



September 11, 2014

Division 4
Financial Services Branch
Financial Services and the Treasury Bureau
15/F, Queensway Government Offices
66 Queensway
Hong Kong

Dear Sirs,

Proposals to Improve the Regulatory Regime for Listed Entity Auditors (“Consultation Paper”)

The Chamber of Hong Kong Listed Companies (“CHKLC”) is pleased to have the opportunity to respond to the Consultation Paper.

We understand that the main objective of the proposals in the Consultation Paper, and we agree with it, is to enhance the independence of the existing regulatory regime for listed entity auditors from the audit profession with a view to ensuring that the regime is benchmarked against international standards. We believe this move will further strengthen the competitiveness of Hong Kong as a key financial market, and as key participants in this market, we listed issuers are in support of it.

A large part of the Consultation Paper deals with the transfer of existing powers from HKICPA to the Financial Reporting Council (FRC), the future mode of operation and division of work between the two. CHKLC has no particular views about these arrangements and would defer this to the two organisations to further deliberate on the details.

Our submission therefore will concentrate on Chapter 9 of the Consultation Paper which is to do with the funding mechanisms for the enlarged FRC, particularly the part where it is proposed that listed issuers will contribute to fund the FRC.

We note that the Government is proposing a fundamental change in the way FRC is funded. In particular, the Government is proposing that (a) it will no longer contribute to the funding of FRC and (b) listed issuers will for the first time be required to contribute to such funding – to the extent of one third. CHKLC submits that these proposals are unjustified, unfair, and contrary to the Government’s stated policy objective in the Consultation Paper of “underpinning Hong Kong’s development as an international financial centre”. CHKLC therefore opposes the funding proposals.

Unjustified

In explaining the rationale behind its proposals to strengthen the independence of the regulatory regime from the auditing profession, the Consultation Paper states:

“In view of the clear international trend that the oversight of the regulation of auditors should be independent of the profession itself, there is a need to reform our present regulatory regime which is considered by many as largely a self-regulatory regime”.

This rationale does not justify the Government’s proposals to cease public funding of the FRC, and to shift the burden of such funding to listed issuers. These proposals are irrelevant to the policy objective of making the regulation of auditing more independent from the auditing profession itself. As pointed out in page 9 of the Consultation Paper, the IFIAR’s Core Principles highlighted that “regulators of auditors should be ‘operationally independent in the exercise of its functions and powers... including not being controlled in its governance by audit practitioners’”. Apparently, the requirement of independence is concerned with the regulators’ governance and operation. With regard to funding, all that is required is that the funding should be secure, and free from undue influence by the auditing profession. The real motives of the Government’s proposals on funding are therefore unclear.

Moreover, there is nothing within the IFIAR’s Charter and Core Principles, the EU’s Statutory Audit Directive, or IOSCO’s Objectives and Principles (which the Consultation Paper refers to as benchmarks) which require listed issuers to contribute to the funding of the regulator, as opposed to Government.

In fact, it is entirely appropriate for the Government to contribute to the funding of auditor regulation, as opposed to listed issuers, since such regulation, as the Consultation Paper recognises, serves public interest objectives, namely “underpinning Hong Kong’s development as an international financial centre”, and “safeguarding the interests of the investing public”. When introducing to Legco the Bill to establish the FRC, the Government emphasised the appropriateness of the existing funding arrangements:

“The sharing of the costs among the four parties [HKEx, HKICPA, SFC and Government] is considered appropriate, as the establishment of FRC will further enhance the regulation of auditors and the quality of financial reporting of listed entities, hence contributing to the improvement of the overall market quality.”

This position is entirely reasonable. It is therefore all the more puzzling as to why the Government now appears to be changing its position.

We believe that it is the Government's responsibility to develop and maintain a sound and solid capital market infrastructure that assures market quality and investor confidence and is conducive to continual growth. The Government should therefore be funding the FRC just as it funds the Consumer Council by way of an annual Government subvention as part of its overall mission of market development and protection. We note that in Australia, the bulk, if not all, of the funding of auditor regulation comes from Government.

Alternatively, since the FRC is currently funded by HKICPA, SFC, HKEx and the Companies Registry Trading Fund, the Government can explore the possibility for SFC and HKEx, both of which are in sound financial position, to continue to fund the FRC in the future.

Unfair

We do not question the role of auditors in providing assurance for the financial reports, in addition to preparing them. That is exactly what they are paid for. Issuers do not just pay for the technical service, but quality service as well; work that adheres to all applicable standards and regulations. That is embodied in their audit engagements and reflected in the audit fee. As such, issuers have the legitimate expectation that their auditors will deliver services of the highest quality that is required of them. If the Government believes that it is necessary to have a stronger and more effective oversight, we would not dispute that, but listed issuers should not be the ones to foot the bill. It gives an unreasonable and unfair burden on buyers of a service if they are required to pay for the regulation of that service at the same time.

In its 2005 consultation paper proposing to establish the FRC, the Government referred to "the underlying philosophy of the regulatory regime, underpinning the financial services sectors of Hong Kong, under which the industry concerned should fund the regime by which it is regulated" in justifying the requirement for the auditing profession to contribute to the costs. This philosophy also applies in the Hong Kong telecommunications industry, where the cost of regulation is funded by licence fees paid by the telecommunications operators which are regulated. It would be completely contrary to this philosophy to require listed issuers to contribute to the costs of regulating a separate industry.

We note that, according to the consultancy study, which the FRC commissioned in 2013, a number of overseas jurisdictions studied – Australia and Singapore – do not require listed issuers to fund the cost of auditor regulation. In Australia, it is the Government which provides the funding. The economies and capital markets in these jurisdictions are much more comparable to Hong Kong than the US and UK, the jurisdictions in the study where listed issuers are required to contribute.

Moreover, even if it was considered fair in principle for listed issuers to share in the funding of the FRC (which we submit it is clearly not), listed issuers are not the only party that benefits from a thriving capital market. A market is composed of different stakeholders, for example, banks, lawyers, financial advisors, accountants, and so on. They all contribute to the market and benefit from it tremendously. If the Government's rationale is that listed issuers should fund the FRC because they benefit from it, it is only fair that the others who also benefit from it should also pay a share of the costs. Of course that will beg the question how to work out the proportion of funding from each party. There is no simple answer to this question and it may well be impracticable to resolve it.

A third aspect of unfairness in the Government's proposals relates to the funding mechanism suggested in the Consultation Paper. It suggests that listed issuers with smaller capitalization would account for a smaller share of the financial contribution than those with large capitalization. We believe that this is a flawed approach in principle. A large part of the enlarged FRC's functions is to inspect the internal quality control system and compliance performance of listed entity auditors, investigate irregularities by them and instigate disciplinary proceedings. Yet, the internal quality control system and any irregularities when conducting the audit are internal issues of the auditors and have little to do with the size of the clients they audit. How can one then justify making larger listed entities pay more when the focus of the regulation is not to do with the size of the subject of the audit work? There is simply no relationship between the two. Even if the irregularities in question are to do with the listed issuers, it cannot be said that larger issuers are prone to cause irregularities, and hence they should pay more. But then if the Government is to demand all issuers to pay an equal share, it will certainly attract criticisms from the smaller issuers. This is an inherent issue about the funding proposals and is one that is not easy to address.

Contrary to the Government's Policy objective

The Consultation Paper states that one of the objectives of strengthening the independence of auditor regulation is "underpinning Hong Kong's development as an international financial centre". It is difficult to see how imposing extra costs on listed issuers by requiring them to fund auditor regulation would further this objective, in circumstances where rival listing centres such as Singapore, Australia and Canada impose no such funding obligation. If anything, it can logically and reasonably be expected to have the opposite effect.

The precise amount of the proposed funding obligation on listed issuers is unclear, because the Consultation Paper does not provide an estimated annual budget of the FRC under the new regime, thereby depriving stakeholders of the opportunity of making a fully-informed response to the Consultation Paper (another flaw in the Consultation Paper). Nevertheless, it is clear that the mere suggestion that listed issuers should bear a third of the costs, when listed issuers in these other jurisdictions do not bear any such

burden, will be counter-productive in terms of developing Hong Kong's competitive position as an international finance centre.

Conclusion

The ultimate conclusion from the above is that asking listed issuers to fund the regulator who regulates their service providers is unreasonable. In our view, the Government, or the SFC and HKEx, should be the main source of funding of the FRC, as part of their mission to uphold the professional standards of listed entity auditors, enhance market integrity, and protect the market reputation of Hong Kong.

Yours faithfully

A handwritten signature in black ink, appearing to read 'Patrick Sun', written in a cursive style.

Patrick Sun
Chairman