AUDITING IN HONG KONG

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Regulation of auditors is vital to financial markets but largely ignored by investors. The EU's humiliating removal of equivalency for auditing regulation from Hong Kong is final proof that self-regulation of the profession in the territory has failed. It is now accepted that the Hong Kong system does not meet international standards, and that audit regulation must be improved. Sadly, there are at least four reasons why reform proposals are inadequate – not least the fact that the Financial Reporting Council (FRC) needs much more money to regulate auditors effectively. Investors must speak up and demand that the FRC be made a tough regulator with sufficient resources to carry out this crucial job.

AUDITING IN HONG KONG IS FAR BELOW INTERNATIONAL STANDARDS

Regulation of auditors is vital to financial markets, but is largely overlooked by investors. The regulatory burden on Hong Kong accountants is light, since they convinced the government to let them regulate themselves through their professional body, the Hong Kong Institute of Certified Public Accountants (HKICPA). But the HKICPA's record at regulation is lamentable. The HKICPA carried out 554 inspections from 2007 to 2011, but all but one case was closed; and the level of transparency in disciplinary actions is appalling. Hong Kong has set up a body called the Financial Reporting Council to improve oversight of auditors, but it has no disciplinary powers and can only refer auditing or reporting irregularities to the HKICPA.

In the light of these deficiencies, the International Forum of Independent Audit Regulators (IFIAR) would not permit Hong Kong to join, and in a major insult the EU has removed equivalency for auditing regulation from Hong Kong. It is now accepted that the Hong Kong system does not meet international standards, and that audit regulation needs to be enhanced. However, the proposed reforms leave too much of the oversight in the hands of the profession.

PROPOSED REFORMS TO HONG KONG AUDITING INADEQUATE

There are at least four reasons why the proposed reforms are inadequate. Firstly, separate registration with the FRC in addition to qualification with the HKICPA is surely needed to regulate auditors effectively, but registration with the FRC has not been proposed. Secondly, while the proposed framework appropriately transfers inspections to the FRC, it also suggests that the FRC may delegate responsibility for inspections to the HKICPA. This is a very bad idea, since the HKICPA would probably hire the accounting firms themselves to do the inspections, and would pay them with money raised from public companies. Thirdly, while the framework concedes that discipline needs to be transferred from the HKICPA to the FRC, it suggests a cap on financial penalties, which at just HK$10mn is ludicrously low. Finally, the FRC needs a lot more money if it is to regulate auditors in Hong Kong effectively. It is unlikely that the auditing firms will pay; no doubt most of the money will come from public companies.

INVESTORS NEED TO DEMAND CHANGE

Investors need to speak up during the public comment process (set to take place in 2014) and demand that the FRC be made a tough regulator with the resources to carry out the crucial job of regulating auditors. What is most important is that the new law should implement a rigorous inspection process that is not outsourced to the profession. The law also requires penalties that are sufficient to make shoddy audits an unprofitable business.

Auditing in Hong Kong far below international standards

Audit regulation is not a topic upon which most investors focus. Regulation of auditors is part of the plumbing that supplies data to the financial markets, but it is invisible until it stops up and threatens everyone's financial health. We saw that happen when the US Public Company Accounting Oversight Board (PCAOB) threatened to pull the plug on Chinese auditors, an action that would have led to a mass delisting of stocks. Fortunately, that problem seems to have been averted for now.

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Hong Kong is about to reform its system for audit regulation, and investors should pay attention. Effective reforms should improve the integrity of financial information coming from companies listed in Hong Kong, and that will reduce the risks for investors.

The accounting profession obtained a regulatory bargain in Hong Kong, like most other jurisdictions, that closes the profession to outsiders in exchange for regulatory control. That has been a very good bargain for Hong Kong accountants, since audits are required of all companies in Hong Kong, not just public companies, which has made Hong Kong one of the most profitable accounting markets in the world. The regulatory burden on accountants is light, since they convinced the government to let them regulate themselves.

Auditors obtained a regulatory bargain in Hong Kong that has made the territory one of the most profitable accounting markets in the world

Under Hong Kong law, regulation of the accounting profession is delegated to the Hong Kong Institute of Certified Public Accountants (HKICPA). All public accountants in Hong Kong must be members of the HKICPA. The HKICPA sets accounting and auditing standards, although these standards are now identical to international standards.

Regulation of auditors in Hong Kong is delegated to the HKICPA

The HKICPA inspects Hong Kong accounting firms to make sure they are following the standards. The Big Four are inspected annually and the other firms on a rotating basis. The process is overseen by the Practice Review Committee, which includes representatives of each of the Big Four as well as other small accounting firms. The HKICPA carried out 554 inspections from 2007 to 2011. While it found deficiencies in 47% of firms auditing listed companies, all but one case was closed after follow-up actions were taken and reviewed. That one case was referred to Financial Reporting Council and the Disciplinary Committee. The HKICPA is very effective at protecting the reputations of its members. Inspection reports are not public, even for firms with identified deficiencies.

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For disciplinary actions, the level of transparency is appalling. Since 2008, the HKICPA has closed 80 cases. HKICPA has 14 disciplinary cases in the dock right now, including two against Ernst & Young, but none against any of the other Big Four firms. One of the Ernst & Young cases has been going on since 2009, and just recently had its first hearing.

For disciplinary actions, the level of transparency is appalling

In the rare instances where an accounting firm is punished by the HKICPA, the punishment is made public for a short time. After one year the HKICPA removes the name of the firm from its website. I could not find any punished firms listed on the HKICPA website. Settling the case is a better option for firms since in those cases the HKICPA removes the details after only 28 days. There are four disciplinary actions listed on the HKICPA website dating back to 2009, with all of the details, including the names of the firms and partners, removed.

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When Enron imploded in 2001, taking down Arthur Andersen, calls erupted for the reform of audit regulation worldwide. Investors and legislators recognized that self-regulation of the accounting profession was ineffective. In the United States, the Public Company Accounting Oversight Board (PCAOB) was formed by the Sarbanes-Oxley Act and became the independent regulator of accounting firms that audit US listed public companies. Similar regulators popped up all over the world. Calls arose in Hong Kong to do something similar in order to protect the standing of the Hong Kong Stock Exchange as a major capital market. Hong Kong accountants, terrified of a strong, independent regulator, instead pushed for the creation of the Financial Reporting Council (FRC). The FRC was established on December 1, 2006 and became operational the following July. The role of the FRC is:

In the 2000s Hong Kong accountants, scared of a strong, independent regulator, instead pushed for the creation of the Financial Reporting Council

- To conduct independent investigations into possible auditing and reporting irregularities with respect to listed entities.
- To enquire into possible non-compliances with accounting requirements on the part of listed companies.

That role is appropriate. However, as Hong Kong's legislature gave birth to this regulatory tiger, its teeth were removed. The FRC is not empowered to discipline or prosecute wayward accountants. It can only refer auditing or reporting irregularities to the HKICPA for follow-up. And to make certain there would not be too many cases referred, the FRC was only given HK$16 million (US$2 million) in 2012 to fund its efforts. That is less than 1% of the PCAOB's budget and 13% of the budget of the Canadian Public Accountability Board (CPAB) (which oversees a similar size market to Hong Kong). Although the FRC is allowed to disclose its reports, it is required first to determine whether the release might affect the HKICPA investigation. Consequentially, no reports or names of auditors referred for discipline are published.

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While the accounting profession may have succeeded in marginalising the FRC, the efforts backfired on it. In July 2012, the Hong Kong Legislative Council passed legislation that criminalised certain audit deficiencies. Accounting firms lobbied against the new legislation, but the lack of an effective regulatory system doomed their efforts.

The Hong Kong Legislative Council has passed legislation that criminalises certain audit deficiencies

Hong Kong put in place a regulatory system with the FRC that met the bare form of emerging international practice for accounting regulation, but fell far short of the expected substance. Other regulators were not fooled. The International Forum of Independent Audit Regulators (IFIAR) would not permit Hong Kong to join, and in a major insult, the European Union in June 2013 removed regulatory equivalency for auditing regulation from Hong Kong, meaning that European regulators cannot rely on Hong Kong regulators for oversight of Hong Kong auditors of companies listed in the EU.

The International Forum of Independent Audit Regulators would not permit Hong Kong to join, and the EU has removed equivalency for auditing regulation from Hong Kong

The EU action seems to have been the final straw, and a joint proposal of the FRC, HKICPA, and Hong Kong government has surfaced to enhance audit regulation in Hong Kong. The HKICPA said that the Hong Kong system "no longer meets international benchmarks or expectation". The proposal is now out for comment by HKICPA members, and will be opened to public comment thereafter. The hope is for a law change in 2015.

It is accepted that the Hong Kong system no longer meets international standards, and that audit regulation needs to be enhanced

In my opinion, the proposed reforms are unsatisfactory, since they leave much of the needed oversight in the hands of the profession. Hong Kong needs a tough, independent regulator, not a regulator that is independent in form only, leaving implementation to the very people it is supposed to regulate. Why the reforms are unsatisfactory is explained over the remainder of this

But the proposed reforms leave too much of the oversight in the hands of the profession report.

Proposed reforms to Hong Kong auditing inadequate

The proposed framework recognizes the international standard that six key elements of regulation (registration, inspection, investigation, discipline, continuing professional development, and standard setting) must be carried out by the independent regulator or subject to oversight by the independent regulator. The proposed framework leans heavily on FRC providing oversight, with the HKICPA continuing to do most regulatory functions, but now under the supervision of the FRC. That is a bad idea in most cases.

REGISTRATION

Registration is essentially the process of licensing firms to audit public companies. In the United States and Canada all public company auditors must first be licensed as public accountants and then must further register with the PCAOB or CPAB before they can audit public companies. Under Hong Kong law the responsibility to license public accountants has been given to the HKICPA. There are differing opinions around the world regarding whether the state or a professional association should serve as the gatekeeper to the profession. But in the case of public company audits, I would argue that separate registration with the FRC in addition to qualification with the HKICPA is needed to regulate auditors effectively. Registration with the FRC is not suggested in the proposed reforms; rather, the FRC is to oversee the HKICPA.

Separate registration with the FRC in addition to qualification with the HKICPA is surely needed to regulate auditors effectively

INSPECTION

The proposed framework transfers inspections and investigations to the FRC. That is appropriate and critical for the system to work. But the framework also says that the FRC may delegate responsibility for inspections to the HKICPA. The HKICPA would probably hire the accounting firms themselves to do the inspections, paid for by FRC funds. That is a very bad idea. The FRC needs to hire its own inspectors. The PCAOB found plenty of qualified auditors who preferred a career in public service to staff up inspection operations. I do not believe that the Big Four will ever be effective at auditing themselves, since they will follow the silver rule –"Do not do unto others what you would not have them do unto you". Oversight cannot change such behaviour in the field.

The FRC needs to hire its own inspectors; it must not rely on the HKICPA, which would probably hire the accounting firms themselves to do the inspections

DISCIPLINE AND SANCTIONS

The framework concedes that discipline needs to be transferred from the HKICPA to the FRC. There is a lot of petulant criticism here. The HKICPA bizarrely argues that there should be no financial penalties but does not suggest alternatives. It argues that if financial penalties are imposed they should not be based on engagement profitability. The framework suggests a cap on penalties of HK$10mn or three times the profit from the engagement, which the HKICPA argues would drive accounting firms out of business. I would argue that such a penalty is not big enough to scare the Big Four. Penalties should be uncapped, but require the FRC to consider multiple factors, and leave it subject to judicial review. There must be complete transparency in the disciplinary process from beginning to end, with full disclosure of the names of the firms and partners involved. The findings of the inspection process must also be made public.

The framework concedes that discipline needs to be transferred from the HKICPA to the FRC, but suggests a cap on financial penalties which is ludicrously low

STANDARD SETTING

It is proposed that standard setting remain the responsibility of the HKICPA, subject to oversight by the FRC. I agree with that recommendation. In the United States, the PCAOB sets auditing standards for public companies, while the AICPA continues to set them for private companies. I believe the US erred in splitting that responsibility, and standard setting should be left to the

Standard setting should indeed remain the responsibility of the HKICPA profession. In the case of Hong Kong, this is all meaningless anyway, since Hong Kong adopts IFRS and International Auditing Standards without modification. But giving HKICPA a role in the process lets them join the international clubs (the IASB and IAASB) that make the rules.

CONTINUING PROFESSIONAL DEVELOPMENT (CPD)

Here is it proposed that the HKICPA continue to mandate CPD subject to FRC oversight. In my view the FRC should set the requirements, but the HKICPA can administer them, subject to review by FRC inspection teams.

FUNDING

The FRC needs a lot more money if it is to regulate auditors in Hong Kong effectively. Using the Canadians as a benchmark, I would suggest HK$150mn as a reasonable number. The FRC spent HK$16.2mn in 2012. Who should pay for it? The PCAOB is allowed to impose a levy on all US listed public companies. That is what is proposed for Hong Kong, together with a registration fee on accounting firms, and possibly a transaction levy on investors.

The FRC needs a lot more money if it is to regulate auditors in Hong Kong effectively

Accounting firms are currently paying dues to the HKICPA for the regulatory services that will be taken over by the FRC. HKICPA spent HK$239mn in 2012. Of course, it does a lot more than just regulation. Nevertheless, HKICPA should be able to significantly reduce its dues with all of that regulatory work going away, and the accounting firms can pay that money to the FRC. I say this with tongue firmly in cheek; the proposal is that listed companies and investors mostly fund the FRC.

What should investors do?

Investors need to speak up during the public comment process and demand that the FRC be made a tough regulator with the resources to get the job done. What is most important is that the new law should implement a rigorous inspection process that is not outsourced to the profession. The law also requires penalties that are sufficient to make shoddy audits an unprofitable business, and plenty of transparency to give investors early warning of poor auditors. The public comment period is set to take place in 2014, with legislation to be enacted in 2015.

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