

**Consultation Paper on
the Proposals to :**

**(a) Enhance the Oversight of the
Public Interest Activities of Auditors and**

**(b) Establish a Financial Reporting
Review Panel**

September 2003

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Introduction

Quality and reliable financial reporting is the key underpinning investors' confidence. While the responsibility for quality financial reporting rests primarily with the company's board of directors, auditors remain the first line of defence against the pressures of defective financial reporting. They have a duty to safeguard the accuracy and integrity of financial reporting. Public expectations on auditors/ accountants have remained high, more so than ever in the light of recent corporate failures in other parts of the world. The Administration is acutely aware of the need to ensure an effective, transparent and accountable regulatory regime for the auditing profession that is in line with international developments. It is equally important to ensure that the high quality accounting standards are properly applied. This paper seeks public views on –

- (a) the proposals to set up an Independent Investigation Board (IIB) (paragraphs 47 to 51) and an independent practice review oversight body to enhance the oversight of the public interest activities of the auditing profession (paragraph 56); and
 - (b) the detailed arrangements in respect of the establishment of the Financial Reporting Review Panel (FRRP) to oversee the application of accounting requirements of the Companies Ordinance, accounting standards and the true and fair view requirement (paragraphs 60, 62, 66, 70, 75, 79, 80 and 84).
2. It is envisaged that the IIB would focus on auditors while the FRRP's remit would cover a company's financial reports.
 3. Public comments are invited on the above specific questions raised in this consultation paper. Comments on the other matters covered in the paper would also be welcomed. Submissions should be made in writing by 31 October 2003 using either hard copy or email to –

Secretary for Financial Services and the Treasury
Financial Services and the Treasury Bureau
18 Floor, Admiralty Centre Tower I
18 Harcourt Road, Hong Kong
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Background

4. The accounting and auditing profession in Hong Kong is subject to a self-regulatory regime in which the Hong Kong Society of Accountants (HKSA) plays a pivotal role. The Professional Accountants Ordinance (the Ordinance) establishes the HKSA and sets out its objects (section 7 of the Ordinance, extract at [Annex A](#)), powers and functions. The HKSA's objects include registration; regulation of practices; education and maintaining the integrity of the profession. In pursuing these objectives, the HKSA sets admission and continuing registration criteria for its members; sets accounting and auditing standards, including ethical standards; oversees the quality of auditing practices and monitors compliance with standards; conducts investigations and exercises disciplinary powers where warranted.

Constitutional Arrangements

5. The management and control of the HKSA is vested in the HKSA Council (the Council). The Council now comprises 16 members. Apart from professional accountants, a representative of the Financial Secretary and the Director of Accounting Services are ex-officio members of the Council. The law also provides for the appointment of two academics to the Council, although no such appointment has been made in the past. At present, the only non-accountant on the HKSA Council is the representative of the Financial Secretary (Registrar of Companies).

6. The HKSA now focuses on four main areas of regulation –

- Admission and continuing registration
- Standards Setting
- Quality of auditing practices and compliance with standards
- Investigation and disciplining of members

These are described in greater detail in paragraphs 7 to 13 below.

Admission and Continuing Registration

7. The qualifications for registration as a professional accountant are stipulated in the Ordinance. The HKSA Council prescribes the

examinations and practical experience required of a candidate and is also empowered to grant exemptions from the registration requirements, subject to certain qualifications. The Council is also empowered to issue practising certificates to members who possess the relevant qualifications. Such certificates allow accountants to practise as certified public accountants or public accountants and perform statutory audits.

Standards Setting

8. The HKSA Council is empowered by law to issue or specify statements of professional ethics as well as standards of accounting and auditing practices. The HKSA has adopted a policy to make Hong Kong's financial reporting and auditing standards converge with those set by the International Accounting Standards Board and the International Federation of Accountants. Under the HKSA's convergence programme, the HKSA has adopted the same standard-setting agenda as the international bodies and most of the existing differences between Hong Kong's professional standards and international standards are being eliminated under this programme. Full adoption of the international standards in the near future is foreseeable.

Quality of Auditing Practices and Compliance with Standards

9. Quality assurance is currently undertaken by the HKSA under Part IVA of the Ordinance which provides for the establishment of the Practice Review Committee and the conduct of practice reviews. Members of the Practice Review Committee are all professional accountants appointed by the Council. The Council is empowered by law to specify that a review of a practice unit or units with regard to a particular professional standard or standards be carried out. Under this continuous programme of practice review, all auditors (not only auditors of listed companies) are subject to on-site inspections by the Society's staff who review audit working papers to ensure that all HKSA members in public practice maintain, observe and apply professional standards. In the case of material non-compliance or where the public interest is believed to have been impaired, the case is referred to a Disciplinary Committee for hearing.

10. Through its Professional Standards Monitoring Committee, the Society also performs continuous reviews of published financial statements with the aim of monitoring the accounting and auditing standards of members in public practice as evidenced by audited financial statements. Where issues are identified that warrant further enquiry, letters are issued to the auditors and members concerned for explanations

and clarifications.

11. With a view to making the practice review programme more efficient and effective, the HKSA plans to move away from a cyclical to a risk based approach in selecting and conducting quality reviews of its members. The Society has engaged the Joint Monitoring Unit Limited (JMU)¹ of the United Kingdom as an external consultant to provide advice as to how to move to a revised risk based approach. It is expected that the first phase of the consultancy will be completed in the second half of 2003.

Investigation and Disciplining of Members

12. The Council is responsible for constituting Investigation Committees 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. It currently comprises three persons selected from an Investigation Panel of professional accountants. One of these three accountant members must be a Society member with a practising certificate.

13. On the basis of the Investigation Committee's findings, Council may constitute a Disciplinary Committee. The Disciplinary Committee comprises five members appointed from a Disciplinary Panel. The Council is empowered to direct that one of these members shall be a lay member. Under Section 35 of the Ordinance, the Disciplinary Committee is empowered to make a number of orders, including an order to remove a professional accountant from the register of professional accountants either permanently or for a period of time.

HKSA's Reform Proposals

14. The present self-regulatory regime for the auditing profession was first established in 1973. It has been refined and enhanced throughout the years, with the introduction of practice reviews in 1992 and investigations in 1994. However, the landscape within which professional accountants operate has undergone dramatic changes in

¹ The JMU is an organization set up by the three professional accountancy bodies in the UK, namely the Institute of Chartered Accountants in England and Wales, the Institute of Chartered Accountants of Scotland and the Institute of Chartered Accountants in Ireland. The JMU is responsible for conducting audit and investment business quality control visits to the member firms of these three bodies and has considerable experience in adopting a risk-based approach in conducting practice reviews.

recent years. Confidence in the profession has been brought into sharp focus after the corporate scandals in the United States. In December 2002, the Secretary for Financial Services and the Treasury met with representatives of the accounting profession to discuss ways to improve the existing regime set out in the Professional Accountants Ordinance. In response to the Administration's request to enhance the element of oversight in the present regulatory regime, the Hong Kong Society of Accountants (HKSA) submitted detailed proposals to the Administration on 22 January 2003. A copy of HKSA's submission is at Annex B.

15. The specific proposals are summarized as follows –

- (a) increase the number of lay members and Government appointed officials on the HKSA Council from two to six;
- (b) expand the membership of an Investigation Committee instigated by the Council from three to five, and alter the composition of the Investigation Committee, with the majority of members (including the chairman) being lay persons;
- (c) alter the composition of the five member Disciplinary Committee instigated by the Society's Council, 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 committed by professional accountants related to companies listed on the Stock Exchange of Hong Kong.

16. The Administration considers that the HKSA's proposals are a move in the right direction. The proposals (a) to (c) above are the key steps in enhancing oversight of the Society's key functions and thus the oversight over the accounting profession. As implementing the proposals to enhance the independence and transparency of the HKSA's Council and Investigation and Disciplinary Committees require legislative amendments, the HKSA announced in June that it would seek to amend the Ordinance by way of a Members Bill.

17. The proposal to establish an IIB warrants more detailed examination, in particular in the light of international developments regarding the oversight of the audit profession.

Independent Investigation Board

18. The justifications put forward by the HKSA on the establishment of an IIB are set out in paragraphs 42 to 46 of Annex B. The HKSA envisages that the IIB's role would be to monitor and consider complaints of alleged accounting, auditing and/or ethics irregularities committed by professional accountants involving 'listed entities'. The IIB should comprise a majority of independent non-accountant members, but accountants who represent financial statement preparers and auditors should also be represented. The IIB should be funded independently, because the focus of such investigations is to serve the public interest. It would need full time paid secretariat support. The HKSA proposes that, when the IIB decides it has reasons to believe that a matter referred to it requires investigation, it would constitute an Investigation Committee to investigate the complaint. The powers of the IIB and its Investigation Committees to request information and to investigate would be similar to those presently afforded to the Securities and Futures Commission (SFC).

19. Where the IIB concludes that it has sufficient evidence, it could take its case to a Disciplinary Committee of the Society. The HKSA is of the view that the IIB should not possess any disciplinary powers, otherwise it will have conflicting roles and will be acting as policeman, judge and jury.

Lines of Reporting

20. The HKSA proposes that an Investigation Committee should report its findings to the IIB and the IIB should be accountable to the Financial Services and the Treasury Bureau (FSTB), whose role should be to oversee the effective operation of the IIB, including the appointment of suitably qualified persons on the Board and the Investigation Panels, regularly review the IIB's report and operations, and assist with funding. However, it should be noted that it is uncommon for statutory bodies to be accountable to a particular Bureau in the Government. In most instances, statutory bodies operate independently, with their duties and responsibilities stipulated in the law.

Housekeeping for the IIB

21. The HKSA has identified three possible places where the IIB could be housed as follows –

- (a) Within the Government, since the IIB should be accountable to FSTB (SFST);

- (b) Under the SFC, since IIB will focus on cases relating to listed companies. Nonetheless, the HKSA has pointed out that, at present, the interpretation of accounting standards is the Society's prerogative and it is not within SFC's functions under section 5 of the Securities and Futures Ordinance to investigate into the conduct of professional accountants in respect of possible breaches of professional standards;
- (c) Under the HKSA, as this option would have the advantage of economies of scale. The Registrar of the Society would be assigned responsibility to oversee the day to day operational aspects of the IIB but since the funding of IIB should be separated (see below), the Registrar, should be required to submit periodic reports to the Government. However, the downside is that the Registrar, under such circumstances, would become accountable to both the HKSA Council and the Government. There may also be cost implications if firewalls between the IIB and HKSA are needed to ensure independence.

Funding Arrangements

22. The HKSA has pointed out that there are a number of options for funding the work of the IIB. These include –

- (a) from the Government;
- (b) contributions from regulators (e.g. SFC/ HKEx);
- (c) levy on listed companies (based on a company's market capitalization; shares turnover, or audit fees);
- (d) levy on investors via a transaction levy;
- (e) a combination of the above.

It should be noted that it is not possible to set out, at this stage, the likely financial implications (including recurrent costs) of setting up an IIB. The recurrent costs would depend on case numbers, complexity and whether the relevant parties would seek judicial review or contest the decisions of the IIB. It should, however, be noted that, at present, the cost of investigations is recoverable by an Investigation Committee in the event that the allegations are proved by the complainant and upheld by a Disciplinary Committee. The same arrangement can be introduced for

investigations undertaken by the IIB. Furthermore, there may also be variations as to the funding options set out above. For example, the accounting profession as a whole or the auditors of listed companies are also possible sources of funding.

International Standards and Experience

23. In considering the appropriate development of the regulatory regime for the auditing profession, the Government's objective is to ensure that the regulatory regime is effective and transparent, inspires confidence in investors, serves the needs of Hong Kong and is in line with international trends. However, the nature of the regime is not a primary concern. We recognise that internationally, there exists established principles of oversight, and there are variations as to the forms and structures in which an oversight function could operate.

International Organisation of Securities Commissions (IOSCO)

24. In October 2002, the Technical Committee of IOSCO published a set of Principles for Auditor Oversight. A copy of the Statement is at [Annex C](#). The Statement recognises that the nature of an auditor oversight body and the process through which it carries out its activities may differ among jurisdictions. The key principles on effective oversight include the following –

- a mechanism to require that auditors have proper qualifications and competency before being licensed to perform audits, and to maintain professional competence. A mechanism should also exist to withdraw authorization to perform audits of publicly traded companies if proper qualifications and competency are not maintained;
- a mechanism to require that auditors are independent of the enterprises that they audit, both in fact and appearance;
- 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;
- a mechanism should exist to require that auditors are subject to discipline by an oversight body that is independent of the audit

profession, or, if a professional body acts as the oversight body, is overseen by an independent body. Such an oversight body must operate in the public interest and have an appropriate membership, 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; and

- the audit 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.

25. The European Commission is also in the process of seeking to reform the regulatory regime of its auditing profession and proposes a set of principles for the public oversight of the European Union audit profession. The key principles are similar to those of the IOSCO. In brief, they require the public oversight mechanisms to –

- be applied to all auditors;
- involve significant participation of non-auditors;
- comprise education, licensing and registration of auditors, standard setting, quality assurance and disciplinary systems;
- include investigation and disciplinary powers;
- be transparent;
- be independently and adequately funded.

Other Jurisdictions

The United Kingdom

26. The Department of Trade and Industry (DTI) has overall responsibility for company law in UK, which includes company reporting requirements, corporate governance, and the regulation of auditors.

27. A statutory framework governs the supervision and qualifications of company auditors, although the day-to-day responsibility for ensuring appropriate training and authorisation of registered auditors, and appropriate supervision of audit firms is delegated to the duly authorised

professional accountancy bodies. Statutory rules also govern accountants carrying out insolvency and investment business work.

28. In 2001, a new body – the Accountancy Foundation - was set up with responsibility for undertaking independent and non-statutory oversight of the regulation by leading professional accountancy bodies and their members. In October 2002, having conducted a review of the existing regulatory regime, the DTI issued a Consultation Document on the Review of the Regulatory Regime of the Accountancy Profession, seeking views on what regulatory functions were needed, who should carry them out, whether the existing balance between professional self regulation and independent regulation was a right one and whether there was a case for taking a different approach to the regulation of auditors in particular.

29. In January 2003, the Secretary of State for Trade and Industry announced new measures to strengthen the regulation of the profession. These include –

- the subsuming of the Accountancy Foundation under the Financial Reporting Council (FRC);
- the Auditing Practices Board should take over the professional bodies' responsibility for setting standards for independence, objectivity and integrity of auditors;
- a Professional Oversight Board (POB) should focus on the oversight of audit practices;
- a new Audit Inspection Unit (AIU) should report to POB;
- the Investigation and Discipline Board should be brought into being to provide a demonstrably independent forum for hearing significant public interest disciplinary cases;
- the annual running costs of the independent regulator should be broadly shared by Government, business and the professional bodies.

A steering group has been set up to implement the above changes.

The United States

30. In June 2002, in the wake of the Enron bankruptcy, the Securities and Exchange Commission (SEC) proposed the establishment of a new Public Accountability Board to take on oversight and improve the accountability of auditors of public companies. These proposals were subsequently overtaken by the Sarbanes-Oxley Act 2002, which became law at the beginning of August 2002. The new structure develops powers which the SEC already possessed in respect of generally accepted accounting standards and the ability to review financial statements registered with it. The SEC can discipline independent public accountants by suspending or barring them from acting as auditors of listed companies, and can also sue individual partners or name a firm for inappropriate conduct.

31. The Sarbanes-Oxley Act established a Public Company Accounting Oversight Board (PCAOB) which became operational in April 2003. Auditors of SEC-registered companies are required to register with PCAOB (this will include any foreign audit firm which audits the accounts of a company or subsidiary listed on the New York Stock Exchange). SEC-registered companies are required to become adjunct members. The PCAOB –

- has the authority to establish or adopt auditing, quality control standards and ethical rules in relation to the conduct of audits of public companies; and
- inspect audit firms and has powers to require co-operation with quality control reviews and disciplinary proceedings, and may also impose a broad range of disciplinary sanctions against accounting firms and individual members. Large firms, for example, will be inspected annually if they undertake more than 100 audits of public companies.

32. The board of the PCAOB comprises five independent members, not more than two of whom may be professional accountants. The PCAOB is funded by its accounting firm members and by its public company adjunct members. The Board sets its own budget - independent of the members or adjunct members - which will have to be approved by the SEC.

33. The Sarbanes-Oxley Act directs state regulators to determine whether the PCAOB's standards shall be applied to small and mid-sized non-registered accounting firms.

Canada

34. A new system for the independent public oversight of auditors of public companies was agreed by the Canadian Securities Administrators, the Office of the Superintendent of Financial Institutions and professional chartered accountancy bodies in July 2002. Strengthening of the system had been planned for some time but was accelerated in the wake of Enron. Under the new arrangements, an independent Canadian Public Accountability Board (CPAB) is to be established to oversee the inspection of auditors of public companies, auditor independence rules and the quality control requirements for firms auditing public companies. The new arrangements do not extend to wider accounting and corporate governance issues, which remain subject to oversight by the profession.

35. The system was originally scheduled to come into operation in October 2002. However, as at the end of August 2003, the Chairman has been appointed but the CPAB is still recruiting.

36. The CPAB is a voluntary body, but the provincial Securities Commissions will be issuing rules to the effect that they will only accept audits carried out by firms which are in good standing with the CPAB.

37. A new National Inspections Unit (NIU) has been formed. It is envisaged that the inspection system will be in place by late autumn this year, and will work with the existing provincial inspection units, reporting to the CPAB. Major firms auditing public accounts would be subject to annual review.

38. The CPAB and the cost of inspections are funded by the member firms, who will have contractual agreements with the CPAB on the operation of the new system. Seven of the 11 voting members on the CPAB must be from outside the chartered accountancy profession.

Australia

39. The Financial Reporting Council (FRC) has a statutory responsibility to provide broad oversight of the work of the Australian Accounting Standards Board (AASB) in setting accounting standards. The standards have to be approved by the Commonwealth Parliament but, to date, there has been only one instance of the standards being disallowed under the statutory disallowance provisions. The FRC comprises senior level stakeholders from the business community, the professional accountancy bodies, government and regulatory agencies.

The FRC is currently funded jointly by the Commonwealth and State Governments, the accountancy profession and business.

40. In the context of the Corporate Law Economic Reform Programme (CLERP), the Australian Treasury has recently published proposals (CLERP 9) to strengthen the financial reporting framework. Under these proposals, only minor changes would be made to the FRC's composition and structure, but it would assume responsibility for the oversight of auditor independence, audit standard settings and for monitoring and assessing the disciplinary procedures of the accountancy bodies. However, it would not have a direct role in disciplining auditors. In addition, a new Auditing Assurance Board would be created under the FRC while auditing standards would be given statutory backing. Fresh funding arrangements may be considered as part of the current review but these have not yet been developed.

41. On the basis of the above, it can be seen that international principles and guidelines do not envisage a one size fits all approach in designing regulatory regimes for the auditing profession. The new oversight reforms or arrangements in the above overseas jurisdictions are still at an early stage of implementation. In practice, in all the overseas jurisdictions examined above, regardless of the form of oversight, the substance is the same, namely that there should be independence and transparency in the process of regulating the public interest activities of the auditing profession.

What is needed for Hong Kong?

42. Any examination of the regulatory regime for the accounting and auditing profession has to ensure that all the 'public interest' issues are fully addressed. These issues can be basically categorized as follows –

- Accounting and Auditing Standards
- Ethical standards
- Investigations
- Disciplinary action
- Quality and monitoring of auditing practices

Accounting and Auditing Standards

43. The need for improving the accounting and auditing standards setting process was examined by the Standing Committee on Company Law Reform (SCCLR) in the context of the Corporate Governance Review. Paragraph 26.13(a) of the SCCLR Consultation Paper on Phase I of the Corporate Governance Review stated that –

‘Hong Kong does not need independent standard setting bodies for accounting and auditing standards given that they are very closely modeled on International Accounting Standards (IASs) and International Standards on Auditing (ISAs). The standard setting function should continue to be vested in the HKSA but the composition of the Financial Accounting Standards Committee (FASC) and the Auditing Standards Committee (AuSC) should be widened to cater for more involvement of the public.’

The SCCLR also made various proposals regarding ways and means in which the memberships of the FASC and AuSC could and should be broadened. These recommendations were supported by consultees. The HKSA has already taken action to broaden the membership of the two committees in line with the SCCLR’s proposals.

44. On the basis of the HKSA’s programme of convergence as outlined in paragraph 8 above, it is expected that Hong Kong Statements of Standard Accounting Practice and Hong Kong Statements of Auditing Standards will conform with the IASs and ISAs. As a result, the baseline for Hong Kong’s accounting and auditing standards will be international standards, but any enhancement over and above these standards will be determined locally. In view of this, the issue is not so much the nature and membership of the standard-setting bodies in Hong Kong, but the degree and nature of Hong Kong’s involvement in the international accountancy bodies which set and develop the baseline standards. One should note that keeping track of the pace of seeking convergence is also important. Nonetheless, given that the convergence process is very transparent, there is already a considerable degree of public scrutiny of the pace of convergence to ensure that the momentum is maintained.

Ethical Standards

45. The HKSA proposes to use the International Federation of Accountants (IFAC) Code of Ethics (proposed revisions to the Code being circulated by IFAC for comments), with appropriate amendments,

as the basis for ethical standards in the accountancy profession. Consequently, as far as Ethical Standards are concerned, the HKSA will largely comply with international best practice. Furthermore, seven of the 21 members of the Ethics Committee are non-accountants.

Investigation and Disciplinary Action

46. By and large, the proposals to appoint additional lay members to the HKSA Council, and a majority of lay members to the HKSA's investigation and disciplinary committees, will enhance the element of independent public oversight of the accountancy profession.

Assessment of the IIB Proposal

47. The Administration has an open mind on the HKSA's proposal in respect of setting up an IIB to monitor and consider complaints of alleged accounting, auditing and /or ethics irregularities committed by professional accountants involving 'listed entities'. We do not dispute the HKSA's view that the IIB can, to a certain extent, address issues, be they apparent or real, of independence, resources and investigatory powers.

48. Nonetheless, setting up an IIB would have wider ramifications not only on professional accountants but also on other relevant parties including the regulators, issuers, investors and other financial data users. It is therefore imperative that we listen to the views of all stakeholders before taking a decision on the way forward.

49. In this connection, public views are sought on the following issues –

- (a) Given the proposed changes to the Council, Disciplinary and Investigation Committees of the HKSA (see background information set out in paragraphs 11 to 41 of Annex B), is there a need to establish a separate IIB to monitor and consider complaints of alleged accounting, auditing and/or ethics irregularities committed by professional accountants involving 'listed entities'?
- (b) If so, should the IIB's jurisdiction be limited to accounting, auditing and ethical irregularities involving listed companies only (see background information set out in paragraph 47 of Annex B)?
- (c) Are there any views on the composition of the IIB as proposed by

the HKSA (see background information set out in paragraphs 49 and 50 of Annex B)?

- (d) Should the IIB be empowered to request information and to investigate or should it only act on referrals from other regulators and complaints (see background information set out in paragraphs 55 to 57 of Annex B)?
- (e) Should the IIB's functions remain purely investigatory and where it considers there is sufficient evidence, the IIB should refer a case as a complaint to the HKSA's re-constituted Disciplinary Committee (see background information set out in paragraphs 58 to 62 of Annex B)?
- (f) Is there any need for referring public interest cases to a disciplinary entity institutionally independent of the HKSA, given that the HKSA's proposal that a Disciplinary Committee should comprise a majority of lay members (including the Chairman) with hearings primarily held in public?

50. If an IIB were to be set up, it would be necessary to place the infrastructure, powers, checks and balances on a statutory basis. In this respect, comments are sought on –

- (a) What institutional form should the IIB take?
- (b) Should the IIB be responsible to the Administration, the SFC or the HKSA?

(see paragraphs 20 to 21 above and background information set out in paragraphs 63 to 68 of Annex B).

51. What form should the funding arrangement for the IIB take (see paragraph 22 above and background information set out in paragraphs 69 to 74 in Annex B)? In this respect, comments are sought on –

- (a) Whether issuers be required to contribute since they would benefit from having good quality audits and enjoy the benefits of being listed in a market that provides quality assurance? If so should this be based on a listed company's audit fees, market capitalization or turnover of its shares?
- (b) Should investors be required to contribute because the existence of the IIB would lead indirectly to better quality assurance on

financial data and hence better protection for investors?

- (c) Whether the accounting profession as a whole or auditors of listed companies be required to contribute since the IIB's work would have a direct impact on investors' confidence in the profession?
- (d) Should the Administration, the SFC or HKEx be required to sponsor the IIB given the high degree of 'public interest' in ensuring the accuracy and probity of financial reporting because of its impact on Hong Kong's reputation as a leading financial centre?
- (e) Should the IIB be funded by all or some of the above groups/bodies and, if so, the justifications for doing so.

Quality and Monitoring of Audit Practices

52. With the implementation of the reform proposals submitted by HKSA, the one public interest function which requires additional independent oversight is quality control of audit practices, i.e., the practice review process (see paragraphs 9 to 11 above). At present, the Practice Review Committee comprises solely of professional accountants while the Council specifies the professional standards to be tested. The practice units subject to review are selected at random. The reviewer, the professional accountant appointed or engaged by the Council for the purpose of carrying out practice reviews, will submit his report to the Practice Review Committee after he has concluded his practice review. After its review, the Practice Review Committee may make recommendations to the practice unit regarding the application by it of certain professional standards or, where it considers appropriate, lodge a complaint with the Registrar. The Registrar is obliged under the Ordinance to submit the complaint to the Council which may refer the complaint to a Disciplinary Committee. The work of the Practice Review Committee is briefly reported every year in the HKSA's Annual Report.

53. The IOSCO Principles for Auditor Oversight envisage that a mechanism should exist to provide that a body provides oversight over the quality and implementation of auditing, independence, and ethical standards used in the jurisdiction, as well as the audit quality control environment. Consideration therefore needs to be given as to how the practice review function could be made subject to some form of public oversight. We recognize that the Practice Review Committee is technically well placed to perform the quality assurance function.

Nonetheless, there is scope for stepping up public oversight of such quality assurance work, in particular in terms of the process and transparency.

54. In the light of the above, one possible approach is to establish a body as part of HKSA which would be responsible for oversight of the practice review programme and reviewing its operational procedures to ensure fairness, reasonableness and consistency of procedures in conducting the reviews. This body could comprise a majority of lay members: the lay appointees to the Council of the HKSA would be possible candidates. Persons with experience in relation to audits, including retired partners of auditing firms would also be well placed to join the oversight body. To highlight its independence, it would be desirable to set out the composition, the charter of powers and responsibilities of, as well as the funding arrangements for, such an oversight body in the law. To enhance transparency, the oversight body could publish a report of its work, including the amount of resources allocated to it and the recommendations it has made in relation to the Practice Review Committee's processes. Where justified, the independent oversight remit of this body could be extended to cover other public interest functions performed by the HKSA.

55. With the above governance and transparency arrangements, independence of the oversight entity would be attained in substance. Enshrining the institutional set-up and funding arrangements in law would go a long way in meeting the requirements on independence in form. It would therefore appear that there is not a strong case for the need to set up an oversight entity institutionally independent of the HKSA.

56. We recognise that the HKSA has engaged the JMU to assist in reviewing the practice review procedure (paragraph 11 above refers). However, we believe that the consideration of the possible approach outlined in paragraph 54 above would not pre-empt the findings of the JMU's review. In view of this, comments are invited on –

- (a) the proposal outlined in paragraph 54 above on the establishment of an independent practice review oversight body within the HKSA; and
- (b) the constitution, membership, scope of work and funding arrangements for such an entity, i.e., should the same considerations in respect of the IIB be applied to this oversight body?

Financial Reporting Review Panel

57. At present, there is no mechanism in Hong Kong's regulatory regime to provide for the making of enquiries into compliance of companies' financial statements with the accounting requirements of the Companies Ordinance, including the true and fair view requirement. In addition, there is no mechanism whereby directors may be required to revise and re-issue financial statements. The SCCLR's Consultation Paper on Phase I of the Corporate Governance Review issued in July 2001 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 the SCCLR indicated support for the establishment of a Financial Reporting Review Panel (FRRP). To take the proposal forward, we need to finalize the detailed design of the FRRP, including the ambit of its activities, mode of establishment, composition, powers, operation, governance, and resource arrangements. In drawing up these proposals, we have taken into account the arrangements regarding the FRRP in the UK, which was set up in 1991 and has a proven operational track record.

Ambit of Activities

58. The FRRP's ambit should be to enquire into apparent departures from the law and accounting standards in the annual accounts of companies and to seek remedial action. In this respect, it is necessary to consider the types of companies that FRRP should cover, and the items that would be classified as comprising the annual accounts.

Types of Companies

59. In the 2001 Consultation Paper, the SCCLR consulted on the FRRP's jurisdiction, namely whether the body's work should be confined to certain categories of companies, for example, public companies only and/or large private companies. The response from the public was mixed. Some parties held the view that only listed entities should be covered, while others agreed to adopting the approach in the United Kingdom (UK) (public and large private companies²). In addition to

² In the UK, FRRP's authority technically extends to statutory financial statements of all companies which prepare annual financial statements under the Companies Act. Nevertheless, by an agreement with the UK's Department of Trade and Industry, FRRP deals only with the accounts of public and large private companies. These companies include public limited companies (PLC), companies within a group headed by a PLC; any private company not qualifying as small or medium sized (as defined in the UK Companies Act) and any private company within a group which does not qualify as a small or medium sized group. Up to 30 June 2000, 92.5% of FRRP's cases concerned listed companies.

listed companies, there is also a substantial number of unlisted public companies in Hong Kong. It is recognised that these two categories of companies, by their very nature, carry a higher public interest element. Furthermore, private companies are not required to file company financial statements at the Companies Registry. Unlike the UK, neither our statutory nor the accounting standards single out ‘large private companies’ as a separate category of companies. We also recognise that, in determining the FRRP’s jurisdiction, we need to balance the cost and benefit of its coverage. The wider the type of companies covered by FRRP, the more extensive the resource implications. Consequently, we can see the advantage of focusing on a confined group of companies as a start.

60. Comments on the FRRP’s jurisdiction are invited, in particular whether this jurisdiction should cover –

- (a) listed companies³ only;
- (b) listed companies and unlisted public companies incorporated in Hong Kong; or
- (c) listed companies and all unlisted companies incorporated in Hong Kong.

Types of financial documents

61. In Hong Kong, every public company (i.e., a company which is not a private company) is required to file with the Companies Registry an annual return which contains certain basic company information including the company’s balance sheet, its profit and loss account, an auditors’ report and a directors’ report. In addition, listed companies are also required, under the Listing Rules of the HKEx, to send other reports, such as management discussion and analysis, to their shareholders. The balance sheet and profit and loss account would inevitably be considered as part of the annual accounts over which the FRRP should have an oversight function. However, it is for consideration whether FRRP’s purview should be extended to cover documents like the auditors’ report, directors’ report and management discussion and analysis. We note that, in the UK, the FRRP’s authority is limited only to the statutory annual financial statements of companies and does not cover other financial material that may be published together with the annual accounts, for example, the auditors’ report, chairman’s statement, directors’ report and

³ Listed companies means companies listed on HKEx, regardless of place of incorporation.

summary financial statements. Consideration is being given in the UK to extending the FRRP's remit to cover all published financial information issued by listed companies, including interim reports and preliminary announcements, where such information is presented in accordance with mandatory requirements.⁴

62. We are of the view that, at the outset, it would be desirable for the FRRP to limit its remit to the statutory annual financial statements of companies namely, the balance sheet and profit and loss account. Comments on this proposal are invited.

Mode of Establishment

63. The mode of establishing enforcement bodies like the FRRP varies. They may be set up as either bodies constituted specifically for the purpose or under a regulator. A body constituted for a specific enforcement purpose has the advantage of being seen as more focussed. Such a body would arguably be in a better position to communicate with the stakeholders of financial statements.

64. In the UK, the FRRP is a body constituted specifically and authorised under the Companies Act to enquire into the annual accounts of public companies and large private companies. It takes the form of a company limited by guarantee and is an independent body under the Financial Reporting Council⁵. In the United States and Australia, the securities regulators assume the responsibility for monitoring and enforcing the financial reporting requirements. For example, the SEC is the front-line regulator in ensuring compliance by listed companies with US accounting principles and is empowered to make such investigations as it deems necessary to determine whether any person has violated any provisions of the Securities Act 1934. In Australia, the Australian Securities & Investments Commission is responsible for enforcing companies' compliance with reporting and disclosure standards. Placing the FRRP under a regulator has the advantage of being able to capitalize on the regulator's enforcement experience, in particular the experience of co-operating with regulators in other markets. It could also be argued that, given the regulator's track record, there would be greater public confidence in the regulator's ability to safeguard the public interest.

⁴ Final Report of the Co-ordinating Group on Audit and Accounting Issues, published on 29 January 2003.

⁵ The Financial Reporting Council is set up as a company limited by guarantee. Its main objective is to promote sound financial reporting and to support that aim through its two operational bodies, the Accounting Standards Board and the Financial Reporting Review Panel.

Furthermore, such an arrangement may also enjoy some economies of scale, hence minimising the resource implications of setting up the FRRP.

65. When the concept was floated for public consultation in 2001, some respondents indicated a preference for placing the FRRP under the securities regulator. In this respect, it should be recognised that the SFC's ambit is presently confined to listed companies and, if the FRRP is to cover unlisted public companies or private companies, a conscious decision to extend the ambit of the securities regulator would be necessary.

66. Comments are invited on whether the FRRP –

- (a) should be set up as an independent statutory body; or
- (b) should be placed under the SFC.

Powers and Composition

67. The primary objective of the FRRP is to ensure that defective financial statements, when identified, are rectified. In view of this, the FRRP should be given adequate powers to compel rectification by a company when necessary. These powers might range from directing a company and its directors to make changes to seeking the court to order changes to be made.

68. In the UK, the FRRP's power is derived from the Companies Act 1985. The Act provides that –

- (a) where the Secretary of State considers that there may be a question on whether the financial statements of a company comply with the Companies Act, he may give notice to the directors to ask for an explanation, or to prepare revised financial statements (section 245A);
- (b) if the directors decline to adopt voluntary rectification of the financial statements and no satisfactory explanation has been given, the Secretary of State may apply to the court for a declaration that the financial statements do not comply with the requirements of the Companies Act, and for a court order requiring the directors to prepare revised financial statements (section 245B), and the court may also order that the cost of the proceedings to be borne by the directors of the company concerned; and

- (c) the Secretary of State may authorize others to apply to the Court (section 245C).

69. The FRRP has been authorized by the Secretary of State⁶ for the purpose of section 245B of the Companies Act. To date, the UK FRRP has succeeded in resolving all cases brought to its attention without having to apply for a court order. Since its inception, the FRRP has required significant corrective action to be taken in 67 cases. Its pronouncements on such cases provide a useful additional analysis of contentious issues. It is also empowered to provide a copy of its correspondence, notes of meetings and other background information to such bodies as it considers appropriate.

70. Having regard to the powers of the FRRP in the UK and its satisfactory record of operation, we propose similar powers for the FRRP in Hong Kong. This would include –

- the power to enquire into the annual accounts of companies;
- where it appears to the FRRP that there is a case to answer, the Panel would question the accounts and hear the company's explanations;
- if the FRRP is not satisfied with the explanations, it would seek to persuade the company voluntarily to propose and adopt a more appropriate accounting treatment. It would not, however, prescribe the solution. The directors may then voluntarily correct the accounts taking the remedial action agreed with the Panel;
- should the FRRP fail to effect a voluntary correction, it can exercise its power to secure revision of the original accounts through the High Court.

Comments on the above proposed powers of the FRRP are sought.

71. As regards the composition of the FRRP, we are of the view that the Chairman and members should include persons with a wide range of financial reporting and commercial experience and expertise. The panel needs to keep in touch with the changing financial world.

⁶ By virtue of a Statutory Instrument 'The Companies (Defective Accounts) (Authorised Person) Order 1991, the Secretary of State authorized the FRRP to apply to the court.

72. In the UK, FRRP members are appointed by the Appointment Committee of the Financial Reporting Council and there is no upper limit to the number of Panel members. The present Chairman of the FRRP is a retired Queen's Counsel who specialized in company law and the Deputy Chairman is the former chairman of one of the big accounting firms. The other members on the Panel are from the business sector (40%), accounting firms (30%), lawyers (20%), company secretaries (5%) and Government (5%). Altogether the FRRP has 20 members. In considering individual cases, the FRRP operates through groups of five or more members drawn from the overall Panel membership, and there is no collective involvement by the other Panel members. To secure consistency in approach, all groups are normally chaired by the Panel Chairman.

73. In Hong Kong, given the technical nature of the FRRP's work, it would be desirable to draw members from the broad based financial reporting community. There should also be a reasonable number of members to avoid any possible conflicts of interests in working on cases. The group approach adopted in the UK appears pragmatic as it helps to avoid conflicts of interest and would likely lead to a more focussed approach in managing cases.

74. We envisage that the FRRP would be supported by a small secretariat mainly to deal with the associated administrative work. The members of the FRRP, being experts of their own, should be in a position to deal with the cases on the basis of the information provided by the company in question. It is worth noting that the FRRP in the UK has a small secretariat of permanent staff⁷, with possibility of secondment arrangements with regulators and other bodies.

75. In the light of the above, comments are sought on whether–

- (a) the Chairman and members of the FRRP should have expertise in financial reporting and related matters;
- (b) the Chairman and members should come from the legal, accounting, business sectors as well as relevant regulatory bodies; and

⁷ The Secretary to the Panel currently also serves the Financial Reporting Council. There is also one full time Assistant Secretary, and the UK FRRP shares basic secretarial support provided by the Financial Reporting Council.

- (c) the ‘group’ approach as adopted in the FRRP in the UK should be adopted to tackle cases.

Operation - Reactive or Proactive?

76. The FRRP could adopt either a reactive or proactive approach in its work. Under the reactive approach, the FRRP would not actively monitor company financial statements or seek out breaches of the regulations and standards. Rather, the FRRP would rely on matters being brought to its attention either directly by complainants or by press comments. A pro-active approach, on the other hand, would mean actively reviewing accounts of companies to ensure compliance. Since its establishment in 1991, the FRRP in the UK has adopted a re-active approach. However, in January 2003, the FRRP has been asked to consider how best an element of proactivity might be introduced into its operating procedures.

77. An analysis of whether the FRRP should be re-active or proactive would not be complete without exploring the nature of its activities and what it seeks to achieve. As we see it, directors and auditors have a fundamental role in preparing and auditing financial statements respectively and the FRRP should not be seeking to replace this role. We envisage that, where it is necessary to rectify a breach of the accounting requirements, the FRRP would not prescribe a solution. It would be incumbent upon the company, its directors and advisers to rectify the matter. Furthermore, it should be recognised that the FRRP’s responsibility should be to ensure that the financial statements under review comply with the law and accounting standards. It does not set accounting standards, nor would it set guidelines on the interpretation of such standards. Accounting standards remain HKSA’s responsibility.

78. As a start, we would recommend that the FRRP should adopt a re-active approach, but keep in view the experience of its overseas counterpart. We are mindful that an element of proactivity would naturally lead to an increase in the funding requirement for the FRRP.

79. Comments are invited on the proposal for the FRRP to adopt a re-active approach to its work.

Governance

80. As an entity that is vested with an enforcement responsibility, it is important that the FRRP’s procedures are transparent and its decisions are published. It should also keep its operating procedures under periodic

review and publish annual reports on its work. In view of this, comments are invited on the following governance arrangements –

- (a) the FRRP should develop a set of operating procedures which should be made public;
- (b) there should be periodic review of its operating procedures;
- (c) where the FRRP has considered a case and concludes that there is no cause for action, no public statement on the case needs to be issued;
- (d) where the FRRP has considered a case and concluded that there is cause for action, a public statement should be issued; and
- (e) the FRRP should prepare and publish an annual report, detailing its work during the reporting period as well as its own audited accounts.

Resource Arrangements

81. Adequate resources would be necessary for the FRRP to operate effectively. As mentioned above, we do not expect the FRRP to have an extensive secretariat, in particular if it adopts a reactive operating mode. It is recognised that there may be instances where the FRRP needs to resort to external assistance to carry out some investigation work and funds would have to be allocated for such purpose. Separately, adequate funds also need to be designated to enable the FRRP to take cases to the court to seek orders as to the financial reports in question. As we hope that members would serve on the FRRP on a voluntary basis, the question of remuneration for members would not arise.

82. As a comparison, the FRRP in the UK operates only on a modest budget of GBP 320,000 in 2002/03. Of this, GBP 260,000 was designated for staff costs and GBP 10,000 for the cost of Panel Investigations. In the UK, the FRRP receives funding from three sources: the Government, the accountancy profession and the City⁸. Each contributes an equal share to the FRRP.

⁸ Comprising – the Financial Services Authority (which in turn is funded by a levy on share transaction); The Bank of England, on behalf of the banking sector; Association of British Insurers; National Association of Pension Funds; Association of Investment Trust Companies; and Association of Unit Trust and Investment Funds.

83. In the Hong Kong context, it seems reasonable that the FRRP should be funded by users. The direct users appear to be investors, although issuers also benefit from the FRRP's existence in terms of enhanced investor confidence in the companies' financial statements. By the same token, account preparers would also benefit indirectly.

84. Comments are invited on –

- (a) whether FRRP should be funded by stakeholders; and if so
- (b) who the stakeholders should be and whether all parties should contribute equally.

Conclusion

85. The FRRP, when established, would play an important role in strengthening Hong Kong's regulatory framework for financial reporting. This is particularly desirable against the background of increasing public concern, both in Hong Kong or elsewhere, over the quality of financial reports. Nonetheless, it is important to stress that no system of enforcement can or should be expected to guarantee the integrity of a financial reporting regime. One should also recognise that there may be limitations as to the FRRP's work and the fact that many of our listed companies are incorporated outside Hong Kong. Enquiries in relation to departures from Hong Kong law and accounting standards (where applicable) of such companies whose major activities are outside the territory would present challenges to the FRRP which are not paralleled in other jurisdictions. In view of this, it would be desirable to keep FRRP's mode of operation and remit under review in the light of experience.

Professional Accountants Ordinance (Cap 50)
Section 7 Objects of the Society

The objects of the Society shall be –

- (a) to maintain a register of professional accountants, firms of certified public accountants or public accountants and corporate practices; (Amended 85 of 1995 s. 3)
- (b) to regulate the practice of the accountancy profession;
- (c) to conduct examinations and act in such other manner as may be necessary to ascertain whether persons are qualified to be admitted to the register;
- (d) to encourage the study of accountancy by accountants and students, and to give certificates, bursaries, scholarships and rewards on such terms and conditions as may be specified from time to time;
- (e) to maintain a library and reading rooms for the use of accountants and students;
- (f) to establish and assist in establishing and supporting associations, funds, trusts and schemes intended to benefit accountants or their dependents, and to grant pensions and allowances to any accountant or his dependents;
- (g) to represent the views of the profession and to preserve and maintain its integrity and status;
- (h) to discourage dishonourable conduct and practices by professional accountants, and for this purpose to hold inquiries into the conduct of professional accountants, firms referred to in paragraph (a), and corporate practices; (Amended 85 of 1995 s. 3)
- (i) to provide for the settlement of disputes within the accountancy profession; (Amended 85 of 1995 s. 3)
- (j) to take such action as the Society considers necessary in any matter affecting the professional interests of the accountancy profession; (Amended 85 of 1995 s. 3)
- (k) to do all such other things as are incidental or conducive to the attainment of the above objects.

**Proposals to Strengthen
the Regulatory Framework of the Accountancy Profession**

Introduction

The collapse of Enron and WorldCom in the U.S. has attracted worldwide public concern over a number of corporate governance issues and the credibility of financial reporting and auditing practices. In response, many jurisdictions have introduced reforms, or are reviewing the regulatory framework governing the accountancy profession. The Council of the Society has been monitoring these developments closely and has been considering whether similar changes should be introduced to our own regulatory system to enhance public confidence in the accountancy profession.

2. The Council acknowledges that its members have a key role to play in maintaining investor confidence and financial market stability. It also recognizes that there are increasing public expectations of the accountancy profession to be in line with international developments. It accepts that more transparency and lay participation in the Society's regulatory processes will provide the public with the added comfort and assurance that their interests are, and will continue to be, served properly.

3. Council would however like to stress that Government should also recognize that there are many parties involved in the corporate reporting framework, the Society's members being only one of them. In addition to the external auditors, other parties who are equally important to maintaining a sound financial reporting system include the company's directors and management, company secretaries, bankers, sponsors, underwriters, financial advisors and analysts, accountants who are employed by companies to assist in the preparation of financial statements, internal auditors and regulators such as the Securities and Futures Commission ("SFC") and the Hong Kong Exchanges and Clearing Limited ("HKEx").

4. While we fully support strengthening the regulation of the accountancy profession, we strongly recommend that the Government should conduct a comprehensive review of the capital markets regulatory framework to ensure that the other key players are similarly reminded of, and are clear about, their respective roles and responsibilities and are adequately regulated. The credibility of our markets is a sum of the contributions from all major players. In our view, any over-regulation of one sector will not necessarily result in greater confidence in, and stability of, the entire market.

Proactive Approach

5. The Society has been pro-active in opening up and improving its regulatory processes. Over the years, we have made continuous refinements to monitor the quality of work of our members and to take remedial and disciplinary action where necessary. For example, powers to conduct regular practice reviews of our members were introduced in the Professional Accountants Ordinance (“PAO”) in 1992 and in 1994, the Society was further empowered to carry out investigations of alleged misconduct by its members.

6. In 2001, after a detailed review of its disciplinary process, the Society decided to open its disciplinary hearings to the public and to increase lay member participation on its disciplinary committees. These proposals have been submitted to the Financial Services and the Treasury Bureau (“FSTB”) for policy clearance and legislative amendments.

7. The Society has also accelerated its review of its practice review programme. Last year, after an internal review conducted by the Practice Review Committee, we decided to engage the Joint Monitoring Unit Limited of the U.K. as our external consultant to assist in an independent review of the Society’s existing processes and to implement improvements. The Society plans to make its practice review programme more efficient and effective by moving away from a random to a risk-based approach in selecting and conducting quality reviews of members in practice. This will require the use of an annual practice profile questionnaire, and the consultant will be assisting us in developing the appropriate supporting systems.

8. In its Fourth Long Range Plan published in 2000, the Society is also committed to conducting a more comprehensive review of the Society's self-regulatory system. A special Task Force will soon be formed. It will be tasked to consider recent international developments, some of which are in the state of flux, concerning the accountancy profession.

Oversight by overseas professional bodies

9. By being a member of the International Federation of Accountants ("IFAC") Board and the International Accounting Standards Board's ("IASB") Standards Advisory Council, the Society participates in the development of internationally recognized accounting, auditing, ethical and quality control standards to ensure that our standards are in line with the latest developments and best practices. Membership to these bodies includes obligations for the Society, and therefore its members, to be subject to their oversight and monitoring. The recent Reciprocal Membership Agreements with seven first tier bodies as listed below underlines our commitment to adopt similar admission and quality control processes –

- Institute of Chartered Accountants in Australia
- Institute of Chartered Accountants in England and Wales
- Institute of Chartered Accountants in Ireland
- Institute of Chartered Accountants of New Zealand
- Institute of Chartered Accountants of Scotland
- Institute of Chartered Accountants of Zimbabwe
- South African Institute of Chartered Accountants

Proposals to strengthen our regulatory framework

10. Council has given considerable thought to possible ways in which the existing regulatory framework of the accountancy profession in Hong Kong can be strengthened to address the issues of transparency and

independence of its regulatory function that are of concern to the public. In making its proposals, Council has been mindful of the need for the system to be efficient and cost-effective. It is important to note that under the existing framework, the memberships of Council, Investigation Panel, Disciplinary Panel are independent of one another, i.e., members of Council cannot be members of Investigation Panel or Disciplinary Panel, and vice versa. Council believes that this separation of power should continue. The Council's proposals, as summarized below, are in 4 parts –

Proposal 1: Increase lay members in the Society's governing body

Proposal 2: Expand the membership of any Investigation Committee instigated by Council from 3 to 5, and alter the composition of the Committee, with the majority of members (including the chairman) being lay persons

Proposal 3: Alter the composition of the 5-member Disciplinary Committee instigated by Council, with the majority of members (including the chairman) being lay persons

Proposal 4: As a variation of Proposal 2, establish an Independent Investigation Board to deal with alleged accounting, auditing and/or ethics irregularities related to "listed entities"¹, whilst alleged accounting, auditing and/or ethics irregularities related to "non-listed entities"² will continue to be investigated by Investigation Committees instigated by Council. This Board may either operate completely outside the Society, or be placed under the Society's secretariat for administrative support subject to the following three principles being observed –

a) majority lay membership;

¹ Listed entities = Companies listed on The Stock Exchange of Hong Kong Limited

² Non-listed entities = Companies which are not listed entities

- b) independent funding; and
- c) reasonable suspicion of a disciplinable offence under the PAO.

The proposals are set out in detail in the following paragraphs.

Proposal 1: Increase lay members in the Society's governing body

11. To increase the transparency of the Society's governance, including decisions relating to regulatory matters, it is recommended that lay participation, including government appointed officials on Council, should be increased from the present 2 to 6. The 4 lay members would be appointed by the Government.

12. There are presently two government appointed members on Council, namely, Mr. Shum Man-to, the Director of Accounting Services and Mr. Gordon Jones, the Registrar of Companies, representing the Financial Secretary. The Director of Accounting Services will invariably be an accountant and will most likely also be a member of the Society.

13. The existing Council includes two members who are "academics from universities". However, their place on Council was obtained through election by members of the Society rather than by appointment of "academics" by the Chief Executive, which is provided for under Section 10(3) of the PAO. Council believes that any member who is eligible should not be debarred from running for election as a Council member even though he/she could join the Council by Government appointment under the PAO.

14. Council therefore suggests that Section 10(3) of the PAO should be repealed and replaced by a provision that will enable the Government to appoint 4 additional "lay members" representing the public interest. The "lay members" should not be accountants in their current occupation or employment at the time of appointment, and remain so throughout for their term of office.

15. Council recommends that the term of office of the 4 Government appointed members representing the public should be for 3 years whilst the term of other elected members of Council should remain as 2 years. A longer term will give the appointed lay members the time necessary to familiarize themselves with the operation of the Society and, in particular, the technical aspects. Renewal of office of these appointees should be at the discretion of the Government, having regard to their attendance record at Council meetings and any other criteria the Government deems appropriate.

16. The proposed revised Council composition, with a comparison with the existing composition, is included at Appendix 1. It is also proposed that the immediate past president be appointed to serve on Council for one year, and thereafter he/she may seek re-election to Council like any other member of the Society.

17. As the composition and terms of office of Council members are currently governed by Part III of the PAO, a change in legislation is required.

Proposal 2: Expand the membership of any Investigation Committee instigated by Council from 3 to 5, and alter the composition of the Committee, with the majority of members (including the chairman) being lay persons

a) Majority lay members in Investigation Committees, including chairman

18. To enhance transparency and public confidence in the Society's investigation processes, it is recommended that –

(a) the chairman of an Investigation Committee be a non-accountant;
and

(b) lay members be included in the committees such that there is a lay majority.

19. The proposed composition of these committees, with a comparison with the existing position, is set out at Appendix 1.

20. At present, under Section 42B(1)(a) of the PAO, the Investigation Panel from which members of the Investigation Committee are selected is restricted to “professional accountants”. The Council proposes that in future, an Investigation Committee should include both “professional accountants” as well as “lay persons” who are not accountants. In addition, the size of an Investigation Committee instigated to deal with an investigation concerning alleged accounting, auditing and/or ethics irregularities should be expanded from the current 3 to 5 persons, with the majority being lay members.

21. As issues arising in these investigations will invariably deal with technical accounting and auditing matters, expert advice from professional accountants will be necessary to ensure that the investigations are completed fairly, quickly and effectively. It is therefore proposed that future Investigation Committees should include 3 lay members and 2 professional accountants. Staff from the Society will continue to provide the secretarial support and assistance to Investigation Committees.

b) Investigation Panels

22. As a number of investigations may be conducted concurrently, and there will be circumstances where a member on the Panel cannot serve because of non-availability or conflicts of interest, a sufficient number of individuals are required to be included in the Investigation Panel. The Society has at present 25 members on its Investigation Panel who are all professional accountants in accordance with the requirements of Section 42B(1)(a) of the PAO. This section will need to be amended to allow lay persons to be included on the Investigation Panel.

23. It is recommended that in future, there should be two Investigation Panels from which an Investigation Committee is formed. Panel A should comprise lay members appointed by the Government, and Panel B should comprise professional accountants appointed by the Council.

24. The members appointed to Panel A should be selected by Government and comprise persons from a broad spectrum of the community, including retired judges or magistrates, barristers and solicitors, bankers, representatives from other regulators, businessmen,

academics, etc. We believe that the Government should seek to identify approximately 40 individuals for Panel A. The current number of professional accountants on the Society's existing Investigation Panel should be maintained at its present level and should be grandfathered to form the new Investigation Panel B.

25. To be consistent with the existing practice of ensuring independence and impartiality, under Section 42B of the PAO, a member of the Investigation Panel should not be a Council member or a member of the Disciplinary Panel.

c) Appointment of members to an Investigation Committee

26. The existing practice of the Society is that Council appoints all members of the Investigation Committee when an Investigation Committee is established. To enhance independence and public confidence in the investigation process, we propose that in future the Government should appoint the Chairman from Panel A who in turn appoints the other 4 members of the Investigation Committee.

27. To facilitate the whole process, it is proposed that the Government should appoint a Panel A member to be an Investigation Committee Convenor who is delegated the power to identify and appoint an appropriate Chairman of an Investigation Committee to deal with a particular case when an investigation is instigated by the Council.

d) Remuneration of Investigation Committee members

28. Council believes that the two future Investigation Panels A and B should continue to be comprised of volunteers who offer their services free as this will be consistent with the Society's present structure where work on committees is regarded as public service and is normally not remunerated.

e) Continuing problems

29. Although the above changes will address the perception problem of the lack of independence and accountability in the governance of the Society, and its investigation and disciplinary processes, it will not expedite or streamline investigations. See paragraph 43 for discussion

of the remaining issues.

f) Amendments to the Professional Accountants Ordinance

30. At present, Section 42B(1) of the PAO requires the members of the Investigation Panel to be “professional accountants” and Section 42C(2)(b) provides that there shall be 3 members in an Investigation Committee each of whom shall be appointed by the Council. The PAO will therefore need to be amended to effect the above proposals.

31. The existing and proposed frameworks are diagrammatically set out at Appendices 2 and 3 respectively.

Proposal 3: Alter the composition of the 5-member Disciplinary Committee instigated by Council, with the majority of members (including the chairman) being lay persons

a) Majority lay members in Disciplinary Committees, including the chairman

32. To enhance transparency and public confidence in the Society’s disciplinary processes, it is recommended that –

- (a) the chairman of a Disciplinary Committee be a non-accountant;
and
- (b) lay members be included in the Disciplinary Committees such that there is a lay majority.

33. The proposed revised composition of these committees, with a comparison with the existing composition, is set out at Appendix 1.

34. At present, the Council appoints the chairman of a Disciplinary Committee. It is the Council’s current policy to instruct the chairman that at least one lay member be appointed to the Disciplinary Committee to hear a case. It is recommended that, in future, lay members will form the majority of a Disciplinary Committee, including the independent chairman appointed by the Government. The ratio of lay members to professional accountants will be 3:2.

b) Disciplinary Panels

35. Similar to our proposals on Investigation Committees, it is recommended that there should be two Disciplinary Panels from which a Disciplinary Committee is formed. Panel A should comprise lay members appointed by the Government and Panel B should comprise professional accountants appointed by the Council. The members appointed to Panel A should comprise of retired judges or magistrates, barristers and lawyers, bankers, representatives from other regulators, businessmen and academics, with good public service record and standing.

36. The Society's present Disciplinary Panel includes 51 members, of which 27 are professional accountants and 24 are non-accountants, all of whom have been identified by the Society. If the above proposal is adopted, the Government should seek to identify approximately 45 individuals for the Lay Disciplinary Panel A to accommodate potential disqualifications due to non-availability or conflicts of interest.

37. As with Investigation Panel members, a member of the Disciplinary Panel should not be a Council member or a member of the Investigation Panel.

c) Appointment of Disciplinary Committee members

38. We suggest that the Chairman of a Disciplinary Committee should be an ex-member of the Judiciary as persons with experience in the judicial process would be able to ensure that hearings are fair, orderly and effective. The existing practice under Section 33(3)(b) of the PAO is that the Chairman of the Disciplinary Committee identifies and appoints the other members of the Disciplinary Committee. We propose that this practice should be continued and the Chairman of a Disciplinary Committee should be appointed by the Government from Panel A members.

39. As with our proposals on Investigation Committees, we propose that the Government should appoint a Panel A member to be a Disciplinary Committee Convenor, who is delegated the power to identify and appoint an appropriate Chairman of a Disciplinary Committee to deal with a particular case. The Chairman should in turn appoint the other 4

members of the Disciplinary Committee.

d) Remuneration of Disciplinary Committee members

40. Council believes that the two future Disciplinary Panels A and B should continue to be comprised of volunteers who normally offer their services free.

e) Amendments to the Professional Accountants Ordinance

41. At present, Section 33(3)(a) of the PAO requires the Chairman of the Disciplinary Committee to be a “professional accountant” and Section 33(3)(b) provides that the Chairman is responsible for appointing the other members. The PAO will therefore need to be suitably amended to effect the above proposed changes.

Proposal 4: As a variation of Proposal 2, establish an Independent Investigation Board to deal with alleged accounting, auditing and/or ethics irregularities related to listed entities, whilst alleged accounting, auditing and/or ethics irregularities related to non-listed entities will continue to be investigated by Investigation Committees instigated by Council. This Board may either operate completely outside the Society, or be placed under the Society’s secretariat for administrative support subject to the following three principles being observed –

a) majority lay membership;

b) independent funding; and

c) reasonable suspicion of a disciplinable offence under the PAO.

a) Establishment of an Independent Investigation Board

42. In addition to the above three proposals, the Council proposes a further longer term solution to enhance public confidence and to address issues of independence and transparency in the Society’s investigation

procedures. This is the establishment of an Independent Investigation Board (“IIB”), which should be funded independently, to conduct investigations into alleged accounting, auditing and/or ethics irregularities committed by professional accountants involving a “listed entity”. Investigations into alleged misconduct in respect of non-listed entities will continue to be carried out by the Investigation Committees described in Proposal 2 above.

43. The Council has considered how investigations involving listed entities can be expedited and made more streamlined. The Council has also considered various other alternatives such as refinements to the Society’s existing procedures for listed entity investigations. However, we do not expect any refinement can address the critical issues of –

- (a) the perception that greater independence is needed for listed entity enquiries;
- (b) the lack of adequate powers to compel non-HKSA members to appear or produce documents;
- (c) the inadequate information provided by complainants;
- (d) the number and complexity of the cases processed at any given time;
- (e) adequacy of resources; and
- (f) the need to follow due process.

44. At present, the costs of investigations are funded by the Society through membership subscriptions. This would normally be acceptable for investigations involving non-listed entities but separate considerations apply for listed entities. As there are more stakeholders interested in the outcome of an investigation concerning a listed entity, greater independence from the Society is justified, and this can only be achieved by an IIB which is independently funded. Such a body will address any doubts or allegations of lack of independence and conflicts of interest.

45. Furthermore, the Society can only regulate its members. For it to be able to verify the representations made by professional accountants

during an investigation, the Society would need to be given the necessary powers over non-members. Transactions undertaken by listed companies are usually more complicated and significantly larger in value than those undertaken by private companies, with more parties being involved. To fully understand the transactions and the circumstances in which they were made and the work done by a professional accountant, evidence from all relevant parties is sometimes required to corroborate information provided by the professional accountant concerned. The ability of the IIB to make enquiries of non-members will considerably assist in a speedy investigation. This expanded investigatory power will resolve the inherent weakness in investigations which are carried out by the Society. The weakness will nevertheless remain for investigations concerning non-listed entities which will be carried out under Proposal 2. Expanding the Society's powers to compel non-members, such as company directors and management, to provide information for non-listed entity investigation cases may not be acceptable to those outside our profession given the lesser public interest concerns in such cases.

46. As far as we are aware, however, there is no similar body such as an IIB as proposed in other jurisdictions, although the Sarbanes-Oxley Act in the U.S., once implemented, will move towards this direction. The U.K. has an Investigation and Disciplinary Board which deals with investigations of accountants but it is presently structured under the Accountancy Foundation. The Department of Trade and Industry (DTI) is reconsidering the structure and funding of the Accountancy Foundation due to concerns over independence and other matters and is currently seeking views on possible reforms. The outcome of its consultation and its proposed changes has yet to be made public. Nevertheless, Council would caution against any suggestion or attempt to import overseas regulatory structures indiscriminately, as there are some significant differences between Hong Kong and other jurisdictions in terms of corporate culture, legal system, regulatory approach, and supporting infrastructure.

b) Role and Function of the IIB

47. If the proposed IIB is established, we envisage that its role would be to monitor and consider complaints of alleged accounting, auditing and/or ethics irregularities committed by professional accountants involving "listed entities". It would decide, on the strength of the

evidence that comes to its attention, whether an Investigation Committee should be constituted to investigate into the matter. Investigations ordered by the IIB should deal solely with investigations into alleged misconduct by professional accountants involving listed companies on the Hong Kong Stock Exchange. It should not be involved in investigating misconduct of any other market players, which we believe should continue to be the responsibilities of the SFC and the HKEx as the front-line regulators of listed companies. In the course of its work, the IIB may require liaison and close co-operation with the Commercial Crime Bureau of the Police, the ICAC, the SFC/HKEx and other regulators.

c) Three principles

48. The Council recommends that the IIB should operate under the following three principles –

- (1) That the IIB should comprise a majority of independent non-accountant members, but accountants who represent financial statements preparers and auditors should also be represented.
- (2) That the IIB should be funded independently, because the focus of such investigations is to serve public interests and the interests of the market. Funding arrangements are discussed in further detail below in paragraphs 69 to 72.
- (3) When the IIB decides that an investigation of alleged accounting, auditing and/or ethics irregularities should be instigated, its decision should be based on sufficient and reliable information and reasonable suspicion or belief that the professional accountant concerned has breached a disciplinable offence under Section 34(1) of the PAO. This is to ensure that the decision to investigate is not based on hearsay and that the investigation is not a “fishing expedition”. This is also consistent with the current basis of instigating an Investigation Committee by the Council under Section 42C of the PAO.

d) Organization of the IIB

49. The Council believes that the IIB should comprise a Board made

up of 7 to 9 members appointed by the Government, which should be adequate to oversee and monitor the progress of the investigations it decides to instigate. As its role is solely to deal with allegations of misconduct by professional accountants, the Board should include a sufficient number of “professional accountants” and we suggest that if the Board comprises 9 members, there should be at least 3-4 professional accountants. There should be a chairman and two vice-chairmen. To avoid any perception of a lack of independence, these three key persons should not be professional accountants. It is expected that the Board members would not be required to work full time. They would have quarterly, or more frequent, meetings to monitor progress of ongoing activities.

50. The Council considers that the IIB would need a full-time paid secretariat to support its activities but as its role is primarily reactive, the staffing level will depend on the number and complexity of cases on hand, and whether their role is purely administrative or whether the staff would be called upon to assist in carrying out detailed investigation work. The IIB should independently recruit the necessary level of secretariat staff. Secondment of staff from the Society in the early stages after the IIB is established, on a temporary basis, can be considered and discussed.

e) Investigation Panel

51. Where the IIB decides it has reason to believe that a matter referred to it requires investigation, it should constitute an Investigation Committee of five persons to investigate the complaint. The IIB should establish two “Investigation Panels – Listed Entities” from which individuals will be selected to form an Investigation Committee. The Investigation Panel members should be independent and should not include individuals who are also on the Council or on the Disciplinary Panel of the Society.

52. It is recommended that, for clarity, two Investigation Panels be established. Panel A should include non-accountants comprising representatives from all market participants including company directors and secretaries, sponsors, lawyers and merchant bankers who are familiar with the operation of the capital markets, and representatives from the public. Panel B should include professional accountants. The professional accountants included in the “Investigation Panel B – Listed

Entities” may include individuals who are currently serving on Investigation Panel B (see Proposal 2 above). Alternatively, a separate panel of professional accountants for investigating irregularities in “listed entities” may be formed. The advantage of the former approach is to draw on the experience of serving members in similar investigation work.

f) Appointment of members to an Investigation Committee

53. An Investigation Committee instigated by the IIB should comprise 5 persons, 3 of whom should be lay persons, including the chairman, and the remaining 2 should be professional accountants. To ensure that investigation proceedings are effective and efficient, the chairman of each Investigation Committee should be a Board member of the IIB. The chairman in turn would be responsible for appointing the remaining 4 members of the Investigation Committee.

54. The proposed framework for the IIB is set out diagrammatically at Appendix 4.

g) Powers of the IIB and its Investigation Committees

55. Under this proposal, the IIB and Investigation Committees constituted by the IIB to investigate cases concerning professional accountants should be given adequate power to interview and investigate all parties, including non-members of the Society, that are relevant to the investigation, and to seize relevant documents. This will facilitate efficient and timely completion of its work. The Council envisages that the powers of the IIB and its Investigation Committees to request information and to investigate should be similar to, but no more than, those presently afforded to the SFC. Alternatively, the IIB could take a more passive stance by waiting for other regulators to do their investigations, and instigate its own investigations into the professional accountant only upon receipt of a complaint and report (backed by sufficient evidence) from the regulators.

56. To ensure effective enforcement of the IIB’s powers of investigation, the IIB should be able to request the Courts to order compliance with its lawful directions. Where an offence relates to a member of the Society, it may also raise a complaint to the Society for failure by the professional accountant to comply with a lawful direction of

the IIB or its Investigation Committees.

57. Statutory immunity for all acts done in good faith by the IIB, its staff and its Investigation Committee members should also be given.

h) Operating procedures

58. The Investigation Committee should be responsible for conducting and supervising an investigation, and collecting sufficient evidence to enable it to draw conclusions, and where appropriate, prepare a complaint and report. On completion of its work, the Investigation Committee should report its findings to the Board. After considering the Investigation Committee's findings, the Board should decide what further action should be taken.

59. If the IIB decides that it has sufficient evidence to take its case as a complainant against a professional accountant before a Disciplinary Committee of the Society, it should raise a formal complaint to the Society under section 34 of the PAO. The IIB would act as the complainant and the complaint will be heard by the Disciplinary Committee instigated by the Council. The Council believes that with lay members on Council, and an independent chairman and a majority of lay members on Disciplinary Committees, together with the Society's earlier proposal for open disciplinary hearings, there will be sufficient independence and transparency for the Society to take on the referral and adjudicate on members who may have breached the Society's professional standards.

60. The Council is presently considering implementing a "consent order system" whereby the professional accountants concerned, if they acknowledge a finding, can be penalized by way of remedial action, fine and/or public censure. This would normally apply to less serious findings, and will be a more effective and efficient method of dealing with less serious offences than going through the full disciplinary process of a hearing. This will be studied by the special Task Force to be established to review the Society's self-regulatory system as mentioned in paragraph 8.

61. Council believes that the IIB should not possess any disciplinary powers; otherwise it will have conflicting roles and will be acting as policeman, complainant, judge as well as jury. This need for independence is recognized and reflected in the PAO where the

composition and roles of Council, an Investigation Committee and the Disciplinary Committee are independent of each other. Moreover, Council wishes to emphasize that the Society is responsible for the regulation of the accountancy profession which includes the integral roles of setting admission criteria for members, licensing, setting professional standards and continuing education requirements, monitoring quality and practice reviews and disciplinary action. The ultimate penalty that can be imposed on a professional accountant is to withdraw his membership and, where applicable, his/her licence to practice as an auditor. In addition, the Society can impose a pecuniary penalty. The Council feels very strongly that the power to discipline any professional accountant should be retained by the Society irrespective of whether the misconduct concerns a listed or non-listed entity.

62. In this context, Council considers that as long as the Society remains as a licensing body for its members and member firms, supported as now by a range of other functions (such as standard setting, membership admission, quality assurance, professional development), the disciplinary powers over its members and member firms for breaches of professional standards should remain with the Society as there is only ONE “membership licence” that a member or firm needs to hold for offering a range of services to clients, including work for listed companies. It would be incongruous for powers to discipline to be separate from the Society as there will be public expectations that the Society, being the licensing body, should be able to hand down sanctions on its members over breaches of its standards and in particular the suspension and withdrawal of licences.

i) Reporting lines and transparency

63. It is Council’s recommendation that the IIB should be accountable to the Financial Services and the Treasury Bureau whose role should be to oversee the effective operation of the IIB, including the appointment of suitably qualified persons for the Board of the IIB and its Investigation Panels, a regular review of the IIB’s reports and operations, and assistance in funding.

64. The FSTB could consider taking a housekeeping role over the functions of the IIB which will be set up under statute. We understand that the FSTB currently provides administrative support to a number of

independent tribunals such as the Insider Dealing Tribunal. We envisage that the mode of operation of the IIB can be similar to that of the Insider Dealing Tribunal except that the IIB is not proposed to be chaired by a serving High Court judge.

65. To ensure that there are proper checks and balances, the operation of the IIB should be transparent. It should publish a report, available to the public, on an annual or half-yearly or quarterly basis setting out its activities and progress. However, the degree of detail in its investigations and reports needs to be considered very carefully as fairness and confidentiality will need to be safeguarded.

66. The Council also recommends that the findings and conclusions of the Investigation Committee should be categorized in such a way as to indicate the significance or severity of each of its findings.

67. Should Government not wish to place the IIB directly under the FSTB even for housekeeping purposes, then we have identified two possible alternatives –

(a) Under the SFC as an adjunct or “independent” arm

The SFC has currently a number of appeal panels such as the Takeovers and Mergers Panel but these panels do not carry out fresh investigations of their own. Out of administrative convenience, it may be possible to place the IIB under the SFC. One disadvantage of this option lies in the fact that it is not within the functions of the SFC, under section 5 of the Securities and Futures Ordinance (“SFO”), to investigate into the conduct of professional accountants in respect of possible breaches of professional standards of the Society. Interpretation of these standards should remain with the HKSA, the recognized authority on accounting, auditing, and professional ethics matters. This does not, of course, preclude the SFC from exercising its powers under the SFO against professional accountants and auditors for any other punishable offences.

(b) Under the HKSA

This option has the advantage of economies of scale. The

Registrar of the Society would be assigned responsibility to oversee the day-to-day operational aspects of the IIB, but since this responsibility and operation is separately funded, he should be required to submit periodic reports of ongoing activities and investigation outcomes to the FSTB. These reports, if directed by the IIB, will also be copied to the Society's Council to decide whether the matter should be referred to the Disciplinary Committee.

This option overcomes the issue of investigation resource but will leave residual perception issues of independence. It is worth pointing out that the Registrar would then be accountable to both the Council and the FSTB that could give rise to problems on his priority setting and managing his performance in these two areas.

68. These alternatives should be considered only if the Government does not wish to create an entirely new IIB outside the Society and other existing regulators. Council would keep an open mind about any of these and other options provided that the IIB is established in accordance with the three principles described in paragraph 48 above.

j) Funding arrangements

69. There are a number of options for funding the work of the IIB. These include –

- (a) funding from the Government
- (b) contributions from regulators (e.g. SFC/HKEx)
- (c) levy on listed companies
- (d) levy on investors based on the trading volume on the HKEx
- (e) a combination of (a) to (d) above.

70. Options (a) and (b) communicate to the public that the Government is very serious about protecting public interests. Options (c) and (d) will be a more equitable way of implementing a “user pay” approach. Option (c) may be based on a listed company's market capitalization, turnover of its

shares, or audit fees. If a levy is to be based on audit fees, a further consideration is whether the levy should be based on the total audit fee or the fee that is attributable to Hong Kong auditors as, in many cases, overseas subsidiaries audited by overseas auditors may represent a substantial part of a group. A levy should not be imposed directly on auditors as this will not achieve the objective of making the IIB independent of the accountancy profession.

71. Funding requirements will be dependent on the assessed volume of work of the IIB and the levy rate should be adjusted from time to time by the IIB, after consultation with the Government.

72. In addition, the costs of investigations should be recoverable by the IIB in the event that allegations are proved by the complainant and upheld by a Disciplinary Committee. At present, Section 42F and Section 35 of the PAO enable the cost of the investigations carried out by the Society to be recovered if the complaint is proved. The PAO can be amended to cover investigations carried out by the IIB so that the IIB has an avenue to recover its costs of investigations.

k) Remuneration of IIB Board members and its Investigation Panel members

73. In line with other statutory committees of a similar nature, appropriate honorariums should be given to the Board members of the IIB.

74. The Investigation Panel members who are appointed to an Investigation Committee to deal with a case should be remunerated in accordance with the Government's policy on remunerating members on committees involved in public duties.

l) Consultation and Legislative backing

75. The establishment of the IIB will require an enabling ordinance or legislative backing to provide it with its investigative powers, funding and the ability to obtain and share information available to other regulators. The framework we outline above will provide a reasonable basis for Government to move forward.

Phased Approach

76. The Council appreciates that some of the above proposals and, in particular Proposal 4, will require wider consultation and will take a longer time to complete the necessary deliberations with the relevant parties. The other three proposals are relatively straightforward as they are the Society's "governance" issues. The amendments to be made to the existing PAO should be relatively simple.

77. We would therefore recommend that the proposals be implemented in two phases. Proposals 1, 2 and 3 concerning changes in the composition of Council, Investigation and Disciplinary Panels and Committees can be implemented in Phase 1. It is recommended that in parallel with effecting the PAO amendments for these, a study should be instigated by the Government to consider detailed implementation issues arising from the proposed establishment of the IIB. The Society will be more than willing to participate in this process.

78. If the Government is in favour of placing the IIB under the Society, (paragraph 67(b)), it may be possible to implement all the four proposals under a single phase. The Society will be pleased to further discuss how this can be achieved.

Establishment of the Financial Reporting Review Panel in Hong Kong ("FRRP")

79. It is of concern to us that the community will view the establishment of an IIB as a singling out of the auditing profession for 'special' attention. We strongly believe, for the reasons set out in paragraphs 3 and 4, that any 'singling out' is unwarranted and could result in a characterisation of the profession both in Hong Kong and internationally that would be both unfair and unacceptable. For this reason, the Council would also urge the Government to set up the FRRP as recommended by the Standing Committee on Company Law Reform ("SCCLR") at the same time, or before, it establishes an IIB. The FRRP would be a body whose principal responsibility would be to police the accuracy and appropriateness of financial information published by listed companies, and as such would be a regulatory authority targeting a different component of the corporate reporting framework – the preparers. The establishment of the FRRP would go a long way towards reducing

our concerns about auditors being singled out for “special” attention. As shown at Appendix 4, misconduct of auditors identified by the proposed FRRP, if any, could also be referred to the IIB for further investigation.

80. In its response to the consultation paper of the SCCLR, we suggested that the FRRP should be independent of the Society and that it should also be empowered to ask the Court to consider imposing disciplinary action against directors for failing to comply with the Companies Ordinance, listing requirements and other appropriate regulatory provisions. These deterrent penalties should be put in place as soon as possible.

81. The Government may also wish to consider whether the FRRP’s role and the IIB’s role can be combined or more clearly delineated.

Closing remarks

82. The Council believes that the above proposals will go a long way towards addressing the call for more transparency, independence and oversight of the accountancy profession. It is of the view that these proposals are practical solutions. In making these proposals, we are in line with international market trends and well ahead of the governance structure, in terms of openness and lay participation, of other professional bodies in Hong Kong. We hope the proposals in this submission can form a good basis for further discussions within Government and with the relevant parties. We look forward to participating in these consultations.

Hong Kong Society of Accountants
22 January 2003

Hong Kong Society of Accountants
Proposal for lay member participation

	Existing			Proposal		
	No. of professional accountants	No. of Government appointed members	Total	No. of professional accountants	No. of Government appointed members	Total
(A) Council						
- Elected	12	0	12	14	0	14
- Co-opted by HKSA Council	2	0	2	2	0	2
- Past President	0	0	0	1	0	1
- Financial Secretary or appointee	0	1	1	0	1	1
- Director of Accounting Services or appointee (Note 1)	0	1	1	0	1	1
- Government appointed members representing the public (Note 2)	0	0	0	0	4	4
	14	2	16	17	6	23
	88%	13%	100%	74%	26%	100%
(B) Investigation Panel (Note 3)	25	0	25	25	40	65
Investigation Committee						
- Chairman	1	0	1	0	1	1
- Members	2	0	2	2	2	4
(C) Disciplinary Panel	27	24	51	30	45	75
Disciplinary Committee (Note 4)						
- Chairman (Note 5)	1	0	1	0	1	1
- Members	3	1	4	2	2	4

Note 1 - Mr. Shum Man-to, the Director of Accounting Services is appointed by the Government. It is expected that the Director of Accounting Services will invariably be a professional accountant and a member of the Society.

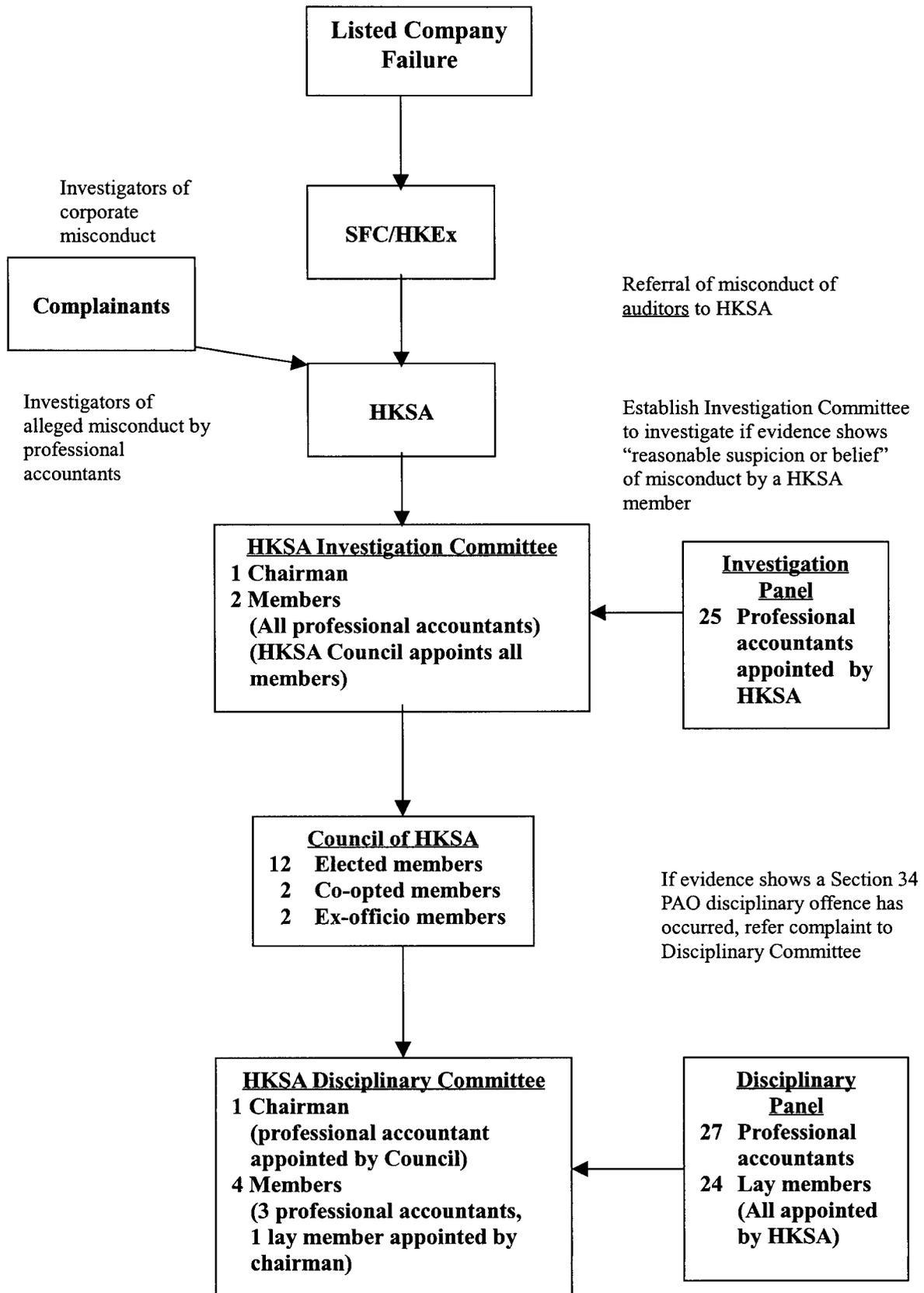
Note 2 - It is suggested that the current Section 10(3) of the PAO, which provides that the Chief Executive may appoint 2 "academics", should be repealed. This section should be replaced by a provision that enables the Government to appoint an additional 4 lay persons.

Note 3 - Members of the Investigation Panel are restricted to professional accountants under present legislation (Section 42B(1)(a) of the PAO).

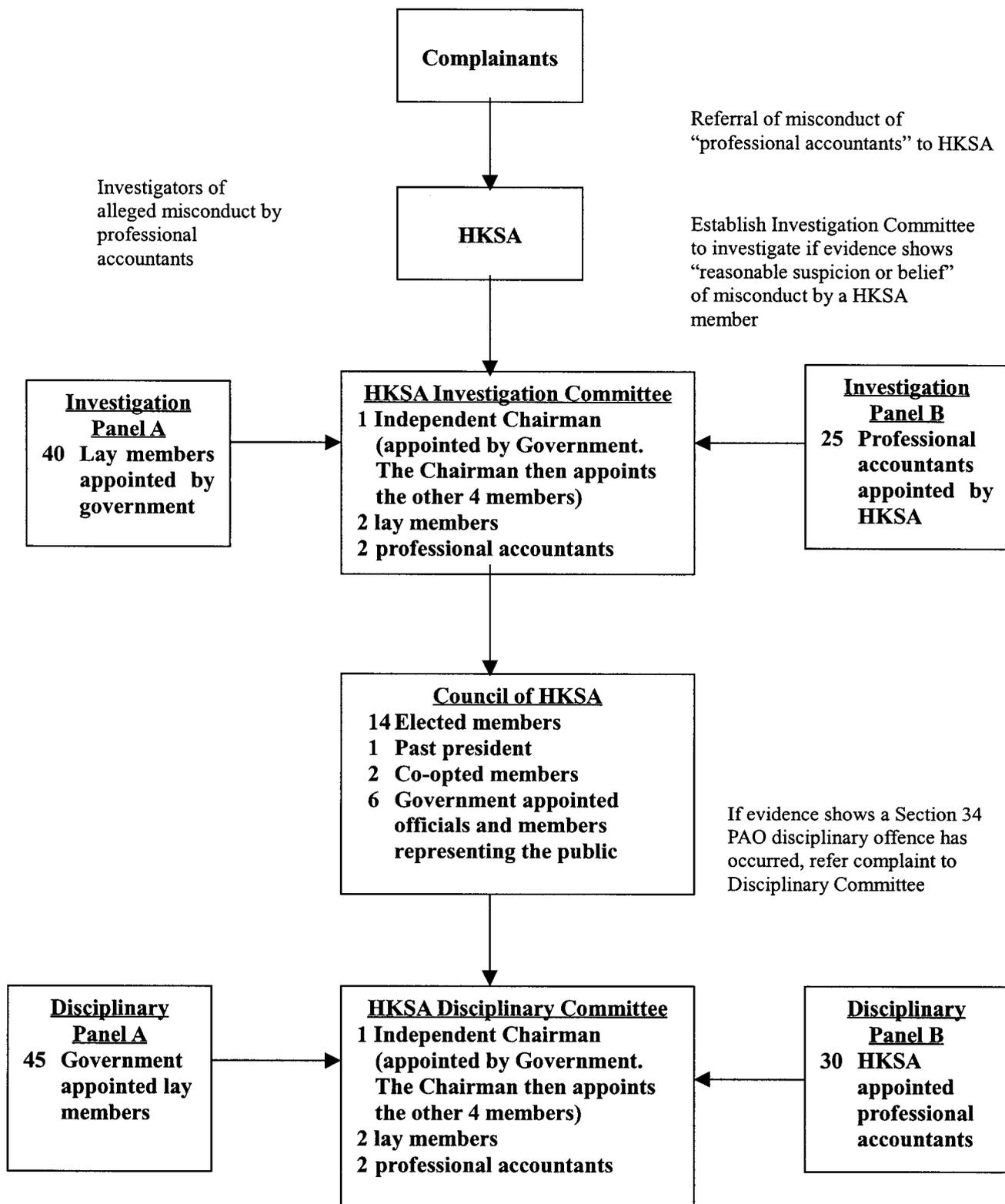
Note 4 - HKSA's original proposal to have 2 lay members in the Disciplinary Committee to be revised to 3.

Note 5 - Chairman of a Disciplinary Committee is restricted to professional accountants under present legislation (Section 33(3)(a) of the PAO).

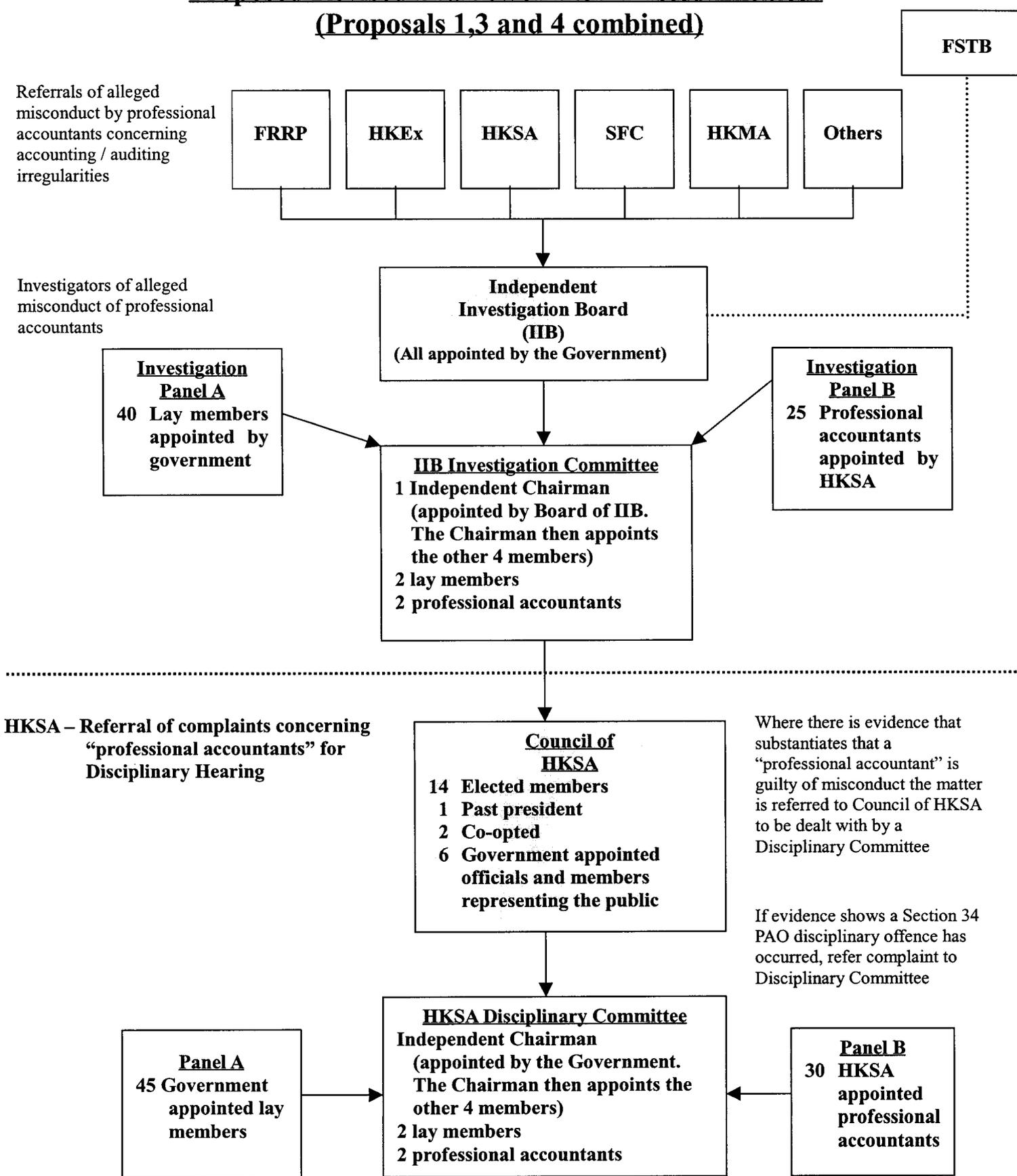
Existing framework



Proposed Revised Framework for proposals 1,2 and 3 combined



Proposed Revised Framework for “Listed Entities”¹
(Proposals 1,3 and 4 combined)



¹ “Listed entities” = Companies listed on The Stock Exchange of Hong Kong Limited

Principles for Auditor Oversight



**A Statement of the Technical Committee
of the
International Organization of Securities Commissions**

October 2002

Introduction

1. Investor confidence is fundamental to the successful operation of the world's financial markets. That confidence depends on investors having credible and reliable financial information when making decisions about capital allocation.

2. The objectives of securities regulation include the protection of investors; ensuring that markets are fair, efficient, and transparent; and the reduction of systemic risk. In pursuit of these objectives, in the area of reporting to investors, there should be full, timely, and accurate disclosure of financial results and other information that is material to investors' decisions. Full and fair disclosure is essential to investor protection, enhances investor confidence, and promotes market liquidity and efficiency.

3. Independent auditors play a critical role in enhancing the reliability of financial information by attesting as to whether the financial statements prepared by management fairly present the financial position and past performance of the public enterprise in compliance with accepted accounting standards.

4. Effective oversight of the accounting profession and of independent audits is critical to the reliability and integrity of the financial reporting process. The Technical Committee of the International Organization of Securities Regulators ("IOSCO") has developed a list of general principles for oversight of audit firms and auditors that audit financial statements of companies whose securities are publicly traded in the capital markets (hereinafter referred to as "auditors").

5. At the present time, a variety of systems for auditor oversight exist among the IOSCO Technical Committee members. In many cases, these existing systems are undergoing review as a result of financial reporting failures, weaknesses discovered in self-regulatory structures, changes in public expectations, requirements of new legislation, or for other reasons. One jurisdiction has reported that firm-on-firm peer review under self-regulation failed and that new legislation has directed the creation of an auditor oversight body, independent of the accounting profession, with strengthened powers for rulemaking, inspection and disciplinary authority. A number of other jurisdictions have announced that changes will be made in auditor oversight processes and structures. The Technical Committee believes that there is a growing consensus internationally as to the benefits of an auditor oversight system that is not based exclusively or predominantly on self-regulation.

6. The principles set forth herein are intended to assist securities market regulatory authorities, and other authorities with responsibility for auditor oversight, in developing and enhancing regulatory structures for auditor oversight in the wide range of different legal, business and professional environments that exist in IOSCO member jurisdictions. The Technical Committee encourages IOSCO members to work towards implementing these principles in their own jurisdictions. In jurisdictions in which the securities regulator does not have primary responsibility for auditor oversight, it will nevertheless

have an interest in ensuring that the oversight system is consistent with maintaining and enhancing investor confidence in published financial statements.

Principles for auditor oversight

7. Oversight of auditors can occur in several ways, including within audit firms, by professional organizations and public or private sector oversight bodies, and through government oversight. In addition, oversight may be provided by supervisory boards and audit committees representing investors in matters relating to individual companies.

8. Within a jurisdiction, auditors should be subject to oversight by a body that acts and is seen to act in the public interest. While the nature of an auditor oversight body and the process through which it carries out its activities may differ among jurisdictions, IOSCO believes that effective oversight generally includes the following:

- I. A mechanism to require that auditors have proper qualifications and competency before being licensed to perform audits, and maintain professional competence. A mechanism also should exist to withdraw authorization to perform audits of publicly traded companies if proper qualifications and competency are not maintained.

IOSCO believes establishing qualification requirements and requiring maintenance of professional competency should improve the quality of auditing. Moreover, the risk that authorization can be revoked for failure to have or maintain the necessary qualification should be an incentive for compliance and adherence to auditing standards.

- II. A mechanism to require that auditors are independent of the enterprises that they audit, both in fact and in appearance. Effective standards, regular assessments, and regulatory oversight generally increase the likelihood that independence is maintained.
- III. 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.
- IV. A mechanism should exist to require auditors to be subject to the discipline of an auditor oversight body that is independent of the audit profession, or, if a professional body acts as the oversight body, is overseen by an independent body. Such an auditor oversight body must operate in the public interest, and have an appropriate membership, 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.

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. This oversight process may be performed in coordination with similar quality control mechanisms that are in place within the audit profession, provided the oversight body maintains control over key issues such as the scope of reviews, access to and retention of audit work papers and other information needed in reviews, and follow-up of the outcome of reviews. Reviews should be conducted on a recurring basis, and should be designed to determine the extent to which audit firms have and adhere to adequate quality control policies and procedures that address all significant aspects of auditing. Matters to be considered include:

- a. Independence, integrity and ethics of auditors
- b. Objectivity of audits
- c. Selection, training, and supervision of personnel
- d. Acceptance, continuation and termination of audit clients
- e. Audit methodology
- f. Audit performance, that is, compliance with applicable generally accepted auditing standards
- g. Consultation on difficult, contentious or sensitive matters and resolution of differences of opinion during audits
- h. Second partner reviews of audits
- i. Communications with management, supervisory boards and audit committees of audit clients
- j. Communications with bodies charged with oversight over the financial reporting process, for example, on matters such as regulatory inquiries, changes in auditors, or other matters as may be required
- k. Provisions for continuing professional education.

An auditor oversight body also should address other matters such as professional competency, rotation of audit personnel, employment of audit personnel by audit clients, consulting and other non-audit services, and other matters as deemed appropriate.

- V. An auditor oversight body should have the authority 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.
- VI. In relation to companies operating or listing on a cross-border basis, IOSCO members are encouraged to provide each other, whether directly or through coordinating with the auditor oversight body in their jurisdiction, with the fullest assistance permissible in efforts to examine or investigate matters in which improper auditing may have occurred and on any other matters relating to auditor oversight. Members are also encouraged to explore approaches to enhance cooperation among jurisdictions.