of whom not more than two may be members of the HKICPA Council. Besides, the PAO requires that not less than two-third of the PRC members shall be holders of practising certificate.

<sup>41</sup> Section 32D of the PAO.

<sup>42</sup> Section 32C of the PAO.

<sup>43</sup> The Big Four audit firms are namely Deloitte Touche Tohmatsu, Ernst and Young, PricewaterhouseCoopers and KPMG.

## **International Standards and Practices**

- 6.7 The Charter of IFIAR specifies that IFIAR’s membership is restricted to regulators that are both (a) independent of the profession (including professional bodies); and (b) engaged in audit regulatory functions in the public interest, including ultimately responsible for the system of recurring inspection of audit firms undertaking audits of public interest entities and exercising that responsibility either directly or through independent oversight. Therefore, all IFIAR members are ultimately responsible for the inspection programmes within their jurisdictions. Besides, IFIAR also specifies, in its “Cores Principles for Independent Audit Regulator”, that regulators should –
- (a) as a minimum, conduct recurring inspections of audit firms undertaking audits of public interest entities in order to assess compliance with applicable professional standards, independence requirements and other laws, rules and regulations;
  - (b) ensure that a risk-based inspections programme is in place;
  - (c) ensure that inspections include effective procedures for both firm wide and file reviews; and
  - (d) have a mechanism for reporting inspections findings to the audit firm and ensuring remediation of findings with the audit firm.
- 6.8 The Statutory Audit Directive adopted by EU in 2006 requires that each Member State shall ensure that all statutory auditors and audit firms are subject to a system of quality assurance with the following major criteria –
- (a) the quality assurance system shall be independent of the reviewed statutory auditors and audit firms and subject to the oversight of the public oversight system;
  - (b) the persons who carry out quality assurance reviews shall have appropriate professional education and relevant experience with specific training on quality assurance review;
  - (c) the reviews shall take place at least every six years; and

(d) overall results of quality assurance should be published annually.

The same benchmark is also adopted by EC in assessing the equivalence status of third country regulators of auditors.

- 6.9 IOSCO's Principles for Auditor Oversight also stipulates that an auditor oversight body should establish a process for performing regular reviews of audit procedures and practices of firms that audit the financial statements of listed public companies. Reviews should be conducted on a recurring basis, and should be designed to determine the extent to which audit firms have adequate quality control policies and procedures that address all significant aspects of auditing and adhere to the same.
- 6.10 In line with these international standards, most independent auditor oversight bodies of overseas jurisdictions assume the responsibility for the direct inspection of all (or in some cases a significant proportion) of their listed entity auditors. In some jurisdictions (e.g. UK), the oversight bodies focus on inspecting large audit firms with a significant number of listed clients while delegating its inspection function to relevant professional accounting bodies for carrying out inspections of smaller audit firms.
- 6.11 Under their inspection programmes, overseas independent auditor oversight bodies inspect the listed entity auditors on a regular basis, often annually on the large audit firms, and adopt a risk-based approach in selecting the firms' audit engagements for review.

## **Proposals**

### *Performing inspection functions*

- 6.12 We **propose** that the statutory functions to conduct recurring inspections of listed entity auditors in respect of their listed entity audit engagements should be transferred from HKICPA to FRC. This will not affect HKICPA's existing statutory functions of conducting inspections of non-listed entity auditors, or listed entity auditors in respect of their non-listed entity audit engagements.
- 6.13 To enable FRC to effectively discharge its inspection functions, we **propose** providing FRC with the following powers, which are similar to the statutory powers which HKICPA is equipped with under its practice review programme (paragraphs 6.3 to 6.4 refer) –



- (a) exercising the powers and performing the duties in relation to the inspection of listed entity auditors;
- (b) specifying the particular professional standards in relation to which inspections are to be carried out;
- (c) determining the practice and procedure to be observed in relation to the inspections;
- (d) issuing directions to require an examination or a review, to determine whether the specified professional standards have been observed, maintained or applied by the listed entity auditors;
- (e) assigning reviewers to conduct the actual inspections, who would be full-time reviewers with appropriate accounting qualifications and an audit background in line with HKICPA's practice review programme; and
- (f) issuing instructions to any reviewers relating to the inspections.

6.14 With reference to the existing arrangements for HKICPA's practice review programme as set out in paragraph 6.5, we **propose** that before making a report to FRC, a reviewer should send the draft report to the listed entity auditor concerned and any individual named in the draft, who are entitled to make submissions or representations in writing to the reviewer. FRC may, having regard to the inspection report and any submissions or representations made in respect of the matters raised in the report, take any one or more of the following actions –

- (a) to conclude the inspection with no follow up action required;
- (b) to make recommendations and specific requests to a listed entity auditor concerned regarding the application by it of professional standards;
- (c) to instruct that another inspection is required; and
- (d) to initiate its investigation/disciplinary processes if a suspected auditing/reporting irregularity is identified (details about the processes are set out in Chapter 7).

- 6.15 To facilitate effective performance of the inspection functions by FRC and with reference to the existing arrangements under the PAO for HKICPA to perform such functions through delegation to its committees, we **propose** that FRC may delegate such functions and relevant powers to committees formed under its auspices.
- 6.16 We note that HKICPA has proposed that FRC may delegate some of its inspection functions and powers to HKICPA. Besides, UK also allows its independent oversight body to delegate some of its inspection functions and powers to the relevant professional bodies (see paragraph 6.10). However, if such proposed approach is to be adopted in Hong Kong, it would be necessary to define clearly in the enabling legislation the scope of inspection work that FRC may delegate to HKICPA (e.g. whether to adopt a risk-based approach to determine the inspection work to be conducted by HKICPA and/or set a limit to the quantity of such inspection work that could be delegated each year) and also provide for an effective mechanism for FRC to monitor the quality of the delegated inspection work performed by HKICPA. In this regard, we would like to **invite views** on whether FRC should be allowed to delegate to HKICPA its functions and powers on the inspection of listed entity auditors in respect of their listed entity audit engagements; and if so, what checks-and-balances measures should be introduced to ensure proper delegation and accountability for the quality of delegated work.

**Question 19**

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

**Question 20**

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

**Question 21**

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

**Question 22**

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

*Inspection powers*

6.17 In order to enable the FRC reviewers to carry out inspections in an effective manner, it is necessary to provide them with statutory powers to exercise their functions. With reference to the existing inspection powers of other financial regulators in Hong Kong, we **propose** that the FRC reviewers be given the following statutory powers –

- (a) to enter any business premises of the listed entity auditor at any reasonable time;
- (b) to inspect, and make copies or otherwise record details of, any record or document of the listed entity auditor in relation to his audit engagement with a listed entity;
- (c) to make enquiries of the listed entity auditor (or a person whom the reviewer has reasonable cause to believe has information relating to, or is in possession of, the record or document of the listed entity auditor) concerning –
  - (i) a record or document of the listed entity auditor in relation to his audit engagement with a listed entity; or
  - (ii) an activity that was undertaken in the course of, or may affect, the audit engagement entered into by the listed entity auditor with a listed entity;
- (d) to require the listed entity auditor (or a person whom the reviewer has reasonable cause to believe has information relating to, or is in possession of, the record or document) to –
  - (i) give the reviewer access to a record or document of the listed entity auditor in relation to his audit engagements with listed entities;

- (ii) produce to the reviewer, within the time and at the place specified in the requirement, a record or document of the listed entity auditor in relation to his audit engagements with listed entities; or
  - (iii) answer any question regarding a record or document of the listed entity auditor in relation to his audit engagements with listed entities, or concerning any activity that was undertaken in the course of, or may affect, the audit engagement entered into by the listed entity auditor with a listed entity;
- (e) if a person gives an answer in compliance with a requirement imposed under (c) or (d) above, to require, in writing, the person to verify the answer by a statutory declaration within a required time; and
- (f) if, for the reason that the information concerned is not within the person's knowledge or possession, a person does not give any answer in compliance with a requirement imposed under (c) or (d) above, to require, in writing, the person to verify, within the time specified in the requirement, that reason and fact by a statutory declaration.

6.18 At present, FRCO already provides for criminal offences in relation to a person who fails to comply with the requirements imposed by FRC in relation to its investigation into auditing/reporting irregularities<sup>44</sup>. Similarly and in line with other financial regulatory regimes in Hong Kong, we **propose** to provide for criminal offences against a person who fails to comply with the requirements in relation to FRC's inspections as set out above. We **propose** that the provisions on such criminal offences should be modelled on the existing provisions in the FRCO concerning failure to comply with requirements in relation to an investigation into relevant irregularities.

**Question 23**

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

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<sup>44</sup> Section 31 of the FRCO.

**Question 24**

- (a) Do you agree with the proposal to provide for criminal offences against a person who fails to comply with the requirements in relation to FRC's inspections?
- (b) If so, do you agree that the provisions on such criminal offences should be modelled on the existing provisions in the FRCO concerning failure to comply with requirements in relation to an investigation into relevant irregularities?

*Inspection approach*

6.19 Since FRC and HKICPA would be responsible for conducting inspections of listed entity auditors in respect of the auditors' listed entity audit engagements and non-listed entity audit engagements respectively, the two organisations will coordinate their activities in order to ensure effective regulation and to minimise any overlap/underlap in their respective inspections of those auditors. To facilitate them to coordinate their inspection activities, we **propose** that the secrecy provisions in PAO and FRCO should be suitably amended to provide that both organisations could share their inspection results in respect of listed entity auditors with each other to enhance regulatory efficiency.

6.20 It is envisaged that the two organisations would also enter into a Memorandum of Understanding to set out, inter alia, the arrangements for coordinating their inspection activities (e.g. conduct joint inspections) with a view to minimising compliance burden on the auditors.

**Question 25**

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

## Chapter 7

### INVESTIGATION AND DISCIPLINARY PROCEEDINGS

#### Present Position

##### *Investigation*

- 7.1 At present, FRC is the statutory authority for investigating into suspected relevant irregularities by listed entity auditors. The nature of such irregularities is clearly defined in FRCO (the full definition is set out in **Annex C**), and largely coincide with areas of irregularities which are subject to HKICPA's disciplinary proceedings under the PAO (the full list of irregularities subject to HKICPA's disciplinary proceedings is set out in **Annex D**). All suspected irregularities in relation to listed entities identified by financial regulators during their day-to-day activities are referred to FRC for independent investigation. In particular, the PAO requires HKICPA to refer matters which constitute a relevant irregularity in relation to a listed entity to FRC<sup>45</sup>.
- 7.2 FRC is vested with extensive powers under the FRCO to conduct independent investigation into relevant irregularities by listed entity auditors. Upon completing an investigation, FRC may refer the investigation report to HKICPA for the latter to determine if any disciplinary actions are warranted, or carry out any follow-up action in accordance with the FRCO as it thinks fit.

##### *Disciplinary proceedings*

- 7.3 After completing an investigation into a relevant irregularity in relation to a listed entity auditor, FRC may refer the investigation report to HKICPA to consider whether disciplinary action is warranted. Upon receipt of an investigation report by FRC, the HKICPA Council may, at its discretion, initiate disciplinary proceedings against the listed entity auditor in question. For hearing each disciplinary case, the PAO provides for the establishment of a Disciplinary Committee, which shall consist of five members drawn from two Disciplinary Panels, as follows –

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<sup>45</sup> Section 42CA of the PAO.

- (a) Disciplinary Panel A shall consist of not less than 18 lay persons appointed by the Chief Executive<sup>46</sup> of whom one shall be appointed by the Chief Executive to be the Disciplinary Committee Convenor; and
- (b) Disciplinary Panel B shall consist of not less than 12 CPAs appointed by the HKICPA Council of whom not less than six shall be CPAs (practising).

Specifically, the five members of a Disciplinary Committee shall consist of –

- (a) a person appointed by the Disciplinary Committee Convenor from Disciplinary Panel A who shall be the chairman of the Disciplinary Committee;
- (b) two persons appointed by the Disciplinary Committee Convenor from Disciplinary Panel A; and
- (c) two persons appointed by the Disciplinary Committee Convenor from Disciplinary Panel B of whom one shall be a CPA (practising)<sup>47</sup>.

Over the past seven years, FRC has referred 26 cases to HKICPA. Out of these cases, the HKICPA Council has initiated disciplinary proceedings and convened Disciplinary Committees in respect of seven cases.

7.4 If a Disciplinary Committee is satisfied that a disciplinary case referred to it by the HKICPA Council in relation to a listed entity auditor is proved, it may, at its discretion, make any one or more of the following orders –

- (a) an order that the name of the auditor be removed from the register, either permanently or for such period as it may think fit;
- (b) an order that the auditor be reprimanded;

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<sup>46</sup> The appointment authority has been delegated by the Chief Executive to the Secretary for Financial Services and the Treasury since November 2004.

<sup>47</sup> Section 33 of the PAO.

- (c) an order that the auditor pay a penalty not exceeding \$500,000 to HKICPA;
- (d) an order that the auditor pay to FRC the sum the Disciplinary Committee considers appropriate for the costs and expenses in relation or incidental to the investigation reasonably incurred by FRC;
- (e) an order that the practising certificate issued to the auditor be cancelled; and
- (f) an order that a practising certificate shall not be issued to the auditor either permanently or for such period as the Disciplinary Committee may think fit<sup>48</sup>.

7.5 Every hearing of the Disciplinary Committee shall be held in public unless the Committee determines that in the interest of justice the hearing (or any part of the hearing) should be held in private<sup>49</sup>. At the hearing, the complainant (who is usually the HKICPA Registrar) or his solicitor or counsel or some other person appointed by the complainant to represent him shall present the case against the listed entity auditor whose conduct is the subject of the disciplinary proceedings. The latter shall also be entitled to be represented by counsel or a solicitor, or, with the approval of the Disciplinary Committee, by some other person appointed by him to represent him throughout the proceedings<sup>50</sup>.

7.6 The Disciplinary Committee is empowered under the PAO to take evidence on oath; summon any person to attend the proceedings to give evidence or produce any document or other thing in his possession and to examine him as a witness; and award to a witness such expenses as, in the opinion of a Disciplinary Committee, he has incurred by reason of his attendance<sup>51</sup>.

7.7 Any person who is aggrieved by an order made in respect of him by the Disciplinary Committee may give notice of an appeal against the order to the Court of Appeal within 30 days after the service of the disciplinary order upon him.

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<sup>48</sup> Section 34 of the PAO.

<sup>49</sup> Section 36(1A) of the PAO.

<sup>50</sup> Section 37 of the PAO.

<sup>51</sup> Section 36(1) of the PAO.



- 7.8 The Disciplinary Committee is also empowered to make a consent order for the listed entity auditor to be reprimanded; to pay a penalty not exceeding \$50,000 to HKICPA; to pay to FRC the costs and expenses in relation or incidental to its investigation; and/or to pay the costs and expenses of and incidental to the disciplinary proceedings without hearing either the complainant or the person subject to the proceedings. However, if either of the two parties does not consent to the consent order, the Disciplinary Committee shall be dissolved and the disciplinary proceedings will start afresh with a new Disciplinary Committee being constituted to hear the disciplinary case<sup>52</sup>.

### **International Standards and Practices**

- 7.9 IFIAR's Core Principles for Independent Audit Regulators stipulate that regulators should have comprehensive enforcement powers which include the capability to ensure that their inspection findings or recommendations are appropriately addressed. These enforcement powers should include the ability to impose a range of sanctions including fines and the removal of an audit licence and/or registration, etc.
- 7.10 The EU Statutory Audit Directive requires that the system of public oversight of all EU Member States shall have the ultimate responsibility for the oversight of the investigative and disciplinary systems for auditors, and the same benchmark is adopted by EC in assessing the equivalence status of third country regulators of auditors.
- 7.11 According to IOSCO's Principles for Auditor Oversight, an auditor oversight body should have the power to stipulate remedial measures for problems detected, and to initiate and/or carry out disciplinary proceedings to impose sanctions on auditors and audit firms, as appropriate.
- 7.12 In line with the aforesaid international benchmarks, the independent auditor oversight bodies of most comparable overseas jurisdictions with major financial centres are directly responsible for investigating into irregularities of their listed entity auditors. In terms of disciplinary proceedings, some overseas jurisdictions have empowered their

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<sup>52</sup> Section 35B of the PAO.

independent auditor oversight bodies to make determinations on sanctions against listed entity auditors, and some have established specialised set-ups appointed by the independent oversight bodies to hear disciplinary cases and to determine on sanctions.

## Proposals

### *Investigation*

- 7.13 In line with international standards and practices, we **propose** continuing the present arrangement as provided in the FRCO for FRC to be responsible for conducting independent investigations into relevant irregularities by listed entity auditors.

#### **Question 26**

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

### *Irregularities subject to disciplinary action*

- 7.14 Same as in HKICPA's existing disciplinary regime whereby both the practice unit and individual(s) involved in the audit engagement concerned may be subject to disciplinary action in relation to an irregularity in respect of the engagement, we **propose** that disciplinary action may be imposed on a listed entity auditor, a person approved to be its audit engagement authorised person and/or a person approved to be its engagement quality control reviewer, if the listed entity auditor and/or the person concerned (as the case may be) is proved to have committed an irregularity in relation to an audit engagement.
- 7.15 The scope of "irregularity" should cover irregularities in respect of all audit and assurance engagements undertaken by listed entity auditors with listed entities as required under the Listing Rules. On this basis, in defining "irregularity", we **propose** following the existing definition of relevant irregularity under the FRCO (i.e. **Annex C**), with suitable modifications to make it clear that apart from irregularities in respect of an auditor's report and a specified report for a listing document, irregularities in respect of other assurance engagements required to be

undertaken by auditors under the Listing Rules<sup>53</sup> will also be covered since the opinions issued under such engagements may also affect the interests of investors.

- 7.16 The prevailing auditing standards contain an express requirement for a practice unit to put in place a system of quality control, and it is also expressly stipulated that the leadership of the practice unit should be ultimately responsible for its system of quality control<sup>54</sup>. The market has raised with us a question that in case a listed entity auditor's deficiencies extend beyond individual audit engagements and are systemic as a result of the absence of a proper system of quality control or systemic failure of the system (depending on the facts of the case) in a practice unit, whether the relevant individual/individuals within the practice unit should be held responsible. There is a concern that there may be regulatory gaps which will affect the integrity and effectiveness of the overall regime of the practice unit if the relevant individual/individuals responsible for the quality control system are not held accountable in any case. In this regard, we would like to **invite views** on whether the new regime should specifically provide that the individual/individuals who assume(s) ultimate responsibility for the system of quality control within a practice unit should be held accountable for the absence/systemic failure of that system.
- 7.17 For clarity and to avoid any possible misunderstanding, the relevant provision would be drafted in such a way to ensure that listed entity auditors could not designate junior staff as such responsible individual(s). Having regard to the existing auditing standard that the leadership of the practice unit should be ultimately responsible for its system of quality control, the relevant individual/individuals in this context are expected to be the practice unit's chief executive officer (or equivalent) or, if appropriate, members of the practice unit's managing board of partners (or equivalent)<sup>55</sup>.

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<sup>53</sup> c.f. Main Board Listing Rules 4.03 and 19.20.

<sup>54</sup> Paragraphs 16-18 of Hong Kong Standard on Quality Control 1.

<sup>55</sup> Paragraph 18 of Hong Kong Standard on Quality Control 1.

**Question 27**

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

**Question 28**

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

**Question 29**

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

*Mechanism for determining disciplinary sanction*

- 7.18 When benchmarked against international standards and practices, HKICPA’s existing disciplinary regime for listed entity auditors is not sufficiently independent from the audit profession. In particular, the provision to allow the HKICPA Council to exercise discretion of not initiating disciplinary action against listed entity auditors for irregularities is incongruous with international standards and practices that the decision-making power on whether to initiate disciplinary proceedings against listed entity auditors should be vested with bodies independent from the audit profession.
- 7.19 Besides, there are also inherent problems with the present system for hearing disciplinary cases, namely that –
- (a) the current disciplinary process is not conducive to the effective handling of disciplinary cases. A lengthy disciplinary process is undesirable from the perspective of the regulatee as he would need to incur more cost in defending his case and endure a longer period of uncertainty. Besides, an effective disciplinary regime which

ensures a fair hearing is necessary in ensuring proper protection of the interests of the investing public, especially when a case involves a listed entity auditor; and

- (b) the range of possible disciplinary sanctions is very limited. This is not conducive to ensuring that irregularities are dealt with by proportionate disciplinary sanctions, which would in turn undermine the principle of fairness and diminish the effectiveness of disciplinary sanctions.

Such inherent problems are largely due to the design of the existing disciplinary regime, which employs a “panel system” for hearing disciplinary cases and deciding on disciplinary sanctions. Whilst such design had been considered appropriate at the time when it was introduced, with the benefit of experience in operating the system in the ensuing years, it is noted in particular that the relatively large size of the HKICPA Disciplinary Committee (five members with a statutory quorum of four members) has increased the difficulty in scheduling meetings of the Committee with the confidence of meeting the quorum for hearing cases, thereby contributing to protraction in the whole process. Besides, the arrangement for drawing members of the Disciplinary Committee from a large pool of individuals who serve on a voluntary basis does not foster the development of expertise and consistent yardsticks for determining the level of disciplinary sanction. These inherent problems were also highlighted by IMF as part of its recent review of Hong Kong’s securities market under the Financial Sector Assessment Programme (paragraph 1.16 refers). In its report issued in May 2014, IMF noted that the current regulatory framework for listed entity auditors “does not ensure the independence of HKICPA.....nor establish a strong enforcement framework”. In particular, IMF expressed concerns that the current enforcement framework for listed entity auditors is weak due to the fact that “(a) the governance of the Disciplinary Committee does not ensure sufficient independence, nor foster the development of expertise, and precedents; and (b) the range of sanctions is limited”.

- 7.20 To address the identified problems, namely the lack of independence (paragraph 7.18 refers) and effectiveness (paragraph 7.19(a) refers) of the present system, we **propose** to replace this system with one which is being practised and has been well-tested in Hong Kong’s financial market and which market players are familiar with. In specific terms, this would mean vesting FRC, as the independent auditor oversight body, with direct disciplinary powers, including powers to make decisions on

disciplinary cases, concerning listed entity auditors under the new regulatory regime. It is noted that comparable overseas jurisdictions such as US and Canada adopt similar disciplinary systems.

- 7.21 To ensure fairness and that there is due process, FRC would be subject to checks and balances and the requirements for ensuring a fair hearing in exercising its disciplinary powers. Specifically, we **propose** requiring that FRC shall inform the person concerned in writing of its intention and give the person a reasonable opportunity of being heard before exercising such disciplinary power. The notice must include the reasons for the disciplinary decision; the time when the decision is to take effect; and, in so far as applicable, the terms of the disciplinary order to be imposed under the decision. This is in line with the procedural requirements for disciplinary sanctioning powers exercised by other financial regulators in Hong Kong<sup>56</sup>.
- 7.22 We note that there are views from the audit profession that given the complexity of audit standards, it is necessary to provide for inputs from persons who have appropriate level of knowledge of professional standards and practice in the disciplinary process. In this regard, we **propose** that FRC be empowered to establish an expert panel with members having audit expertise to provide advice on the application of audit standards, related practices of the audit profession or experiences in previous cases of similar nature.
- 7.23 We also note that some sectors of the audit profession have expressed concern that there should be a clear separation between the investigation conducted by FRC and the disciplinary mechanism. On this question, we believe that the most important considerations for this reform exercise are to ensure that the disciplinary system is independent from the audit profession in line with international standards and practices, and to safeguard the fairness of the system by providing for adequate checks and balances and the requirements for a fair hearing. Besides, an important safeguard will also be provided in the form of an appeal mechanism which is independent of FRC. In this regard, we **propose** that any person who is aggrieved by a disciplinary decision made by FRC in respect of him may appeal against the decision through an independent appeal mechanism by giving notice within 21 days after the decision is served. Details on the independent appeal mechanism are

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<sup>56</sup> The regulatory regimes as set out in the Securities and Futures Ordinance (Cap. 571), the Mandatory Provident Fund Schemes Ordinance (Cap. 485) and the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615).

set out in Chapter 8. A disciplinary decision made by FRC will not take effect before the expiry of 21 days after the date of service of the disciplinary order or, in the case of an appeal made against the decision under the independent appeal mechanism, before the appeal is determined.

- 7.24 To further allay the concerns expressed, we **propose** that FRC would be required to put in place appropriate arrangements to ensure that its investigative staff will not be involved in the disciplinary process and the determination of disciplinary sanctions. To persons who are subject to disciplinary process, this would provide assurance that the FRC staff responsible for handling disciplinary cases would make independent disciplinary decisions having regard to the investigation reports and any submissions made by them. Similarly, as a disciplinary case may also originate from FRC's inspection work in future, FRC would also be required to put in place arrangements to ensure that its inspection staff will not be involved in handling the disciplinary cases.
- 7.25 In sum, the above proposals seek to ensure that disciplinary proceedings for listed entity auditors would be conducted in an effective manner and in accordance with the principle of nature justice. They are similar to the arrangements under other financial regulatory regimes in Hong Kong, and adhere to the international standards and practices that the disciplinary regime for listed entity auditors should be independent from the audit profession. They should also address the views and concerns raised by the audit profession.
- 7.26 We are aware that some sectors of the audit profession have indicated preference for subjecting listed entity auditors to a disciplinary system which requires a disciplinary decision to be made by a disciplinary committee comprising members drawn from panels of individuals who are independent of FRC. In our view, this approach could not address the need for handling all disciplinary cases in a timely and effective manner. Besides, as the members of the committee will serve on a rotating basis, it will also be difficult for the committee to foster the development of expertise and consistent yardsticks for determining the level of disciplinary sanctions. We believe that in overall terms, our proposals could ensure that disciplinary cases are handled in a fair and effective manner.

**Question 30**

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

*Range of disciplinary powers*

7.27 We **propose** that FRC should be empowered to exercise any one or more of the following disciplinary powers on a person subject to disciplinary action –

- (a) to reprimand him publicly or privately;
- (b) to direct him to carry out remedial actions as specified by FRC;
- (c) to order that his name be removed from the register of listed entity auditors, either permanently or for a period of time as specified by FRC;
- (d) to prohibit him from applying to be registered/approved as a regulated person for such period or until the occurrence of such event as FRC may specify;
- (e) to impose conditions on his registration/approval as a regulated person;
- (f) to order him to pay to FRC the costs and expenses in relation or incidental to the investigation reasonably incurred by FRC; and
- (g) to order him to pay a pecuniary penalty not exceeding the amount which is the greater of –
  - (i) \$10,000,000; or
  - (ii) three times the amount of the profit gained or loss avoided by the listed entity auditor as a result of the irregularity.

7.28 It should be noted that the power to impose pecuniary penalties against listed entity auditors is not new, and such power already exists under the present disciplinary regime administered by HKICPA and also the



auditor regulatory regimes of comparable overseas jurisdictions. Besides, it is relevant to note that IFIAR has emphasised, in its Core Principles for Independent Audit Regulators, that regulators should have the ability to impose a range of disciplinary sanctions including fines (paragraph 7.9 refers). Therefore, it is necessary to empower FRC to impose pecuniary penalties which is in line with international practices and also helps enable that proportionate disciplinary sanctions be imposed for different irregularities.

7.29 We note that some sectors of the audit profession have expressed concern that a pecuniary penalty imposed by FRC close to or up to the proposed maximum of \$10 million might seriously threaten the viability of small and medium-sized audit practitioners, and result in them withdrawing from the market, thus reducing choice. We would emphasise that the amount only represents the maximum penalty which FRC could impose on a regulatee, and that in determining the level of pecuniary penalty to be imposed, FRC must have regard to the principles of fairness and proportionality taking into account the circumstances of each case. To enhance transparency and provide further assurance that such power would be exercised in a fair and reasonable manner, we **propose** that FRC would be required by law to issue guidelines to indicate the manner in which it exercises its power to order a regulated person to pay a pecuniary penalty, and to have regard to the issued guidelines when exercising such power. The guidelines would include the factors which would be considered by FRC when determining the level of pecuniary penalty to be imposed. They would include, for example –

- (a) the nature and seriousness of the irregularity;
- (b) the amount of profits accrued or loss avoided as a result of the irregularity;
- (c) the audit fees received by the listed entity auditor; and
- (d) other circumstances of the regulated person, which would include the size and financial resources of the firm or individual and that the penalty should not have the likely effect of putting a firm or individual in financial jeopardy.

7.30 We have considered whether the maximum penalty level should be linked to a multiple of the audit fees of the relevant listed entity auditors instead of “profit gained or loss avoided” (paragraph 7.27(g)(ii) refers).

In this regard, we note that the auditor regulatory regime in UK will take into account the financial benefit derived or loss avoided by the auditor as a result of an irregularity when determining the disciplinary sanction to be imposed on him<sup>57</sup>. Besides, linking the maximum pecuniary penalty to the profit gained or loss avoided is in line with the maximum penalty which could be imposed by other financial regulators in Hong Kong on their regulatees. Removing the power to impose a penalty up to three times the amount of the profit gained or loss avoided by the listed entity auditor as a result of an irregularity will limit the scope for FRC to impose a disciplinary sanction which is proportionate to the seriousness of the irregularity in future if so warranted. On the other hand, there is market concern that linking the maximum penalty level to the audit fees earned instead could be subject to possible abuses, e.g. by artificially depressing the audit fees whilst recouping the income foregone from their clients through other means. Therefore, on balance, we consider it more appropriate to link the maximum penalty level to “profit gained or loss avoided”, but we agree that the audit fees earned would also be one of the factors to be taken into account by FRC when determining the level of penalty (paragraph 7.29(c) refers).

- 7.31 To ensure the impartiality of the disciplinary process, we **propose** that any pecuniary penalty paid to or recovered by FRC would be paid by FRC into the Government general revenue.

**Question 31**

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

**Question 32**

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

**Question 33**

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

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<sup>57</sup> Auditor Regulatory Sanctions Guidance issued by the UK Financial Reporting Council in November 2013.

*Resolution of disciplinary case*

- 7.32 To provide an alternative route for both the person subject to disciplinary action and FRC to conclude a disciplinary matter in a less-costly manner under appropriate circumstances, we **propose** that FRC may enter into a resolution with the person subject to disciplinary action at any time it is contemplating exercising its disciplinary power. FRC must consider it appropriate to do so in the interest of the investing public or in the public interest when exercising such power.
- 7.33 Similar to the proposed arrangement for pecuniary penalty paid to or recovered by FRC under the disciplinary proceedings, we **propose** that any amount paid to or recovered by FRC arising from a resolution would be paid by FRC into the Government general revenue.

**Question 34**

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

**Question 35**

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

## Chapter 8

### APPEAL MECHANISM

#### Present Position

8.1 Under the PAO, any person –

- (a) whose registration application has been rejected or whose application for a practising certificate has been refused by the HKICPA Council;
- (b) whose name has been removed from the register by the HKICPA Council; or
- (c) who is aggrieved by an order made in respect of him by the Disciplinary Committee

may give notice of an appeal against the decision/order to the Court of Appeal within 30 days after the service of the relevant decision/order upon him.

8.2 The Court of Appeal may confirm, vary or reverse the said decision/order. It may also exercise such powers as are vested in it by the High Court Ordinance (Cap. 4) and the practice and procedure shall be in accordance with rules of court made under the Ordinance<sup>58</sup>.

#### Proposals

8.3 To provide appropriate checks and balances against the power to be exercised by the HKICPA Registrar in respect of registration matters as well as the disciplinary powers to be exercised by FRC, it is necessary to provide for an appeal mechanism for persons who are dissatisfied with registration/disciplinary decisions in respect of them to seek an independent review of such decisions. We **propose** that a new independent appeals tribunal should be set up for hearing appeals instead of referring such appeals directly to the court system. This

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<sup>58</sup> Section 41 of the PAO.

would help reduce the time and cost to be incurred by both the appellant and FRC/the HKICPA Registrar.

8.4 We **propose** that any person –

- (a) who disagrees with a registration decision made by the HKICPA Registrar in respect of him, e.g. a decision to reject a registration application/renewal application or to remove his name from the register; or
- (b) who is aggrieved by a disciplinary decision made in respect of him by FRC

may apply to the proposed new independent appeals tribunal for a review of the decision within 21 days after a notice of the relevant decision has been served upon him.

8.5 We **propose** that the independent appeals tribunal may, upon application by the relevant person, extend the time within which an application for review of the specified decision shall be made. However, an extension shall only be granted after the applicant and FRC/the HKICPA Registrar have been given a reasonable opportunity to be heard on the proposed extension, and if the independent appeals tribunal is satisfied that there is a good cause for granting the extension.

8.6 We **propose** that the independent appeals tribunal shall comprise a chairman, who should be a person qualified for appointment as a judge of the High Court<sup>59</sup>, and two members who are not public officers. All of them are to be appointed by the Chief Executive.

8.7 In terms of the review proceedings, we **propose** that the independent appeals tribunal –

- (a) may confirm, vary, reverse, set aside the relevant decisions or remit the matter to FRC/the HKICPA Registrar with any directions that it may consider appropriate;
- (b) will determine any relevant question or issue on the basis of standard of proof applicable to civil proceedings in a court of law;

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<sup>59</sup> Section 9 of the High Court Ordinance contains detailed provisions on the eligibility for appointment as a judge of the High Court.

- (c) will give both the applicant and FRC/the HKICPA Registrar an opportunity of being heard in reviewing a decision; and
- (d) will be empowered to obtain evidence, including ordering a person to attend before it to give evidence, and to prohibit the disclosure of evidence it receives at any sitting which is held in private.

We **propose** that a person commits an offence if he, without reasonable excuse, fails to comply with an order or a requirement of the appeals tribunal (e.g. to answer truthfully any question the independent appeals tribunal considers appropriate) for the purpose of a review. In addition, the independent appeals tribunal will have the same powers as the Court of First Instance to punish for contempt.

- 8.8 We **propose** that sittings of the independent appeals tribunal are to be held in public unless it determines that in the interests of justice a sitting or any part thereof shall be held in private.
- 8.9 The introduction of an independent appeals tribunal will preserve the existing two-tier structure under which a regulated person, after a fair hearing and due process, may still file an application to a body independent of the registration/disciplinary authority to appeal against the latter's registration/disciplinary decision. Nevertheless, noting that the affected party may have access to the court system for an appeal under the existing regime, we **propose** to maintain an access to the court system under the proposed regime although this would mean an additional (third) layer on top of the existing two-tier structure for handling appeals. Under this proposal, a party to the appeal who is dissatisfied with a determination of the independent appeals tribunal may further appeal to the Court of Appeal on a question of law, fact, or mixed law and fact. To avoid unnecessarily prolonging the case, we **propose** that no appeal may be made unless leave to appeal has been granted by the Court of Appeal, and the leave may only be granted if the Court of Appeal is satisfied that the appeal has a reasonable prospect of success or there is some other reason in the interests of justice why the appeal should be heard.
- 8.10 The above proposals are largely modelled on the appeal mechanism for other financial regulatory regimes in Hong Kong.

**Question 36**

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

**Question 37**

- (a) Do you agree that a person who disagrees with a registration decision made in respect of him or is aggrieved by a disciplinary decision made in respect of him may apply to the new independent appeals tribunal for a review of the decision within 21 days after a notice of the relevant decision has been served upon him?
- (b) If so, do you agree that the independent appeals tribunal may, upon application by the relevant person, grant an extension to application for review of a specified decision, and that such extension should only be granted after the applicant and FRC have been given a reasonable opportunity to be heard on the proposed extension and the independent appeals tribunal is satisfied that there is a good cause for granting the extension?

**Question 38**

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

**Question 39**

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

**Question 40**

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

**Question 41**

- (a) Do you agree that a party to the appeal who is dissatisfied with a determination of the independent appeals tribunal may further appeal to the Court of Appeal on a question of law, fact, or mixed law and fact?
- (b) If so, do you agree that no appeal to the Court of Appeal may be made unless leave to appeal has been granted by the same Court, and the leave may only be granted if the Court of Appeal is satisfied that the appeal has a reasonable prospect of success or there is some other reason in the interests of justice why the appeal should be heard?

## Chapter 9

### FUNDING MECHANISM

#### Present Position

- 9.1 Since its establishment in 2006, the operation of FRC has been funded through contributions made by HKICPA, SFC, HKEx and the Companies Registry Trading Fund (CRTF) on an equal basis under a Memorandum of Understanding (MoU) entered into by the four parties, with the CRTF also providing office accommodation to FRC at a licence fee of \$1 per annum. This is not a standing funding mechanism, and the four parties would need to review and enter into new MoUs on a regular basis<sup>60</sup>.
- 9.2 At present, HKICPA collects a “FRC levy” from practice units who have entered into audit engagements with listed companies in order to meet its contribution to FRC. The levy is proportional to the number of audit engagements entered into by the practice units with listed companies.

#### International Standards and Practices

- 9.3 IFIAR’s Charter provides that its membership shall be confined to regulators whose funding should be “free of undue influence by the profession”.
- 9.4 In line with the IFIAR Charter, the EU Statutory Audit Directive requires that the funding of the system of public oversight of all EU Member States shall be “secure and free from any undue influence by statutory auditors or audit firms”.
- 9.5 In accordance with these requirements, most comparable overseas jurisdictions with dedicated independent auditor oversight bodies adopt a mechanism with its operation being supported by levies on the regulatees and/or market users. For example, the audit regulatory

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<sup>60</sup> The four parties entered into the first MoU in 2007, which expired by the end of 2009. Upon review by the parties involved, they entered into the second MoU, which is due to expire by the end of 2014. The second MoU will be subject to review by the four parties within this year.



functions of the oversight body in UK are mainly funded by a combination of levies/fees payable by the accounting professional bodies and listed entities. On the other hand, the independent auditor oversight body in US is primarily funded through a levy on listed entities, while the oversight body in Canada is primarily supported by fees payable by listed entity auditors.

## **Proposals**

### *Levy on listed entities*

9.6 Auditors of listed entities are not merely the “agent” or “service provider” of such entities. They play an important role as independent gatekeepers in respect of listed entities by providing assurance for their financial reports. A robust and more independent auditor regulatory regime which is benchmarked against international standards is necessary to ensure the integrity of financial reports of listed entities and is conducive to consolidating Hong Kong’s status as an international financial centre. As listed entities rely on the capital market to raise funds, they have a stake in maintaining public confidence in the effectiveness of the overall market regulatory framework. With these considerations, and with reference to overseas practices, we **propose** that a statutory levy on listed entities in Hong Kong should be introduced to help finance FRC under the proposed regime.

9.7 We **propose** that the levy on listed entities in Hong Kong should be based on the prevailing formula under which listed entities pay their annual listing fees to HKEx, and HKEx would collect the levy on behalf of FRC. This would save the cost of establishing and maintaining a new system for collecting levies from listed entities. Under this proposal, listed entities with small capitalisation would be expected to account for a smaller share of the financial contribution than those with larger capitalisation. This is consistent with the approach adopted by overseas jurisdictions (e.g. UK and US) in respect of their listed entity levies.

### *Levy on securities transactions*

9.8 According to IOSCO’s Principles for Auditor Oversight, listed entity auditors play a critical role in enhancing the reliability of financial information by attesting as to whether the financial reports prepared by management fairly present the financial position and past performance

of listed entities. As such financial information forms the basis of investment decisions made by investors, the introduction of independent oversight of the regulatory regime for listed entity auditors could help enhance the protection of investors. We **propose** that investors should also help finance FRC under the proposed regime and a new statutory levy on securities transaction should be introduced for the purpose.

- 9.9 We **propose** that the proposed securities transaction levy should be based on the modus operandi for the existing levy charged by SFC under the Securities and Futures Ordinance (Cap. 571). SFC would collect the levy on behalf of FRC, when collecting its transaction levy, to save the cost of establishing and maintaining a new system for collecting levies from securities investors.

#### *Levy on listed entity auditors*

- 9.10 With reference to overseas practices, the international standard that the funding of independent auditor oversight bodies should be free from undue influence by the audit profession does not mean that the listed entity auditors must not be one of the parties to fund the future operation of FRC under the proposed regime. Some stakeholders have pointed out, in line with the established arrangement under Hong Kong's financial regulatory regimes that regulatees also contribute to help finance the operation of such regimes, it would raise the issue of fairness if listed entity auditors are not also a contributory party to FRC's funding under the proposed regime. In this connection, it is also relevant to note that at present, listed entity auditors are already required to contribute to the operating costs of the existing regulatory regime through the payment of the "FRC levies" and relevant fees to HKICPA (paragraph 9.2 refers).
- 9.11 As mentioned in paragraph 9.5, the independent oversight regimes operating in a number of comparable overseas jurisdictions specifically provide for their independent auditor oversight bodies to recoup all or some of their operating costs through statutory levies/fees payable by listed entity auditors. These include jurisdictions which require their auditors to pay for the full operating costs of their oversight bodies (e.g. Canada), and those which require their auditors to account for a substantial part of the oversight bodies' operating costs (e.g. UK).
- 9.12 Against the above background, we **propose** that a new statutory levy should be introduced to require all listed entity auditors to help finance FRC under the new regulatory regime, and that the new levy should be

proportional to the number of listed entity audit engagements entered into by the auditors. In other words, small and medium practitioners with a smaller number of listed entity audit engagements would be expected to account for a smaller share of the financial contribution than large audit firms with a larger number of listed entity audit engagements. We also **propose** that the HKICPA Registrar should collect the levy on behalf of FRC at the time of first registration or registration renewal of the listed entity auditors. After implementation of this new levy, the present “FRC levy” charged by HKICPA on listed company auditors will be abolished. Besides the proposed levy, there should also be user fees for specific services provided by FRC, e.g. notification in relation to changes of particulars of a registrant.

- 9.13 The requirement for listed entity auditors to pay a levy would not render FRC being subject to undue influence by the audit profession because the law will clearly stipulate that it is a statutory obligation for the listed entity auditors to pay the said levy, and there are other funding sources for FRC under the proposed regime.

*Level of the proposed levies and the mechanism for their adjustment*

- 9.14 We **propose** that as a matter of principle, the three new levies, i.e. the levy on listed entities, the levy on securities transactions, and the levy on listed entity auditors should be determined at levels which would enable FRC to sustain its operation without subsidy from general taxpayers. From the perspective of fairness, we **propose** that the three levies should each provide roughly equal contributions to FRC’s operation i.e. one third from listed entities, one third from securities investors and one third from listed entity auditors.

- 9.15 In line with other statutory fees and charges, all three proposed levies would be determined by the Chief Executive in Council by order published in the Gazette. We **propose** that the order would be subsidiary legislation subject to negative vetting by the Legislative Council.

- 9.16 We also **propose** that FRC should be required to review the levels of the three levies once its reserves has reached a level equivalent to 24 months of its operating expenses, after deducting depreciation and all provisions, and to consult the Secretary for Financial Services and the Treasury with a view to recommending to the Chief Executive in Council that the levies be reduced.

9.17 Whilst we have made initial liaison with HKICPA, SFC and HKEx, amongst others, on the broad principles governing the funding of FRC after the proposed reform, we have not gone into detailed arrangements. We will engage them further to work out the details based on comments received in this consultation exercise. If there is general support for the scope and coverage of the reform, and also the additional functions and powers which FRC should take up in assuming the role of an independent auditor oversight body to oversee the regulation of listed entity auditors, we shall prepare the broad estimates for FRC and the levels of the new levies that would be required to support FRC's operation after the reform.

*Other relevant matters*

9.18 As a trading fund under the Trading Funds Ordinance (Cap. 430), CRTF operates in accordance with the "user pays" principle and is funded on a cost recovery basis through user fees generated by companies registered in Hong Kong, with less than 0.14% of which being listed companies. There is no strong argument for CRTF to continue to be a funding party for FRC's operation after the reform. And in line with the practices and trend in most of the other comparable jurisdictions, and also to be consistent with the existing funding approach for other financial regulators in Hong Kong, FRC should operate without subsidy from general taxpayers and with financial independence from the Government.

**Question 42**

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

**Question 43**

Do you agree that –

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

**Question 44**

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

**Question 45**

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

## Chapter 10

### GOVERNANCE OF THE FINANCIAL REPORTING COUNCIL

#### Present Position

- 10.1 Under the FRCO, FRC comprises –
- (a) three members appointed by the Chief Executive on the nomination of SFC, HKEx and HKICPA respectively;
  - (b) not fewer than four, and not more than six, other members appointed by the Chief Executive from amongst persons who either because of their experience in accounting, auditing, finance, banking, law, administration or management, or because of their professional or occupational experience, appear to the Chief Executive to be suitable for such appointment;
  - (c) the Registrar of Companies, or a person appointed by the Registrar, in writing, as his representative, as an ex officio member; and
  - (d) the Chief Executive Officer of FRC, as an ex officio member.
- 10.2 The FRCO provides that the Chairman of FRC shall be a lay person appointed by the Chief Executive from within the persons appointed under paragraph 10.1(a), and FRC shall have a majority of lay persons as members. A lay person is defined as a person who is not a CPA within the meaning of the PAO or a member of an accountancy body that is a member of IFAC.
- 10.3 The FRCO also provides for appropriate checks and balances for the powers to be exercised by FRC. These include the following –
- (a) FRC's annual budget to be subject to the approval of the Secretary for Financial Services and the Treasury;
  - (b) its annual report and statement of accounts to be submitted to the Secretary who shall cause them to be tabled before the Legislative Council; and
  - (c) its statement of accounts to be audited by the Director of Audit.

Besides, an independent Process Review Panel has been established by the Chief Executive to review internal operating procedures, including those for ensuring consistency and fairness. FRC also falls within the purview of the Office of the Ombudsman and the Independent Commission Against Corruption.

## **International Standards and Practices**

- 10.4 IFIAR's Charter provides that its membership shall be confined to regulators that are independent of the profession. Specifically, this means that a majority of members of the relevant governing body should be non-practitioners (with an appropriate cooling off period for former auditors).
- 10.5 In line with the IFIAR Charter, the EU Statutory Audit Directive requires that the system of public oversight of all EU Member States shall be governed by non-practitioners<sup>61</sup>. Specifically, the non-practitioners should be knowledgeable in the areas relevant to statutory audit. However, Member States may allow a minority of practitioners to be involved in the governance of the public oversight system.

## **Proposals**

- 10.6 The current arrangements for HKICPA, HKEx, SFC to nominate individuals to be appointed as FRC members and for the Registrar of Companies to be an ex-officio member of FRC stem from the present funding mechanism for FRC, which is supported by contributions from HKICPA, HKEx, SFC and the Companies Registry Trading Funding. As a corollary to the proposal for a new funding mechanism, we **propose** to abolish the above arrangements for the nomination of FRC members and for the Registrar of Companies to be an ex-officio member, and to provide that FRC should in future comprise not less than seven members appointed by the Chief Executive, together with the Chief Executive Officer of FRC as an ex officio member.

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<sup>61</sup> According to the Directive, non-practitioner is defined as a natural person who, for at least three years before his or her involvement in the governance of the public oversight system, has not carried out statutory audits, has not held voting rights in an audit firm, has not been a member of the administrative or management body of an audit firm and has not been employed, or otherwise associated with, an audit firm.

10.7 We acknowledge that it would facilitate the work of FRC in discharging its new regulatory functions if its governing board comprises members who have the relevant expertise and knowledge about listed entities and auditing of their financial reports. Therefore, we **propose** making it clear that out of the FRC members to be appointed by the Chief Executive, there should be at least two persons who possess knowledge of and experience in the auditing of Hong Kong listed entities. In appointing the remaining members, the Chief Executive will continue to consider candidates who either because of their experience in accounting, finance, banking, law, administration or management, or because of their professional or occupational experience, are suitable for such appointment.

10.8 We **propose** maintaining the present requirement for FRC to have a chairman and a majority of members who are independent of the audit profession. However, under the FRCO, “lay members” are defined to exclude not only audit professionals but also non-audit professionals who have acquired accounting qualifications (paragraph 10.2 refers). This has unduly restricted the pool of potential candidates with financial and accounting expertise for appointment to FRC. Drawing reference from the prevailing international standards and practices (paragraphs 10.4 and 10.5 refer), we **propose** that the restriction on FRC membership should be by reference to “non-practitioner” instead of “lay person”, and “non-practitioner” will be defined as a person who –

- (a) is not, or has not during the previous three years been, a CPA (practising); and
- (b) is not, or has not during the previous three years been, a partner, director, agent or employee of a practice unit (i.e. a CPA (practising) practising on his own, a firm of CPAs (practising) or a corporate practice).

This proposal will ensure that FRC will continue to maintain a majority of members who are independent of the audit profession.

10.9 The present checks and balances for the powers to be exercised by FRC as set out in paragraph 10.3 have worked well, and we do not propose any change.



**Question 46**

- (a) Do you agree with the proposed new composition of FRC membership, i.e. not fewer than seven members appointed by the Chief Executive, together with the FRC Chief Executive Officer as an ex-officio member, and abolishing the existing arrangements for the nomination of FRC members and for the Registrar of Companies to be an ex-officio member as set out in paragraph 10.6?
- (b) Do you agree that there should be at least two persons who possess knowledge of and experience in the auditing of Hong Kong listed entities out of the FRC members to be appointed by the Chief Executive?

**Question 47**

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

**Jurisdictions whose audit regulators  
are members of IFIAR**

1. Abu Dhabi
2. Albania
3. Australia
4. Austria
5. Belgium
6. Botswana
7. Brazil
8. Bulgaria
9. Canada
10. Cayman Islands
11. Chinese Taipei
12. Croatia
13. Czech Republic
14. Denmark
15. Dubai International Financial  
Centre
16. Egypt
17. Finland
18. France
19. Germany
20. Gibraltar
21. Greece
22. Hungary
23. Indonesia
24. Ireland
25. Italy
26. Japan
27. Liechtenstein
28. Lithuania
29. Luxembourg
30. Malaysia
31. Malta
32. Mauritius
33. Netherlands
34. Norway
35. Poland
36. Portugal
37. Singapore
38. Slovak Republic
39. Slovenia
40. South Africa
41. South Korea
42. Spain
43. Sri Lanka
44. Sweden
45. Switzerland
46. Thailand
47. Turkey
48. UK
49. US

## **Annex B**

### **List of third countries and territories which have obtained EC's recognition of equivalence status of their auditor regulatory regimes**

1. Abu Dhabi
2. Australia
3. Brazil
4. Canada
5. China
6. Croatia
7. Dubai International Financial Centre
8. Guernsey
9. Indonesia
10. Isle of Man
11. Japan
12. Jersey
13. Malaysia
14. Singapore
15. South Africa
16. South Korea
17. Switzerland
18. Taiwan
19. Thailand
20. US

### **List of third countries and territories which have been granted a transitional period for achieving the equivalence**

1. Bermuda
2. Cayman Islands
3. Egypt
4. Mauritius
5. New Zealand
6. Russia
7. Turkey

**Definition of Relevant Irregularity under the FRCO**

Under the FRCO, there is a relevant irregularity in respect of the audit of the accounts of a listed entity or the preparation of a specified report for a listing document by or on behalf of the entity –

- I. if the auditor or the reporting accountant –
  - (a) falsified or caused to be falsified a document;
  - (b) made a statement, in respect of a document, that was material and that he knew to be false or did not believe to be true;
  - (c) has been negligent in the conduct of his profession;
  - (d) has been guilty of professional misconduct; or
  - (e) did or omitted to do something that, were the auditor or reporting accountant an individual certified public accountant, would reasonably be regarded as bringing or likely to bring discredit upon the auditor or reporting accountant himself, HKICPA or the accountancy profession.
  
- II. where the auditor or the reporting accountant is a corporate practice, if –
  - (a) the auditor –
    - (i) failed to comply with a requirement referred to in section 28D(6)(a) or (7) of the PAO;
    - (ii) ceased or failed to comply with a requirement of section 28D(2)(b) or (c) of the PAO applicable to the practice;
    - (iii) rendered any service under a company name other than the name that then appeared in relation to the practice in the CPA register;
    - (iv) practised accountancy as such a practice without being covered by professional indemnity insurance at all or to the extent required by the PAO;
    - (v) failed or neglected to observe, maintain or otherwise apply a professional standard; or
    - (vi) refused or neglected to comply with the provisions of any bylaw or rule made or any direction lawfully given by the HKICPA Council; or
  
  - (b) a director (who is a certified public accountant) of the auditor –

- (i) rendered any service as, or purporting to be, a director of a company whose name did not, at the time when the service was rendered, appear in Part II of the CPA register; or
- (ii) practised accountancy as such a director at a time when the auditor or reporting accountant was covered by professional indemnity insurance either not at all or not to the extent required by the PAO.

III. where the auditor or the reporting accountant is a certified public accountant, if the auditor or the reporting accountant –

- (a) failed or neglected to observe, maintain or otherwise apply a professional standard; or
- (b) refused or neglected to comply with the provisions of any bylaw or rule made or any direction lawfully given by the HKICPA Council.

IV. where the auditor or the reporting accountant is a firm of certified public accountants (practising), if the auditor or the reporting accountant –

- (a) failed or neglected to observe, maintain or otherwise apply a professional standard;
- (b) refused or neglected to comply with the provisions of any bylaw or rule made or any direction lawfully given by the HKICPA Council; or
- (c) rendered any service under a firm name other than the name that then appeared in relation to the firm in the CPA register.

**Irregularities subject to disciplinary proceedings under PAO**

Under the PAO, the following irregularities are subject to disciplinary proceedings –

- (a) A certified public accountant –
- (i) has been convicted of any offence under Part V (Perjury) of the Crimes Ordinance (Cap. 200);
  - (ii) has been convicted of any offence under section 31 of the FRCO;
  - (iii) has been punished by the Court of First Instance under section 32(2)(b) of the FRCO for failing to comply with a requirement imposed under section 25, 26, 27 or 28 of that Ordinance or for being involved in the failure;
  - (iv) has been punished by the Court of First Instance under section 45(2)(b) of the FRCO for failing to comply with a requirement imposed under section 43 of that Ordinance or for being involved in the failure;
  - (v) has been convicted in Hong Kong or elsewhere of any offence involving dishonesty;
  - (vi) whether as a certified public accountant or not –
    - (A) falsified or caused to be falsified any document;
    - (B) made any statement which is material and which he knows to be false or does not believe to be true, in respect of any document;
  - (vii) has been negligent in the conduct of his profession;
  - (viii) without reasonable excuse, failed or neglected to comply with any direction issued under section 32F(2) and with which he was required by the Practice Review Committee to comply;
  - (ix) failed or neglected to observe, maintain or otherwise apply a professional standard;
  - (x) without reasonable excuse, failed or neglected to comply with any requirement made under section 42D in relation to him by an Investigation Committee;
  - (xi) has been guilty of professional misconduct;
  - (xii) refused or neglected to comply with the provisions of any bylaw or rule made or any direction lawfully given by the Council;
  - (xiii) was guilty of dishonourable conduct;
  - (xiv) while a director of a corporate practice, rendered any service as, or purporting to be, a director of a company whose name did not appear in Part II of the register at the time when the service was rendered; or
  - (xv) being such a director, practised accountancy as such a director at a time when the corporate practice was covered by professional indemnity insurance either not at all or not to the extent required by the PAO;

- (b) a corporate practice –
  - (i) or any of its directors –
    - (A) falsified or caused to be falsified any document;
    - (B) made any statement which is material and which any of its directors knows to be false or does not believe to be true, in respect of any document;
  - (ii) failed to comply with a requirement referred to in section 28D(6)(a) or (7) or ceased or failed to comply with any requirement of section 28D(2)(b) or (c) applying to it;
  - (iii) rendered any service under a company name other than the name which then appeared in relation to the practice in the register;
  - (iv) being such a practice, practised accountancy without being covered by professional indemnity insurance at all or to the extent required by this Ordinance; or
  - (v) did or omitted to do something which, were the practice an individual certified public accountant, would reasonably be regarded as being dishonourable conduct by an individual.

## LIST OF QUESTIONS FOR CONSULTATION

- Question 1** Do you agree with the proposed objective of the reform, i.e. to enhance the independence of the regulatory regime for auditors of listed entities from the profession itself with a view to ensuring that the regime is benchmarked against international standards and practices and continues to be appropriate in the local context?
- Question 2** Do you agree that the new regulatory regime should only cover auditors of public interest entities, which will be defined to cover listed entity auditors?
- Question 3** Do you agree that the definition of public interest entities should be set out in the main legislation such that any change in future could only be made by way of an amendment bill?
- Question 4** Do you agree that FRC should become the independent auditor oversight body with respect to listed entities in Hong Kong by enlarging its regulatory remit?
- Question 5**
- (a) Do you agree that a listed entity auditor must be a practice unit as defined under the existing PAO and a fit and proper person to be registered as a listed entity auditor?
  - (b) If yes, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for considering whether a person is fit and proper to be registered as a listed entity auditor, i.e. by reference to the existing fit and proper test for becoming a CPA?
- Question 6**
- (a) Do you agree that in order for an application for registration as a listed entity auditor to be approved, the individuals who are authorised by the auditor to perform the roles of an audit engagement authorised person, an engagement quality control reviewer or a quality control system responsible person should be fit and proper persons to perform such roles?
  - (b) If so, do you agree that for the purpose of the reform, there should be no change to the existing qualification and experience requirements for individuals taking up



such roles with respect to a registered listed entity auditor when considering whether they are fit and proper to perform those roles?

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

**Question 8** (a) Do you agree that HKICPA Registrar should be assigned the role of Registrar of Listed Entity Auditors and be vested with the registration functions and powers as outlined in paragraph 3.23, and FRC should exercise oversight through arrangements as proposed in paragraph 3.24?  
(b) Do you agree that FRC should publish the periodic reports received by the HKICPA Registrar as mentioned in paragraph 3.24(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?

**Question 9** Do you agree that any person subject to a registration decision by the HKICPA Registrar may appeal against the decision, and any such appeal should be handled by an appeal mechanism which is independent of both the HKICPA Registrar and FRC?

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

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

- Question 12** Do you agree that FRC should be vested with statutory powers to take over SFC/HKEx's existing roles in receiving and making decisions on applications for recognising overseas auditors of specific overseas entities which have been approved for listing in Hong Kong on a case-by-case basis?
- Question 13** Do you agree that an applicant must meet the criteria as proposed in paragraph 3.30 for being recognised as an overseas auditor of the overseas entity listed in Hong Kong as set out in its application?
- Question 14** Do you agree that the recognition of an overseas auditor of an overseas entity listed in Hong Kong should remain in force until the following 1 January or the time when the overseas auditor ceases to be the auditor of the listed entity in question, whichever is earlier, subject to renewal of the recognition?
- Question 15** Do you agree that the HKICPA Registrar shall maintain and update a list of overseas auditors who were recognised by FRC for entering into audit engagements with specific overseas entities listed in Hong Kong, and make available for public inspection/publish on HKICPA's website the list?
- Question 16**
- (a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers with regard to setting CPD requirements for listed entity auditors, subject to independent oversight by FRC in accordance with paragraph 4.6?
  - (b) Do you agree that FRC should publish the periodic reports received by it as mentioned in paragraph 4.6(a) on its website, and provide information on the results of its quality review and the written directions given by it in its annual report?
- Question 17**
- (a) Do you agree that HKICPA should continue to perform its statutory functions and exercise its statutory powers in specifying standards on professional ethics, auditing and assurance to be observed, maintained or otherwise applied by CPAs (practising), and FRC should exercise oversight of the performance of such functions and the

exercise of such powers by HKICPA which are applicable to listed entity auditors as proposed in the arrangements set out in paragraph 5.8?

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

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

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

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

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

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

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

- Question 24** (a) Do you agree with the proposal to provide for criminal offences against a person who fails to comply with the requirements in relation to FRC’s inspections?  
(b) If so, do you agree that the provisions on such criminal offences should be modelled on the existing provisions in the FRCO concerning failure to comply with requirements in relation to an investigation into relevant irregularities?
- Question 25** Do you agree that the secrecy provisions in the PAO and the FRCO should be suitably amended to provide that both HKICPA and FRC could share their inspection results with each other to facilitate them to coordinate their inspection activities?
- Question 26** Do you agree that FRC should continue to be responsible for conducting independent investigations into relevant irregularities by listed entity auditors?
- Question 27** Do you agree that a disciplinary action may be imposed on a listed entity auditor, a person approved to be its audit engagement authorised person and/or a person approved to be its engagement quality control reviewer if the listed entity auditor and/or the person concerned (as the case maybe) is proved to have committed an irregularity in relation to an audit engagement?
- Question 28** Do you agree that the definition of “irregularity” under the new regulatory regime should be refined to cover irregularities in respect of all audit and assurance engagements undertaken by listed entity auditors with listed entities as required under the Listing Rules?
- Question 29** What is your view on whether the new regime should specifically provide that the individual/individuals who assume(s) ultimate responsibility for the system of quality control of a practice unit would be held accountable for the absence/systemic failure of such system, and whether it should stipulate expressly that such responsible person(s) shall be the practice unit’s chief executive officer (or equivalent) or, if appropriate, members of the practice unit’s managing board of partners (or equivalent)?

- Question 30** Do you agree that FRC, as the future independent auditor oversight body, should be vested with disciplinary powers, including powers to make decisions on disciplinary cases, concerning listed entity auditors, subject to the requirements for ensuring fairness and a due process as proposed in paragraphs 7.21 to 7.24?
- Question 31** Do you agree that FRC should be empowered to exercise the range of disciplinary powers on a person subject to disciplinary action outlined in paragraph 7.27?
- Question 32** Do you agree that FRC should be required by law to issue guidelines to indicate the manner in which it exercises its power to order a person subject to disciplinary action to pay a pecuniary penalty, and to have regard to the issued guidelines when exercising such power?
- Question 33** Do you agree that any pecuniary penalty paid to or recovered by FRC would be paid by FRC into the Government general revenue?
- Question 34** Do you agree that FRC may enter into a resolution with the person subject to disciplinary action at any time it is contemplating exercising its disciplinary power, and in exercising such power, FRC must consider it appropriate to do so in the interest of the investing public or in the public interest?
- Question 35** Do you agree that any amount paid to or recovered by FRC arising from a resolution would be paid by FRC into the Government general revenue?
- Question 36** Do you agree that a new independent appeals tribunal should be set up for hearing appeals in respect of registration decisions made by the HKICPA Registrar and disciplinary decisions made by FRC?
- Question 37** (a) Do you agree that a person who disagrees with a registration decision made in respect of him or is aggrieved by a disciplinary decision made in respect of him may apply to the new independent appeals tribunal for a review of the decision within 21 days after a notice

of the relevant decision has been served upon him?

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

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

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

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

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

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

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

third from securities investors and one third from listed entity auditors?

**Question 43**

Do you agree that –

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

**Question 44**

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

**Question 45**

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

**Question 46**

- (a) Do you agree with the proposed new composition of FRC membership, i.e. not fewer than seven members appointed by the Chief Executive, together with the FRC Chief Executive Officer as an ex-officio member, and abolishing the existing arrangements for the nomination of FRC members and for the Registrar of Companies to be an ex-officio member as set out in paragraph 10.6?
- (b) Do you agree that there should be at least two persons who possess knowledge of and experience in the auditing of Hong Kong listed entities out of the FRC members to be appointed by the Chief Executive?

**Question 47**

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