



Financial Reporting Council

Update on Independent Audit Oversight

Press Briefing
27 October 2016

Agenda

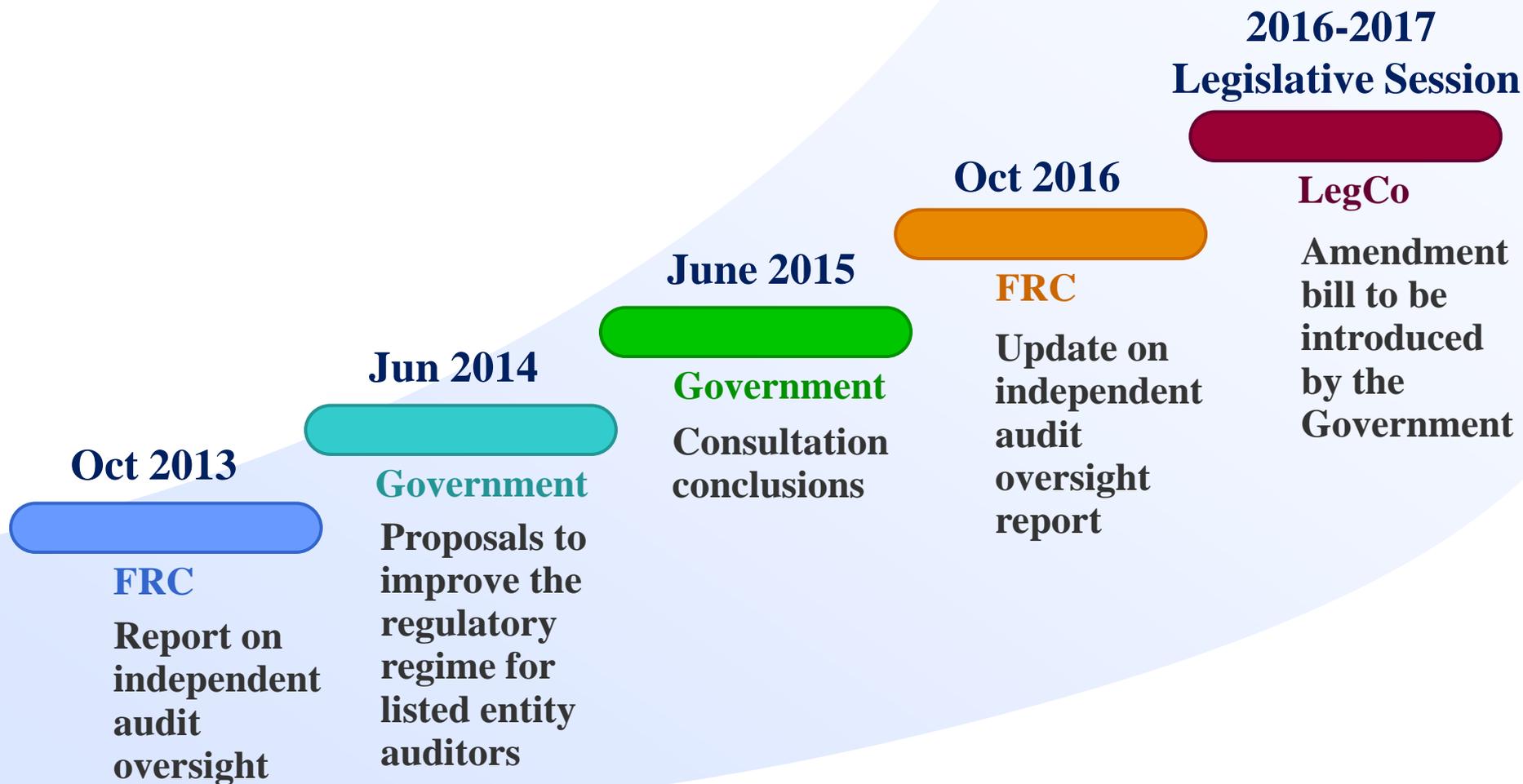
- Opening Remarks
- Report Findings
- Closing Remarks
- Q&A Session



Opening Remarks

Dr John Poon, BBS, JP
Chairman
Financial Reporting Council

Long Journey to Independent Audit Oversight



Findings of the 2013 Report on Independent Audit Oversight

- HK did not meet both the International Forum of Independent Audit Regulators (IFIAR) membership and European Commission (EC) equivalence requirements because it had no independent audit regulator
- Independent audit regulators of major jurisdictions, e.g. US, UK, Canada, Australia and Singapore have ultimate authority over auditors of listed entities on the following **6 functions**:

- Inspection
- Investigation
- Enforcement
- Registration
- Standard Setting
- Continuing professional education

Decision of European Commission (2013)

- In June 2013, the EC decided to remove the transitional equivalence status of HK because HK:
 - Has not established an independent system of public oversight, quality assurance, investigations and penalties
 - Has not taken measures to comply with the EC equivalence requirements

IFIAR Membership and EC Equivalence

IFIAR

- Global organisation for independent audit regulators which focuses on inspections of auditors
- Currently it has **51 members** (2013: 46 members)

EC Equivalence

- Recognition given to a country/ jurisdiction whose audit regulatory regime complies with the EC requirements
- **50 jurisdictions** worldwide, including China, meet EC requirements (2013: 50 jurisdictions)

41 jurisdictions worldwide are IFIAR members and are also in compliance with the EC requirements



Benefits of IFIAR Membership and EC Equivalence for HK and HK FRC

- Meet global investing community expectations
 - In line with major capital markets (e.g. London and New York)
 - Recognition with international bodies –
International Monetary Fund (IMF), IFIAR, EC
 - International best practice
 - Independent of audit profession
- Strengthen integrity of financial reporting by HK listed entities
- Enhance investor confidence
- Entrench HK's status as a major international financial centre
- Facilitate collaboration with other independent audit regulators for cross-border regulation

IMF Financial Sector Assessment Report (2014)

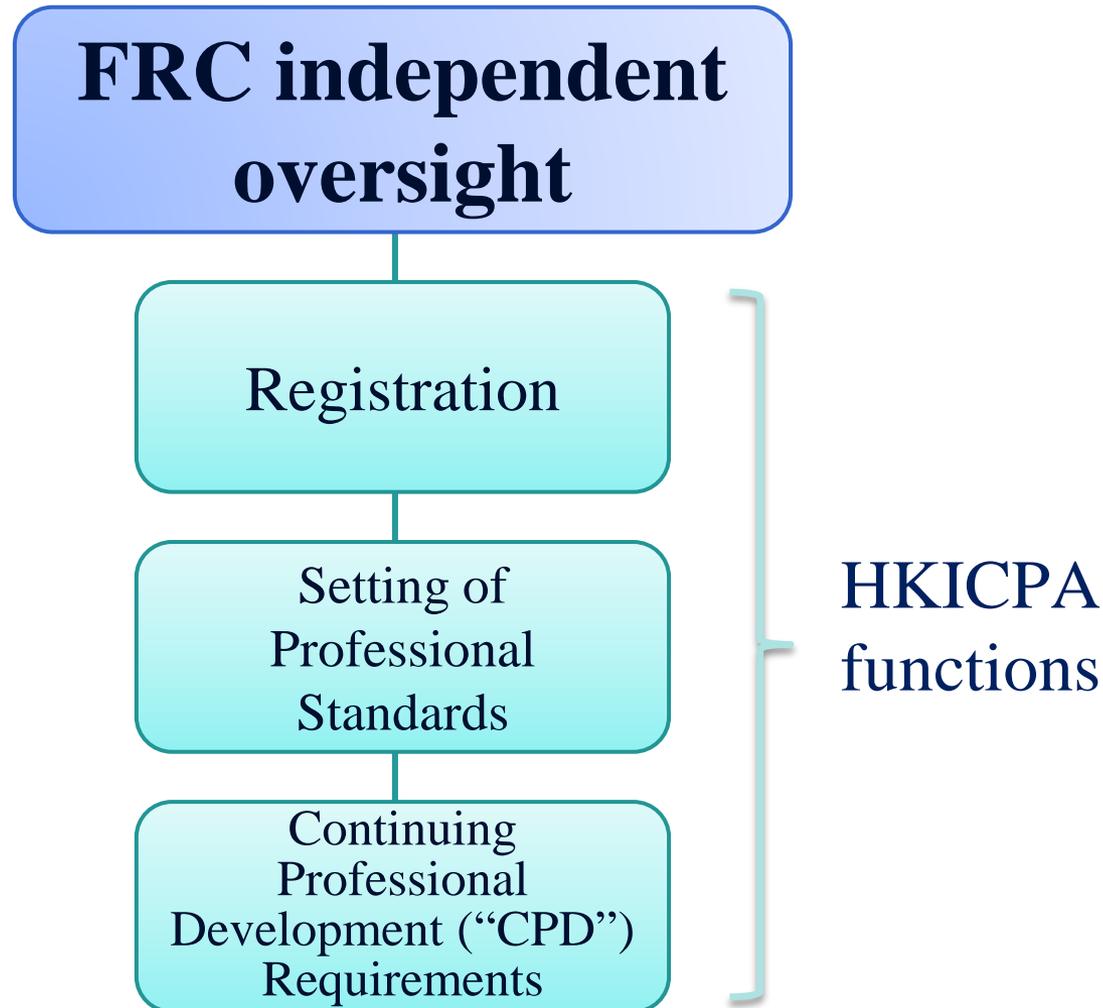
- *“...the current framework does not ensure the independence of the Hong Kong Institute of Certified Public Accountants (HKICPA), which is the body in charge of the supervision of auditors, nor provides it with powers to oversee foreign auditors who audit companies listed in HKSAR, nor establishes a strong enforcement framework.”*
- **Recommended action:** *“The authorities should proceed with their proposals to establish a fully independent authority with responsibility for the oversight of the audit profession and with strong enforcement power. Such authority should have jurisdictions over all auditors that audit companies listed in HKSAR.”*

Government Consultation (2014)

- Launched a public consultation on “Proposals to Improve the Regulatory Regime for Listed Entity Auditors”
- Public Consultation Period
 - 20 June 2014 – 19 September 2014
- To enhance the independence of the existing regulatory regime for listed entity auditors

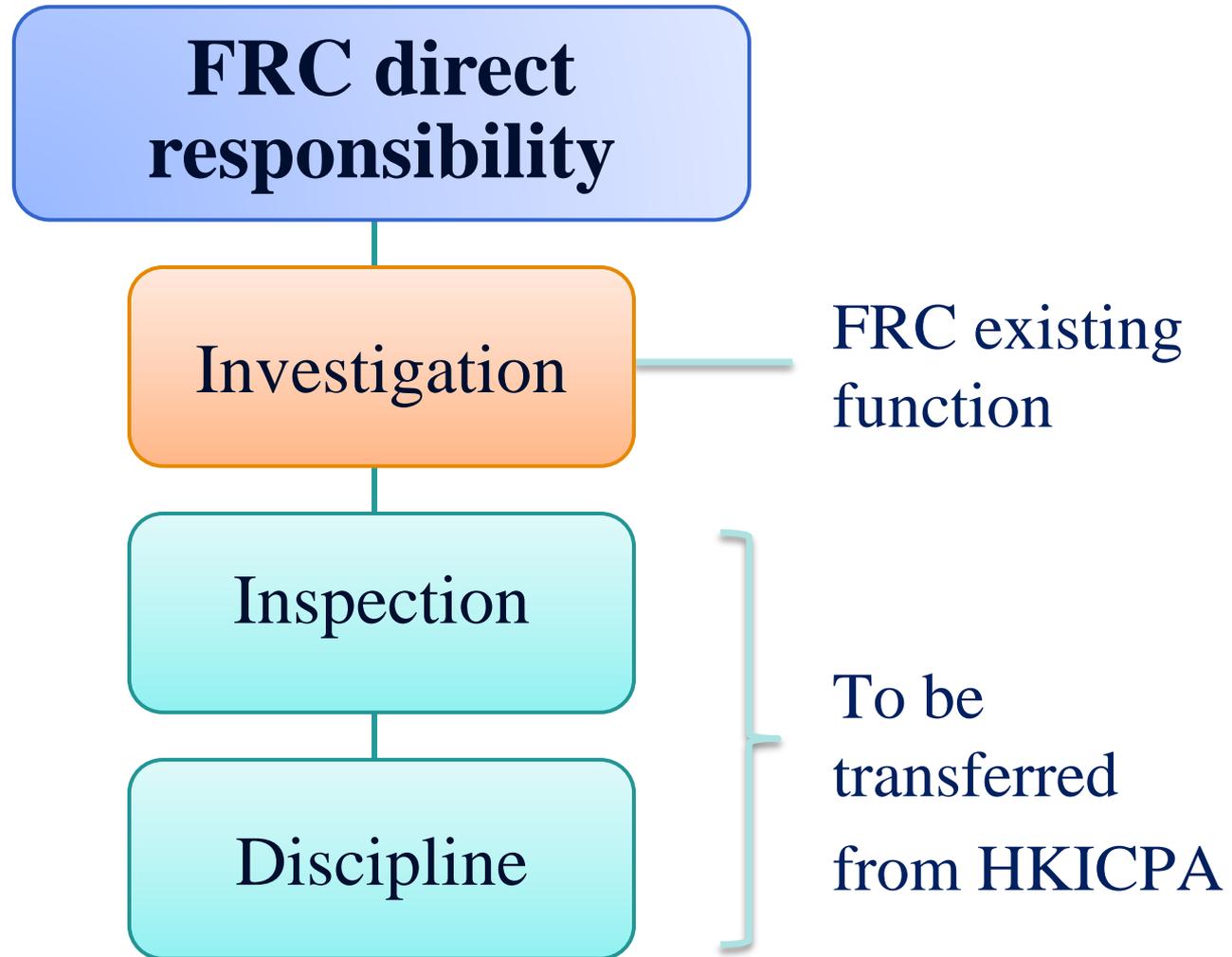
Consultation Conclusions (2015)

Proposed Regime for Listed Entity Auditors



Consultation Conclusions (2015)

Proposed Regime for Listed Entity Auditors



Since Our 2013 Report

- 5 more jurisdictions (i.e. Botswana, Cayman Islands, Czech Republic, New Zealand and Russian Federation) achieved IFIAR membership
- 2014 European Union audit reform legislation now requires that the governing body of audit regulators shall comprise of non-practitioners only
- HK loses out to Singapore in Corporate Governance Watch 2016 organised by Asian Corporate Governance Association because HK lacks an independent body to handle the regulation of auditors

2016

- HK still does not have an independent audit regulator
- HK is not a member of IFIAR
- HK is not in compliance with the EC equivalence requirements

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

In the Best Interests of Investing Public and HK

- The proposed audit regulatory regime will:
 - Similar to 41 other jurisdictions worldwide, achieve international recognition and meet the IFIAR membership and EC equivalence requirements
 - Assuming the future Council will comprise of non-practitioners only
 - Enable HK to
 - meet international best practice
 - be in line with major international financial centres



Report on
independent
audit
oversight

2016 update

David Barnes
27 October 2016

Agenda

1. Background and scope
2. Key changes since 2013
3. Key IFIAR and EC requirements
4. How the proposed audit regulatory regime of Hong Kong meets the IFIAR and EC requirements

1. Background and scope

- The Hong Kong FRC asked us to refresh the work we performed in 2013
- Since then:
 - The EC equivalence requirements have evolved
 - Audit oversight around the world has also continued to develop
 - The Hong Kong Government has consulted and concluded on reform of the local audit market
- Deloitte's 2016 report maps Hong Kong's current regime for audit oversight against:
 - The IFIAR and EC requirements
 - Practice in other key jurisdictions (UK, US, Canada, Australia, Singapore)
- We also looked at how the proposed regime measures up against the IFIAR and EC requirements, covering the six functions of regulation as well as funding models:

1. Inspection	4. Registration
2. Investigation	5. Continuing professional education / development (CPE / CPD)
3. Enforcement / disciplinary	6. Standard setting

2. Key changes since 2013

Focussing on the EU audit reforms

- Some of the EC equivalence requirements have evolved in line with the 2014 changes to the Statutory Audit Directive, including:
 - The *removal* of the ability to allow the involvement of (a minority of) practitioners in the governance of the oversight system; must comprise solely non-practitioners (NPs)
 - The new need for the designation of a 'competent authority', responsible for the oversight of statutory auditors and audit firms. In Hong Kong context, it is the HK FRC
 - Where the competent authority delegates tasks to other authorities or bodies, it shall be able to reclaim those delegated competencies on a case-by-case basis
 - The competent authority needs to be able to initiate as well as to conduct investigations (for which adequate resources are required) and take appropriate action
 - New requirement that reviews take place on the basis of risk analysis and are appropriate and proportionate in relation to the scale and complexity of the reviewed auditor's/audit firm's activity
 - New specifications relating to the selection of quality assurance reviewers

3. Key IFIAR and EC requirements

Area	IFIAR / EC requirements
Overall system (governance)	<ul style="list-style-type: none">• Governance by non-practitioners (NPs)
1. Inspection	<ul style="list-style-type: none">• Responsibility for the inspection of auditors of PIEs (including at least listed entities)• Operationally independent; adequately resourced; risk-based, proportionate approach covering the firm's system of internal quality control and testing of individual audits
2. Investigation	<ul style="list-style-type: none">• Enforcement of inspection findings/recommendations• Right to investigate• Appropriate, effective system of investigations
3. Enforcement	<ul style="list-style-type: none">• Comprehensive enforcement powers including the ability to impose a range of sanctions and remove registration

3. Key IFIAR and EC requirements (cont'd)

Area	IFIAR / EC requirements
4. Registration	<ul style="list-style-type: none">• Address compliance with (IFIAR) / ultimate responsibility for authorisation / registration (EC)
5. CPE / CPD	<ul style="list-style-type: none">• EC: ultimate responsibility for oversight
6. Standard setting	<ul style="list-style-type: none">• IFIAR: power to address compliance with auditing, professional and independence standards• EC: oversight of the adoption of professional ethics, internal quality control of audit firms and auditing
Funding model	<ul style="list-style-type: none">• Stable, sufficient, secure source of funding• Free from any undue influence from the profession

4. How the proposed audit regulatory regime of Hong Kong meets the IFIAR and EC requirements

Area(s)	Overview of IFIAR / EC requirements	Government's conclusion	Action	
✓	Overall system (governance)	Governance by non-practitioners (NPs)	<ul style="list-style-type: none"> • At least 7 members • 2 to have relevant audit experience • CEO ex-officio • Majority of NPs 	Government must put in place mechanism to exclude practitioner involvement in FRC Council
✓	1. Inspection	<ul style="list-style-type: none"> • Responsibility for the inspection of auditors of PIEs 	FRC to have <u>direct powers</u> for all three areas in relation to listed entity auditors	FRC must: <ol style="list-style-type: none"> 1. Ensure the requisite independence of inspection division 2. Put in place mechanism to ensure inspection findings are addressed within a reasonable period 3. Publish sanctions guidance; prevent involvement of investigative staff in disciplinary process and determination of sanctions
✓	2. Investigation	<ul style="list-style-type: none"> • Appropriate, effective system of investigations 		
✓	3. Enforcement	<ul style="list-style-type: none"> • The right to remove registration; recourse to a range of penalties/ sanctions 		

4. How the proposed audit regulatory regime of Hong Kong meets the IFIAR and EC requirements (cont'd)

Area(s)	Overview of IFIAR / EC requirements	Government's conclusion	Action
<input checked="" type="checkbox"/> 4. Registration	<ul style="list-style-type: none"> Address compliance with (IFIAR) / ultimate responsibility for (EC) authorisation / registration 	HKICPA with FRC <u>oversight</u> (to include receiving periodic reports and giving HKICPA written directions)	
<input checked="" type="checkbox"/> 5. CPE			
<input checked="" type="checkbox"/> 6. Standard setting	<ul style="list-style-type: none"> Ultimate responsibility for oversight Covers: auditing, professional and independence standards (IFIAR) / ethics, internal quality control and auditing standards (EC) 		
<input checked="" type="checkbox"/> FRC's regulatory scope	<ul style="list-style-type: none"> IFIAR: PIEs EC: listed companies 	Auditors of PIEs (defined to cover entities listed in HK)	

4. How the proposed audit regulatory regime of Hong Kong meets the IFIAR and EC requirements (cont'd)

Area(s)	Overview of IFIAR / EC requirements	Government's conclusion	Action
<input checked="" type="checkbox"/> Funding	<ul style="list-style-type: none"> • Stable, sufficient, secure source of funding • Free from any undue influence from the profession 	FRC funded via levies on: <ul style="list-style-type: none"> - listed entities - securities transactions - listed entity auditors 	
<input checked="" type="checkbox"/> Appeals	<ul style="list-style-type: none"> • Decisions and actions subject to appropriate scrutiny and review, including appeal to higher authority (IFIAR) 	New independent appeals tribunal	

Overall conclusion: The proposals would put in place much of the framework and, if implemented as proposed, are likely to meet the IFIAR and EC requirements and indeed international best practice. The FRC will however still need to put in place further regulations / policies / procedures to meet the detail of those requirements



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Concluding Remarks

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CEO

Financial Reporting Council

Role of the FRC in the Audit Regulatory Reform

Advocacy	Implementation
<ul style="list-style-type: none">• Audit regulatory regime independent of the profession• A regime that qualifies for IFIAR membership and meets EC equivalence requirements• Stable source of funding, secure and free from influence• Adequate resources to discharge statutory functions	<ul style="list-style-type: none">• Promulgate policies, guidelines and procedures• Ensure future organisation will:<ul style="list-style-type: none">- discharge statutory functions in an efficient and competent manner- separate inspection, investigation and disciplinary functions• Enhance international recognition, relationships and involvement

HK – About 2,000 Listed Entities; Market Capitalisation: Approx. HK\$26 Trillion (Approx. US\$3.3 Trillion)

- **Financial Reporting Council**
 - Have ultimate responsibility over the 6 functions
- **Approx. 50 audit practices/firms, together with those practising members who undertake audits of Hong Kong listed entities**
- **2016 Budget: HK\$29.4 million**
- **2016 Headcount: 22**

US – Over 6,000 Listed Entities; Market Capitalisation: Approx. US\$25 Trillion

- Public Company Accounting Oversight Board (PCAOB)
 - A statutory body under Sarbanes-Oxley Act
 - Have ultimate responsibility over the 6 functions
 - 2016 Budget: approx. US\$258 million
 - 2016 Headcount: 876
 - Published rules
(<https://pcaobus.org//Rules/Pages/default.aspx>)

UK – About 2,300 Listed Entities; Market Capitalisation: Approx. £4.4 Trillion (Approx. US\$5.4 Trillion)

- **Financial Reporting Council (UK)**
 - Independent audit regulator
 - Have ultimate responsibility over the 6 functions
 - 2016 Budget: £33.5 million (approx. US\$41.1 million) for about 50 audit firms under review
 - 2016 Headcount: 165
 - Issued operational policies and guidance (<https://frc.org.uk/Our-Work/Enforcement/Enforcement/Policies-and-guidance.aspx>)

The World of Independent Audit Regulators



International Forum of Independent Audit Regulators (IFIAR) members:

- Abu Dhabi
- Albania
- Australia**
- Austria
- Belgium
- Botswana
- Brazil
- Bulgaria
- Canada**
- Cayman Islands
- Chinese Taipei
- Croatia
- Czech Republic
- Denmark
- Dubai International Financial Centre
- Egypt
- Finland
- France
- Germany
- Gibraltar
- Greece
- Hungary
- Indonesia
- Ireland
- Italy
- Japan
- Jersey
- Korea
- Liechtenstein
- Lithuania
- Luxembourg
- Malaysia
- Mauritius
- Netherlands
- New Zealand
- Norway
- Poland
- Portugal
- Russian Federation
- Singapore**
- Slovak Republic
- Slovenia
- South Africa
- Spain
- Sri Lanka
- Sweden
- Switzerland
- Thailand
- Turkey
- UK**
- USA**

European Economic Area:

- | | | | |
|----------------|---------|---------------|-----------|
| Austria | Finland | Latvia | Portugal |
| Belgium | France | Liechtenstein | Romania |
| Bulgaria | Germany | Lithuania | Slovakia |
| Croatia | Greece | Luxembourg | Slovenia |
| Cyprus | Hungary | Malta | Spain |
| Czech Republic | Iceland | Netherlands | Sweden |
| Denmark | Ireland | Norway | UK |
| Estonia | Italy | Poland | |

Third countries with European Commission (EC) equivalence status:

- | | |
|--------------------------------------|------------------|
| Abu Dhabi | Japan |
| Australia | Jersey |
| Brazil | Malaysia |
| Canada | Singapore |
| China | South Africa |
| Dubai International Financial Centre | South Korea |
| Guernsey | Switzerland |
| Indonesia | Taiwan |
| Isle of Man | Thailand |
| | USA |

(Bold font denotes the jurisdictions covered in this study)