

## **Update on Independent Audit Oversight Report**

### **Q&As**

#### **Background**

In 2013, the Financial Reporting Council (**FRC**) commissioned Deloitte LLP (UK) to prepare a report on independent audit oversight to compare Hong Kong with international standards and practices. That report identified certain areas where Hong Kong did not meet the membership requirements of International Forum of Independent Audit Regulators (**IFIAR**) and regulatory equivalence requirements of the European Commission (**EC**).

Since then, there have been further developments in European Union (**EU**) audit reform legislation and the Government released its conclusions on the proposed Hong Kong regulatory regime for listed entity auditors. We therefore consider that it is an opportune time to release our Update on Independent Audit Oversight Report which focuses on how Hong Kong, through the audit regulatory reform, will meet international best practice, fulfil the requirements for membership of IFIAR and meet EC equivalence.

#### **1. What is the focus of the Update on Independent Audit Oversight Report?**

The updated report focuses on comparing the proposed audit regulatory regime outlined in the Government's conclusions against the requirements of IFIAR membership and EC equivalence.

#### **2. What is IFIAR membership and EC equivalence?**

##### *IFIAR Membership*

IFIAR is a global organisation for independent audit regulators worldwide. The organisation's primary aim is to enable its members to share knowledge of the audit market environment and practical experience of independent audit regulatory activity, with a focus on inspections of auditors and audit firms.

Membership of IFIAR is confined to independent regulators that are responsible for inspection of audit firms and have investigative and enforcement powers which include fines and removal of an audit license and/or registration. Currently it has 51 members.

*EC equivalence*

EC equivalence is a recognition given to a country/jurisdiction that its audit regulatory regime complies with the EC requirements. There are 50 jurisdictions worldwide, including China, which are in compliance with the EC requirements.

To be recognised by the EC as having regulatory equivalence, the audit regulators are required to have ultimate responsibility for the oversight of the following six functions - registration, inspection, investigation, enforcement (discipline), standards on professional ethics and auditing, and continuing professional education. In addition, the audit regulators shall be governed by non-practitioners (i.e. persons not associated with or employed by an audit firm for at least three years).

**3. What are the benefits of the audit regulatory reform, IFIAR membership and EC equivalence for Hong Kong?**

The Hong Kong capital market has grown exponentially in recent years and has attracted the greatest number of new listings during the last few years. There are about 2,000 listed entities in Hong Kong with market capitalisation of approximately HK\$26 trillion.

The global investing community expects the Hong Kong audit regulatory regime to be independent of the audit profession, adopt international best practice and be in line with other major capital markets worldwide. The regime should achieve recognition with international bodies such as the International Monetary Fund, IFIAR and the EC.

It will enhance investor confidence, strengthen the integrity of financial reporting by Hong Kong listed companies, and further entrench Hong Kong's status and reputation as a major international financial centre.

#### **4. What are the major findings of the updated report?**

The updated report reiterates that audit regulators of major jurisdictions, for example, the United Kingdom and the United States are (i) independent of the profession with authority over auditors of listed entities; (ii) members of IFIAR; and (iii) in compliance with the EC requirements.

There is no change to the membership requirements for IFIAR since the 2013 study. In the meantime, five more jurisdictions, namely Botswana, Cayman Islands, Czech Republic, New Zealand and Russian Federation achieved membership of IFIAR.

The 2014 EU audit reform legislation now requires that, for the purpose of gaining EC equivalence, the governing body of audit regulators shall comprise of non-practitioners only. Audit regulators of 50 jurisdictions worldwide, including China, meet the EC requirements and have ultimate responsibility for the following six functions - registration, inspection, investigation, enforcement (discipline), standards on professional ethics and auditing, and continuing professional education.

It was further noted that a total of 41 jurisdictions around the world are IFIAR members and are also in compliance with the EC requirements.

The report concludes that the proposed legislative changes, based on the Hong Kong Government's consultation conclusions, are likely to enable Hong Kong to meet the IFIAR membership and EC equivalence requirements, assuming that the future Council will comprise of non-practitioners only.

#### **5. What is the current status of independent audit oversight in Hong Kong?**

As set out in our 2013 and 2016 study, Hong Kong did not and still does not meet the requirements for membership of IFIAR and EC equivalence mainly because Hong Kong has no independent audit regulator.

## **6. What will happen next for the reform?**

In June 2014 the Government issued its consultation paper containing proposals to improve the regulatory regime for listed entity auditors in Hong Kong.

The Government released the consultation conclusions on “Proposals to Improve the Regulatory Regime for Listed Entity Auditors” on 26 June 2015, key features of which are summarised in Appendix.

We understand that the Government is preparing the amendment bill with an aim to introduce it into the Legislative Council in the 2016-17 legislative session.

## **7. What is the role of the FRC in the audit regulatory reform?**

The global investing community expects the Hong Kong audit regulatory regime to be independent of the audit profession, adopt international best practice and be in line with other major capital markets worldwide.

The FRC has been unwavering in its commitment to taking the reform process forward and remains committed to supporting it to its successful completion and implementation which will strengthen confidence in the integrity of the financial reporting by Hong Kong listed companies, safeguard the investing public and further entrench Hong Kong’s status and reputation as a major international financial centre.

## **8. Where can I find the report?**

The report (both abridged and full versions) is available on our website ([www.frc.org.hk](http://www.frc.org.hk)).

**Key features of the 2015 Government’s consultation conclusions on “Proposal to Improve the Regulatory Regime for Listed Entity Auditors”**

- The new regulatory regime will basically cover auditors of entities listed in Hong Kong. (About 2,000 Hong Kong listed entities, approximately 50 audit firms/practices, together with those practising members who undertake audits of Hong Kong listed entities)
- The FRC will become the independent audit regulator with the ultimate responsibility for the following six functions:
  - directly responsible for:
    - inspection of auditors of listed entities
    - investigation of auditors of listed entities (which is currently within the scope of the FRC)
    - discipline of auditors of listed entities
  - conduct independent oversight over Hong Kong Institute of Certified Public Accountants in respect of:
    - registration of listed entity auditors
    - standard-setting on professional ethics, auditing and assurance related to those working for listed entities
    - setting of continuing professional development requirements for listed entity auditors.
- FRC will also be empowered to decide on applications for recognising overseas auditors to audit specific overseas entities listed in Hong Kong.
- FRC will comprise not less than eight members, with at least two persons who possess knowledge of and experience in the auditing of Hong Kong listed entities.

## Appendix

- A new independent appeals tribunal will be set up for hearing appeals against registration and disciplinary decisions under the new regime. In addition, an aggrieved person may appeal to the Court of Appeal against the decision of the independent appeals tribunal if leave to appeal has been granted by the Court of Appeal.
- FRC will be funded by levies on an equal basis by the three stakeholder groups, namely, listed entity auditors, listed entities and investors.