

**For discussion
on 2 April 2004**

**Legislative Council
Panel on Financial Affairs**

**Regulation of the Auditing Profession
and Preparers of Financial Statements**

PURPOSE

This paper updates Members on the progress of the initiatives to enhance the regulation of the auditing profession and preparers of financial statements, and presents proposals on the way forward.

BACKGROUND

2. Quality and reliable financial reporting is of paramount importance for upgrading market quality and maintaining investors' confidence. The auditing profession is the first line of defence against defective financial reporting and in upholding corporate governance. Two parallel proposals for reform are under discussion, the first from the Hong Kong Society of Accountants (HKSA), the second from the Standing Committee on Company Law Reform (SCCLR).

3. In January 2003, in response to the Secretary for Financial Services and the Treasury's request, the HKSA put forward a series of proposals to reform the regulatory regime. The proposals are summarized below –

- (a) increase the lay members in the HKSA's Council (i.e. the governing body). The current and proposed composition of the Council is at **Annex A**;

- (b) expand the membership of any Investigatory Committee (IC) instigated by the HKSA's Council from three to five, and alter the composition of the IC, with the majority of members (including the chairman) being lay persons;
- (c) alter the composition of the five-member Disciplinary Committee with the majority of members (including the chairman) being lay persons; and
- (d) as a variation of (b) above, establish an Independent Investigation Board (IIB) to deal with alleged accounting, auditing and/or ethics irregularities related to listed companies.

4. The HKSA briefed Members on the above proposals at the meeting on 13 June 2003. At the meeting, Members generally agreed that the above proposals were in the right direction. They considered that the regulatory regime of the accounting profession should be open, effective, transparent and able to inspire the confidence of the investing public. Members urged the early implementation of the proposals.

5. Separately, the SCCLR had noted the absence in Hong Kong's regulatory regime of any mechanism either to provide for the making of enquiries into compliance of companies' financial statements with the accounting requirements of the Companies Ordinance, or whereby directors may be required to revise and re-issue financial statements. In its Consultation Paper on Phase I of the Corporate Governance Review, the SCCLR thus proposed that a body with authority to investigate financial statements and enforce any necessary changes to companies' financial statements should be set up. The submissions received by SCCLR indicated support for the establishment of a Financial Reporting Review Panel (FRRP). To take forward the proposal, we need to finalise the detailed design of the FRRP.

OPENING UP OF THE HKSA

6. Proposals in paragraphs 3(a) to (c) above are key steps in enhancing transparency of the Society's key functions and thus the oversight over the accounting profession. These opening up proposals

have been taken forward in the form of a Member's Bill which was introduced by Dr Hon Eric Li on 24 March 2004.

CONSULTATION ON THE IIB AND FRRP PROPOSALS

7. Before taking a decision on the proposals to establish the IIB and FRRP, the Administration considered it appropriate to listen to public views on the need for such entities, their functions, composition, powers, institutional form and funding arrangements. On 19 September 2003, a Consultation Paper was issued on the Proposals to: (a) Enhance the Oversight of the Public Interest Activities of Auditors and (b) Establish a Financial Reporting Review Panel to seek public comments. In response to the consultation paper, we received 22 submissions. A summary of the consultation exercise is at **Annex B**.

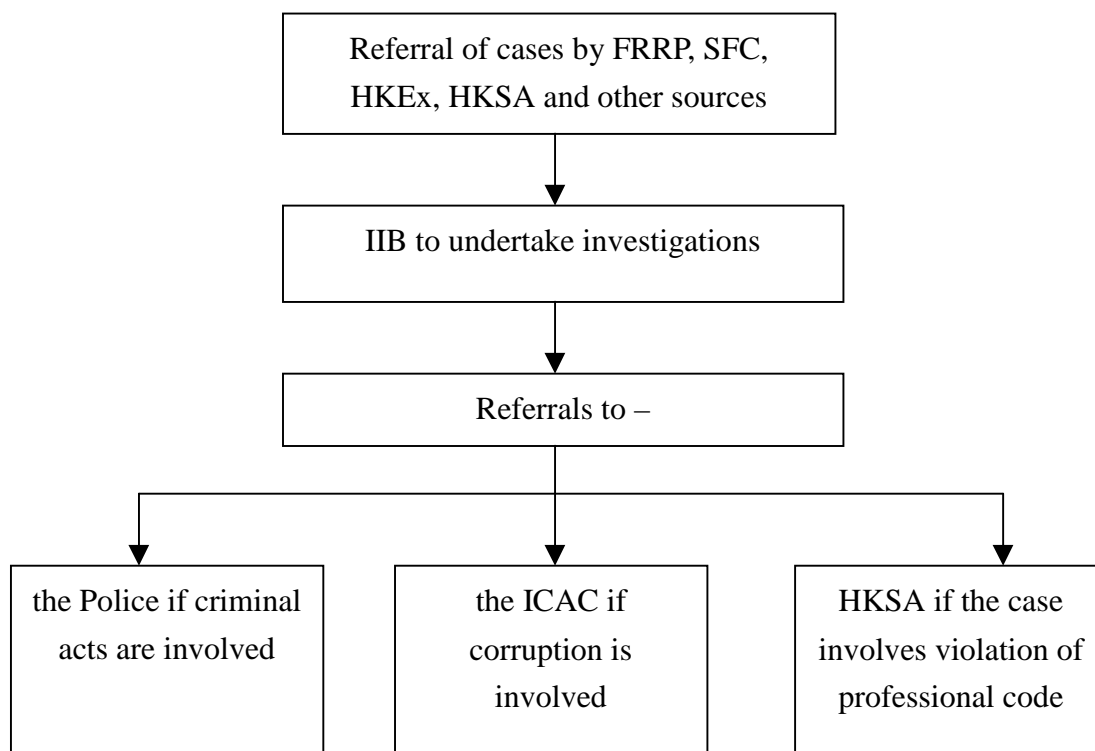
PROPOSED ARRANGEMENTS FOR THE IIB AND FRRP

Scope and Functions of the IIB

8. There is overwhelming support for the establishment of the IIB and most respondents agreed that the IIB's functions should be confined to undertaking investigations and not extended to disciplinary decisions. As the intention is to deal with public interest activities of the auditing profession, the IIB would concentrate only on those cases relating to listed companies. In this regard, we note that following the episodes of Enron and Worldcom in the US, the accounting profession worldwide faces a perception issue. Hong Kong is no exception. It is also noted that some cases handled under the current mechanism have continued for four to five years and no decision has so far been made to discipline any person or firm. We therefore propose that cases involving public interest, i.e. those relating to listed companies, be dealt with by the IIB. Investigation of auditing anomalies relating to non-listed companies would continue to be undertaken by HKSA, as would decisions on discipline.

9. As a start, the Administration proposes that the IIB should act only on referrals from other regulators and on complaints. The IIB would be tasked to undertake investigations and prepare investigation reports.

Upon completion of an investigation, the IIB would refer the case to the relevant law enforcement agency if it appears to involve criminal offences. If the case related only to a violation of the professional code of the auditors in question, the IIB would report the outcome of the investigation to the HKSA. A flow chart illustrating the above procedures is as follows –



Scope and Functions of FRRP

10. Most respondents agree with the proposal to establish the FRRP and take the view that it should adopt a reactive approach, at least at the initial stage.

11. We propose that the FRRP's ambit should be to enquire into apparent departures from the law, accounting standards and listing rules in the annual accounts of companies and to seek remedial action. It would be desirable for the FRRP to limit its remit to the statutory annual financial statements of companies. The FRRP's work should cover the financial statements of all listed companies, at least initially.

Institutional Arrangements of IIB and FRRP

12. We have looked into developments in other jurisdictions. In the wake of recent corporate scandals the international trend has been to move away from self-regulation by the accounting profession through the formation of various forms of oversight body. In the United States, the Sarbanes-Oxley Act of 2002 provided for the establishment of a Public Company Accounting Oversight Board to, inter alia, investigate, inspect and enforce compliance relating to registered public accounting firms. The Board is not an agency or establishment of the US government, but is a non-profit entity operating under general oversight of the Securities and Exchange Commission. In the United Kingdom, the Financial Reporting Council was set up as the new and single regulator of the accounting profession, independent of the profession and separate from the Financial Services Authority. It was established by way of a company limited by guarantee.

13. The consultation results show that some respondents prefer to house the IIB and FRRP within the Government while others propose to locate them under the Securities and Futures Commission (SFC). Each option has its merits and drawbacks in terms of perceived independence, accountability, costs, etc. On balance, we propose the establishment of an independent governing board to oversee both the IIB and FRRP. This would have the advantage of being seen as more focussed, with one independent entity overseeing auditors and financial statements preparers. In this context, we note that the SFC was not created to oversee and regulate the accounting profession. Putting the two entities under the SFC would distract it from its core function of regulating the securities and futures market of Hong Kong.

14. To achieve synergy and minimize costs, we propose that the IIB and FRRP should be created under one roof such that the overhead costs could be shared by both bodies. A governing board of not more than 10 members can be created to oversee the two entities. The governing board should comprise members from the Financial Services and the Treasury Bureau, the Companies Registry (CR), persons nominated by the SFC and the Hong Kong Exchange and Clearing Limited (HKEx). Consideration will be given as to whether the accounting profession should be represented on the board. The Government may also appoint other

members to broaden the representation of public interest.

15. The governing board will be supported by an executive arm which handles investigations as well as providing secretariat support. The executive arm will be headed by a director who is assisted by expert teams to carry out investigations. It is envisaged that the executive arm would employ a maximum of ten staff. All the staff will be recruited openly and employed on non civil service terms. Secondment from other enforcement agencies will be considered if necessary.

16. As far as the status of the legal entity is concerned, we are considering setting up the governing board of IIB and FRRP in the form of a company limited by guarantee, similar to the Financial Reporting Council in the United Kingdom. This option will help expedite the formation of the governing board while, at the same time, ensuring that it would be non-profit making in nature. This would also offer its directors the protection of limited liability.

17. Without losing its independence, the governing board can be physically accommodated at the premises of the CR. The CR appears to be a suitable department responsible for its housekeeping as one of CR's core functions is to administer and enforce the provisions of the Companies Ordinance which touches on accounting and auditing. In addition, the Registrar of Companies (R of C) represents the Financial Secretary (FS) on the HKSA's Council.

Sources of Funding

18. The results of the consultation suggest that while most respondents agree that funding should be borne by issuers and investors, views on whether the auditing profession should contribute are more diverse. However, investigation of auditors is a duty of the HKSA as a Self Regulatory Organisation and is currently funded by the profession. There is no reason why the profession should not continue to pay for this function when responsibility for investigation is transferred. The only new function is the FRRP.

19. The underlying philosophy of Hong Kong's financial services regulatory regime is that it should be funded from the industry it regulates. This practice is not unique to Hong Kong and we have therefore made reference to developments internationally. We have gathered information regarding the practice of overseas countries as set out at Annex C. Overseas experience indicates that the funding of the oversight body for the auditing profession is shared by several parties including the profession, business and government.

20. We therefore propose that the cost of the new board be shared among the SFC, the HKEx, the accounting profession and the Government. Rather than funding it direct from general revenue, we propose Government's contribution be borne by the Companies Registry Trading Fund. In any event, the cost of investigation should ultimately be recoverable from the parties being investigated if they are found responsible for the irregularities.

21. We are in discussion with the three parties and the R of C. The exact funding mechanism will be discussed further when the structure, terms of reference and other details of the proposed governing board of the IIB and FRRP have been worked out and endorsed.

Legislative Implications

22. If the proposal of forming the governing board for the IIB and FRRP is endorsed, it would be necessary for the Government to introduce legislative amendments to empower the governing board to collect evidence and undertake investigations. The amendments would also need to cover issues such as the appointment of board members, budgeting and the role of the Government in relation to the governing board. We plan to submit legislative proposals to the Legislative Council in the next session.

WAY FORWARD

23. We will continue discussing with the relevant parties on the details regarding the structure, functions and funding of the IIB and FRRP, as well as the preparatory work on the legislative amendments relating to

their establishment. We reckon that the establishment of the IIB and FRRP requires co-operation of all relevant parties who recognise the importance of maintaining market quality. The accounting profession in particular has an important role to play in ensuring public interest is taken care of in the process of financial reporting.

24. Members are requested to note the content of the consultation report and the preliminary proposals outlined in this paper.

Financial Services and the Treasury Bureau
March 2004

Composition of Hong Kong Society of Accountants' Council

Existing Composition

The existing Council can consist of no more than 18 members, presently consisting of the following –

- 12 elected members who are professional accountants;
- 2 co-opted members who are professional accountants;
- the Financial Secretary (FS) or a representative appointed by the FS, currently Registrar of Companies (R of C); and
- Director of Accounting Services (DAS) or a representative appointed by him.

Proposed Composition

Under the new proposal, the Council will be made up of 23 members as follows –

- 14 elected members who are professional accountants;
- 2 co-opted members who are professional accountants;
- the immediate past president who is appointed to serve on the Council for one year;
- FS or a representative appointed by the FS;
- DAS or a representative appointed by him; and

- 4 members appointed by the Chief Executive who are “lay persons” representing the public interest. “Lay persons” means a person who is not a certified public accountant or a member of an accountancy body which is a member of the International Federation of Accountants.

**Summary of the Responses to the Consultation Paper to –
(a) Enhance the Oversight of the Public Interest Activities of Auditors &
(b) Establish a Financial Reporting Review Panel**

Overall Summary

With a view to ensuring an effective, transparent and accountable regulatory regime for the auditing profession and upholding high quality standards for financial statements, the Administration published the above Consultation Paper on 19 September 2003 to seek public views on the proposals to enhance the oversight of the public interest activities of auditors and to establish a Financial Reporting Review Panel (FRRP). We invited a total of 124 persons/organisations (including all LegCo Members and Members of the Standing Committee for Company Law Reform (SCCLR)) for comments on the paper.

2. We received a total of 22 submissions from various professional accounting bodies such as Hong Kong Society of Accountants (HKSA), accounting firms, academic institutions, chambers of commerce and Securities and Futures Commission (SFC) etc. There were two courtesy replies with no comments made on the proposals either specifically or generally. The two courtesy replies were from the Official Receiver's Office and Hong Kong Bar Association. The list of the remaining 20 submissions is at Appendix.

Establishment of an Independent Investigation Board (IIB)

Need for establishment

3. Of the 20 submissions, **16** of them supported the establishment of an IIB whereas **2** of the respondents made no comment on the issue. **1** respondent considered that the necessity of the IIB depended on its cost-effectiveness. The **remaining** respondent disagreed with the proposal. It considered there was no real need to establish an IIB given the proposed

changes to the HKSA Council, its Disciplinary and Investigation Committees.

Mode of Operation

4. This issue appears to be rather controversial. **8** respondents considered that the IIB should be reactive and act on referrals only, or at least initially. A review should be undertaken once the IIB had been operating on a referral basis for a certain period of time. These respondents are mainly accounting bodies and accounting firms.

5. **7** respondents were of the view that the IIB should have power to request information and initiate investigations. The remaining **5** respondents made no comment on the issue.

Functions of IIB

6. **14** of the respondents agreed that the IIB's function should remain purely investigatory. Amongst them, one mentioned that it was not against letting the disciplinary action remain with the HKSA at the initial stage in view of HKSA's recent opening up proposals. However, this should be subject to review in the light of experience. Another considered that whether the IIB should be given disciplinary power depended on whether the predominant purpose of having an independent board of investigation would be adequately served if the disciplinary power remained vested with the HKSA.

7. **3** respondents made no comments and the remaining **3** supported giving disciplinary powers to the IIB.

Source of Funding

8. The 20 respondents had diverse views.

9. **3** respondents had no comments on the funding arrangements of the IIB.

10. **6** respondents held the view that all stakeholders should contribute to the costs of the IIB. As set out in the consultation paper, “stakeholders” include issuers, investors, accounting profession as a whole or auditors of listed companies, the Government, the SFC and the HKEx. One of the six suggested that licensed banks and insurance companies should also contribute to the costs. Another stated that if the IIB was to be located under the SFC, it preferred a general increase in the SFC’s budget to cover the costs rather than specific additional charges, thus saving considerable administration expenses. Still one considered that the auditing profession should contribute to the extent they were involved in serving the types of companies/organisations to be covered and non-practising accountants should not be required to contribute.

11. **4** respondents from the accounting sector expressed clearly that neither the accounting profession nor auditors should share the burden of the costs. However, **another** major accountancy firm supported the “user pay” approach but it did not agree that the running costs of the IIB should be borne solely by auditors.

12. **2** respondents from the academic sector suggested that issuers and investors should contribute to the costs of the IIB. However, **2** other respondents considered that funding should not be borne by investors.

13. The remaining **2** respondents held different views on the matter – one proposed that fees be charged from investors through transaction levy whereas the other considered that the funding could come from the Government, regulators (SFC/HKEx) as well as levies on listed companies and investors.

Institutional Arrangements

14. There were different views among the 20 respondents on where to place the proposed IIB.

15. **3** respondents made no comment on the institutional arrangements for the IIB.

16. **8** respondents agreed to place the proposed IIB under the Government.

17. Another popular option was to locate the IIB under the SFC. **5** respondents supported this proposal.

18. **2** of the respondents were indifferent to the two options of housing the IIB under the Government or the SFC.

19. **1** respondent agreed for the IIB to be placed under the HKSA. **Another one** considered that the IIB, as an independent statutory body, should not be under the Government, any regulator or the HKSA.

Establishment of a Financial Reporting Review Panel (FRRP)

Need for Establishment

20. Out of the 20 replies, **16** respondents agreed to the establishment of a FRRP. **3** respondents made no comment on the issue and **1** respondent considered that its necessity depended on cost-effectiveness.

Mode of Operation

21. The majority of the respondents (**13**) agreed that the FRRP should adopt a reactive approach, at least initially. Some of them indicated that such arrangement was more efficient and effective in utilising available resources. It may be possible for FRRP to progressively transform into a more proactive body at a later date on a risk approach basis, having regard to costs and benefits.

22. **2** of the respondents proposed to adopt a proactive approach. The remaining **5** respondents made no comment on the issue.

Funding Arrangements

23. Similar to the case of the IIB, the 20 respondents had divergent views on the issue.

24. **5** respondents made no comment on the funding arrangements of the FRRP.

25. **7** respondents agreed that the funding should be borne by all stakeholders. In particular, two of them stressed that investors should not be charged directly for the costs of the FRRP.

26. **3** respondents considered that funding should be provided from all stakeholders except the accounting profession.

27. **2** respondents suggested funding from investors and issuers. The **HKSA** held the view that funding should be from stakeholders but it stressed the importance of contribution by issuers and investors.

28. **One** proposed funding from investors through a transaction levy whereas **another** saw the merits of funding by the SFC.

Institutional Arrangements

29. Respondents' views on this issue were diverse.

30. **5** had no comment.

31. **5** respondents considered that the FRRP should be an independent statutory body without giving specific proposal on where to house the body.

32. **3** respondents suggested placing the FRRP under the Government.

33. 4 respondents supported the other option by locating the FRRP under the SFC if the FRRP covered listed companies only. Another 3 held the view that the FRRP should be an independent statutory body but they had no objection if it was housed under the SFC.

Others

34. One international accountancy body recommended an overall structure for IIB and FRRP, i.e., instead of being established as two separate entities, they could be put under and report to an independent oversight board.

Appendix to Annex B

List of Submissions Received

- (1) Dr Peter Chan
- (2) Hong Kong University of Science & Technology (HKUST)
- (3) Lingnan University (LU)
- (4) The Hong Kong Association of Restricted Licence Banks and Deposit-taking Companies
- (5) The Association of International Accountants (AIA)
- (6) Mr Peter Wong
- (7) Hong Kong Society of Accountants (HKSA)
- (8) Securities And Futures Commission (SFC)
- (9) Ernst & Young (E & Y)
- (10) The Association of Chartered Certified Accountants (ACCA)
- (11) Hong Kong Democratic Foundation
- (12) Deloitte Touche Tohmatsu (DTT)
- (13) The Hong Kong Institute of Company Secretaries (HKICS)
- (14) KPMG
- (15) Consumer Council
- (16) The British Chamber of Commerce in Hong Kong
- (17) The Chinese General Chamber of Commerce
- (18) The Law Society of Hong Kong
- (19) The Chartered Institute of Management Accountants (CIMA)
- (20) PricewaterhouseCoopers (PWC)

Information regarding the practice of overseas countries

United Kingdom

With two main exceptions, the core annual running costs of the Financial Reporting Council (FRC) are met on an approximately one-third basis equally by the accountancy profession (through the Consultative Committee of Accounting Bodies), business (the London Stock Exchange, together with the banking and investment community) and the Government. The two exceptions are –

- (a) the audit firms will fund the inspection costs of the new Audit Inspection Unit which will carry out the monitoring of audits of public interest entities; and
- (b) the case costs of investigating and prosecuting public interest disciplinary cases will continue to fall to the professional accountancy bodies.

USA

The Sarbanes-Oxley Act provides the establishment of the Public Company Accounting Oversight Board (PCAOB) which collects two types of fees –

- (a) the accounting support fees from the issuers; and
- (b) the registration and annual fees from the public accounting firms.

It is unclear about the actual proportion that the accountants contribute, but it is likely that the accounting support fees from the issuers form the major portion of the budget.

Canada

The Canadian Public Accountability Board (CPAB) published in December 2003 certain proposed rules on fees. Under the proposed rules, fees will be payable by public accounting firms to the CPAB in connection with their application to participate in the oversight programme, and subsequently, their participation in the programme. For instance, on top of an annual fee, each of the Big Four firms should contribute a one-off fee of C\$500,000 and other public accounting firms with more than 50 reporting issuer audit firm clients should contribute a one-off fee of C\$25,000.

Australia

Under the current tripartite funding model for the Financial Reporting Council (FRC), funds emanate from those stakeholder organizations that stand to benefit from improved accounting standards are as follows –

- (a) the public sector;
- (b) the accounting profession; and
- (c) the business sector.

While it is intended that each group should contribute one third of the funding, in practice, funding has been provided predominantly by the public sector (mainly the Commonwealth Government, but also with an important contribution from the States and Territories Governments), followed by voluntary contributions from the accounting profession and from the business sector. With the expansion of powers of the FRC, it is still considering ways to increase the contributions from various sectors.