

Update on Independent Audit Oversight Report

The global picture



*Equivalence of third countries' regulatory systems is determined by the EC, the executive body of the EU. Auditors of an entity incorporated outside the European Economic Area (EEA) (the EU plus Norway, Liechtenstein and Iceland) but listed on an EEA regulated market must generally be registered as third country auditors. However, if the systems of public oversight, quality assurance, investigations and penalties are deemed to be equivalent by the EC, these requirements may be dispensed. (**Bold font** denotes the jurisdictions covered in this study)

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 (DIFC)
- Egypt
- Finland
- France
- Germany
- Gibraltar
- Greece
- Hungary
- Indonesia
- Iran
- 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 Union (EU) Member States:

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

Third countries with European Commission (EC) equivalence*

- status:**
- Abu Dhabi
 - Australia**
 - Brazil
 - Canada**
 - China
 - Dubai International Financial Centre (DIFC)
 - Guernsey
 - Indonesia
 - Isle of Man
 - Japan
 - Jersey
 - Malaysia
 - Singapore**
 - South Africa
 - South Korea
 - Switzerland
 - Taiwan
 - Thailand
 - USA**

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Dear Dr Poon,

Independent consultancy services for the Financial Reporting Council (FRC): update on independent audit oversight report

We are delighted to present our study of independent audit oversight drawing on information available to June 2016. This follows on from our September 2013 study, prepared with a view to Hong Kong achieving International Forum of Independent Audit Regulators (IFIAR) membership and/or European Commission (EC) equivalence. Since 2013, the IFIAR Principles have not changed but the 2014 European Union (EU) audit reform legislation, applicable from 17 June 2016, does impact some of the criteria for European Commission (EC) equivalence. Indeed, a major new requirement is that the audit regulator is fully governed (in Hong Kong this would relate to the FRC Council) by non-practitioners.

As we previously set out in our 2013 study, audit regulators are required to have ultimate independent oversight responsibility for registration, inspection, investigation, enforcement, standard setting and continuing professional education (CPE). Delegation to other authorities or bodies (designated or otherwise authorised by law to carry out such tasks) is permitted and adopted in some jurisdictions, provided that the independent regulator retains ultimate oversight. It is clear from this updated study that independent statutory regulators in major jurisdictions continue to have regulatory oversight of registration, inspection, investigation, enforcement, standard setting and CPE.

Since we undertook our 2013 study, the Hong Kong Government has consulted and concluded on reform of the local audit market. 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.

Finally, and by way of background, the data for the jurisdictions covered by the original study in addition to the EU (the UK, US, Canada, Australia and Singapore) was originally gathered using a question set provided to Deloitte by the FRC in 2013. This updated study reflects the relevant changes in those jurisdictions, provided to us by local Deloitte experts and – in addition to the new information regarding the Government's proposed reforms – also features various analyses, possible approaches and comparisons relating to independent audit oversight, as well as detail on each of the jurisdictions and an updated overview of global regulatory reform activity.

Yours sincerely,

David Barnes
Deloitte LLP

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This is an abridged version of Deloitte LLP's 2016 update on independent audit oversight report. The full report is available on the FRC's website (www.frc.org.hk)

1.1 Executive Summary – IFIAR / EC

Introduction

This report follows on from our 2013 study which looked at the requirements to achieve IFIAR membership and/or EC equivalence. Since 2013, the IFIAR Principles have not changed. However, the 2014 EU audit reform legislation, applicable since 17 June 2016 and comprising revisions to the existing Statutory Audit Directive (SAD) and a new Audit Regulation (AR), impacts some of the criteria for EC equivalence.

The scope of the two regimes against which we benchmark Hong Kong are as follows:

- IFIAR is concerned with the audit of public interest entities (PIEs). Neither its Charter nor Core Principles define PIEs, but it is understood to align with the definition used by the International Auditing and Assurance Standards Board (IAASB) and the International Ethics Standards Board for Accountants (IESBA). This includes listed entities (on any exchange) together with any entities designated by local law or regulation as a PIE or for which law or regulation requires compliance with the same independence framework as a listed entity.
- EC equivalence is relevant to the role of a third country auditor¹; if a third country auditor is subject to an equivalent regime then it is exempt from direct inspection by the relevant EU audit regulator.

Overview of IFIAR and EC requirements

Audit regulators are required to have ultimate independent oversight responsibility for registration, inspection, investigation, enforcement, standard setting and continuing professional education (CPE). Delegation to other authorities or bodies (designated or otherwise authorised by law to carry out such tasks) is permitted, provided that the independent regulator retains ultimate oversight. Key requirements of the oversight system are set out in the following table; many are common to both IFIAR and EC:

Area of audit oversight	IFIAR	EC equivalence
Overall system	<i>Mainly governed by non-practitioners²</i>	<i>Fully governed by non-practitioners</i>
Registration	Adequate powers and authority to address compliance with the requirements for authorisation / registration	Ultimate responsibility for the oversight of approval and registration
Inspection	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. Plus:	
	<i>Not specified</i>	Three year cooling-off period for quality assurance reviewers
	Established minimum cycle but specific frequency not mandated	Reviews at least every six years

¹ Third-country audit entity / auditor mean, respectively, an entity regardless of its legal form / a natural person that carries out audits of the annual or consolidated financial statements of a company incorporated in a third country (non-EU country), other than an entity / person registered as an audit firm / statutory auditor in any EU Member State.

² EC Directive 2014/56/EC defines non-practitioner as: any natural person who, during his or her involvement in the governance of the public oversight system and during the period of three years immediately preceding that involvement, has not carried out statutory audits, has not held voting rights in an audit firm, has not been a member of the administrative, management or supervisory body of an audit firm and has not been employed by, or otherwise associated with, an audit firm.

1.1 Executive Summary – IFIAR / EC (cont'd)

Area of audit oversight	IFIAR	EC equivalence
Investigation	Appropriate, effective system of investigations and penalties / sanctions in relation to inadequate or noncompliant execution of an audit Plus:	
	Authority and ability to enforce inspection findings and recommendations	Right to investigate and conduct investigations and take appropriate action
Enforcement	Comprehensive enforcement powers including the ability to impose a range of sanctions	Effective, proportionate and dissuasive sanctions in respect of statutory auditors and audit firms
	The right to remove registration	
Standard setting	Adequate powers and authority to address compliance with applicable auditing, professional and independence standards	Ultimate responsibility for adoption of standards on professional ethics, internal quality control and auditing
CPE	<i>Not specified</i>	Ultimate responsibility for oversight
Funding	Stable, sufficient, secure source of funding; free from any undue influence from the profession	

Proposed future framework

In June 2014, the Hong Kong Government (Financial Services and the Treasury Bureau) conducted a public consultation to solicit views on proposals to introduce an independent oversight regime for the regulation of listed entity auditors (LEAs). The regulatory regime would cover auditors of PIEs, with PIEs defined in Hong Kong to mean, at least for the immediate future, listed entities.

The respondents' views on the proposals, the specific issues raised and the Government's responses to those were summarised in the consultation conclusions, [available online](http://www.fstb.gov.hk/fsb/ppr/consult/doc/conclu_rpirlea_e.pdf) (http://www.fstb.gov.hk/fsb/ppr/consult/doc/conclu_rpirlea_e.pdf), which also set out in detail the major refinements and elaborations of the relevant proposals in light of the respondents' comments. We understand that the Government's target is to introduce the amendment bill into the Legislative Council in the 2016-17 legislative session.

The reform proposals will result in a division of responsibilities between the FRC and the Hong Kong Institute of Certified Public Accountants (HKICPA), with the FRC becoming the independent audit oversight body vested with direct inspection, investigation and disciplinary powers with regard to the audits of listed companies by LEAs – the cohort that this study focuses on – as set out below. The HKICPA's existing oversight of non-LEAs and of the audits of non-listed entities audited by LEAs will be unchanged.

Area of audit oversight	LEAs as proposed
Registration	HKICPA to manage; FRC to have oversight
Inspection	FRC to conduct (LEAs' listed entity engagements)
Investigation / enforcement	FRC to conduct re. listed entities / make decisions re. LEAs

1.1 Executive Summary – IFIAR / EC (cont'd)

Area of audit oversight	LEAs as proposed
Standard setting (professional ethics / auditing and assurance – these standards are converged with the standards issued by the IESBA and the IAASB)	HKICPA to issue / specify professional ethics / auditing and assurance standards; FRC to have oversight
CPE	HKICPA to manage; FRC to have oversight

The impact of the proposed changes

The proposed way forward is likely to a) close the gaps originally identified in our 2013 study and that remain currently and b) meet the EC and IFIAR requirements. The overall system of governance is an exception to this, see below, and there are also certain other areas where the FRC will need to put in place further regulations / policies / procedures to ensure that all aspects of the detailed requirements for IFIAR membership and EC equivalence are met. The principal areas, drawing on the key gaps originally identified, are set out below:

Overall system of governance

- Meets IFIAR requirements
- EC requirements are not yet fully met as, from 17 June 2016, no practitioners are permitted to be involved in the governance structure – i.e. the Council of the FRC. Whilst it is likely that the Council members will all be independent by the first year to which equivalence could apply, there is no proposed mechanism that would prevent (an)other practitioner(s) from being appointed to the Council.

Cooling-off period for quality assurance reviewers

- Not relevant for IFIAR
- In principle meets the EC requirements, but in finalising all aspects of its new responsibilities, the FRC will need to ensure that former audit practitioners acting as quality assurance reviewers have a three year cooling off period

Source of funding

- Meets IFIAR and EC requirements
- To note: the requirement for LEAs to pay a levy would not render the FRC subject to undue influence by the audit profession as the law will clearly stipulate that it is a statutory obligation for LEAs to pay the levy

Composition of the inspection team

- Meets IFIAR and EC requirements, but:
 - The FRC will still need to ensure that the inspection division and its operation and governance are suitably independent from the reviewed firms and auditors, are not controlled by a professional body and that conflicts of interest are avoided

1.1 Executive Summary – IFIAR / EC (cont'd)

Disciplinary mechanism

- Meets IFIAR and EC requirements, but:
 - The FRC will still need to ensure that: experts it engages for specific assignments are not conflicted; there is a mechanism for ensuring findings are addressed within a reasonable period; there are adequate complaints procedures / whistleblowing arrangements in place

System of public oversight

- Not relevant for IFIAR
- Likely to meet EC requirements but:
 - The FRC needs to be able to reclaim competencies on a case-by-case basis from the HKICPA. The FRC considers that the fact that it is able to issue a direction to the HKICPA, with which it must comply, will achieve the same effect. We agree that it will do so, but it is possible that the EC may take a different view

1.2 Executive Summary – other considerations

It can be observed that the proposed changes would bring Hong Kong closer to a number of other jurisdictions, for example the proposed future disciplinary mechanism will be similar to the new disciplinary system in the UK (effective – in line with the EU audit reforms – from 17 June 2016). The following are also worthy of consideration:

- **Registration**

- The consensus approach amongst the jurisdictions reviewed is to distinguish between public interest companies (entities – i.e. PIEs) and private companies. The focus of the independent regulators is on the former, with most jurisdictions covering all listed companies (equity and debt issuers), significant financial institutions and in some cases, a wider class of PIEs. This allows a balance of resource and focus, recognising the need to demonstrate benefits in support of the cost of independent regulation. It is noted that the revised EU audit legislation has broadened the definition of PIEs in Europe. It also introduces stricter requirements relating to PIE audits / auditors.

- **Inspection**

- The importance of independent challenge to the audit firms is evident from each of the jurisdictions. While the mechanics vary, there is an ever increasing trend towards transparency (note the new voluntary Canadian Protocol regarding communication of inspection findings to audit committees) as well as rigour and independence. The UK practice of publishing annual reports for the largest firms and providing a copy of individual inspection reports to the entity's audit committee is of particular note. The US, in contrast, publishes individual firm inspection reports as well as summarised reports (under Public Company Accounting Oversight Board (PCAOB) Rule 4010). These practices demonstrate different approaches to striking a balance between fostering improvement and transparency of findings.
- Furthermore, national regulators are increasingly working and cooperating together and conducting joint inspections. For example, the PCAOB has signed Memoranda of Understanding (MOUs) with multiple jurisdictions in recent years and the European Audit Inspection Group (EAIG) – expected to become a sub-group of the Committee of European Audit Oversight Bodies (CEAOB)³ – is developing a Common Audit Inspection Methodology to be used by all inspectors in carrying out their work and has an inspection findings database where Member State regulators share findings.

- **Investigation and Enforcement**

- The need for a disciplinary process and potential sanctions is evident from each of the jurisdictions reviewed. Processes vary in their focus on and interpretation of 'public interest', but there is an operational consensus that high profile listed companies are of public interest, as is confidence in the largest audit firms. The jurisdictions generally adopt a quasi-legal approach to disciplinary processes, with a recognition of the right to a fair hearing and to appeal.
- The range of sanctions is generally wide-ranging, from reprimand, to fine, to some form of exclusion from practice. In certain circumstances, the fines can be unlimited (the UK and Canada) and one jurisdiction (Australia) allows for imprisonment as a sanction for non-compliance with a notice. Publicity is typically part of the sanction and anonymity is granted only in exceptional cases.

³ In finalising the EU audit reform legislation, the EU decided to create a new body, the CEAOB, which will play a role in establishing colleges of Member State regulators to inspect members of accounting networks. The European Securities and Markets Authority (ESMA) is a non-voting member of the CEAOB and the European Banking Authority and European Insurance and Occupational Pensions Authority attend as observers. These changes will not directly affect EC equivalence but the CEAOB will contribute to the technical assessment of third countries' public oversight systems carried out by the EC.

1.2 Executive Summary – other considerations (cont'd)

- **Standard setting**

- The regulatory bodies are typically responsible for implementing applicable auditing standards and will normally conduct their deliberations in public. With an increasingly global regulatory agenda, in most cases the bodies are implementing international standards rather than drafting entirely new ones for local use only.

- **Funding**

- In most cases, the regulator’s funding is obtained from a combination of direct levies on companies, levies on the professional bodies of which the audit firms are members and levies on the audit firms themselves. The level of funding from government appears to be declining, with the UK withdrawing it and Australia likely moving towards a user pays model (with the amount of government funding reduced).

Possible further considerations for the system of audit oversight in Hong Kong

- The Hong Kong Government has already acknowledged that it may broaden the definition of PIEs in future, which may result in the FRC having a broader scope of independent audit oversight. However, it will do so in a step-by-step approach and only once the new regime has bedded in. Also, the definition will be set out in legislation such that any change in future could only be made by way of an amendment bill.
- While IFIAR can be inferred to refer to covering only PIEs in an established minimum cycle, in the spirit – and with the objective – of ever-improved audit oversight and audit quality and robust capital markets, it could be a consideration to ensure that all auditors are covered at least regularly and in a minimum cycle.
- The FRC could also conduct the inspections of auditors of those companies listed in the EEA and/or of systemically important financial institutions in which IFIAR is also interested.
- While six years is the baseline inspection frequency requirement for EC equivalence, other major jurisdictions typically cover key audit firms much more frequently (as is indeed currently the case in Hong Kong, notably for the Big Four firms).
- Transparency of findings – there is a trend noted towards increasing transparency (beyond annual inspection / work plan reporting) e.g. communicating with Audit Committees on inspection findings.
- While not a gap per se, another feature of the current system is that the FRC is unable to enter into MOUs with IFIAR members. This is because the FRC does not have inspection and enforcement powers – although this is likely to be addressed by the proposed reforms.

2. IFIAR-EC overview and impact of the proposed changes

2.1 IFIAR-EC overview

IFIAR Core Principles for Independent Audit Regulators⁴

IFIAR is the organisation for independent audit regulators. Membership of IFIAR requires subscription to the IFIAR Charter (most recently revised in July 2013⁵ and again in September 2015⁶, with changes resulting from the latter coming into effect from April 2017, other than the transposition provision, in force as set out in section 5.4 of the updated Charter). This requires that members must be independent of the audit profession and engaged in audit regulatory functions in the public interest. The 2015 Charter changes mostly relate to IFIAR's own governance and notably provide for the creation of a board; IFIAR's current Advisory Council will be dissolved. Membership requirements have not changed since 2013 (between 2012 and 2013, the wording of the membership requirements was slightly adjusted). Membership of IFIAR does not require implementation of all the IFIAR Core Principles (unchanged since our original study on audit oversight was conducted in 2013), but members are encouraged to work towards their implementation where appropriate in their own jurisdictions, taking account of the risk profile, size and complexity of audit firms in their market. IFIAR considers that the Principles will also assist audit regulators who are not members of IFIAR to develop effective independent audit oversight arrangements. It is recognised that legislative change or other measures by national authorities not in control of the audit regulator may be required to achieve adherence to the Principles.

EC Equivalence Requirements

The EU Statutory Audit Directive 2006/43/EC⁷ ('SAD'), last amended⁸ in 2014⁹, applies from 17 June 2016 throughout the EU (and in the additional EEA countries, namely Norway, Liechtenstein and Iceland, as from a later date when formally adopted). The 2014 reforms are intended to strengthen the quality of statutory audit, reinforce the independence of statutory auditors and improve supervision; stricter requirements will apply to the statutory audit of PIEs. A statutory audit is defined as an audit of annual financial statements or consolidated financial statements in so far as: (a) required by EU law; (b) required by national law as regards small undertakings; (c) voluntarily carried out at the request of small undertakings which meets national legal requirements that are equivalent to those. Auditors of an entity incorporated in an EEA Member State must be registered with the relevant competent authority in that state. Auditors of an entity incorporated outside the EEA but listed on an EEA Regulated Market (as defined in the Markets in Financial Instruments Directive) must generally be registered as Third Country Auditors (Article 45 of the SAD). However, if the system of public oversight, quality assurance, investigations and sanctions are deemed to be equivalent by the EC, these requirements may be disapplied. The analyses below include the provisions of the amended SAD (applicable from 17 June 2016) against which the third country regime must be assessed in order to achieve equivalence under Article 46 of the SAD. Note that while the definition of PIE is broader than listed companies in the EU, third country equivalence relates only to the audits of listed companies (i.e. unchanged since 2013).

⁴ <http://www.ifiar.org/IFIAR/media/Documents/General/Final-Core-Principles.pdf>

⁵ <https://www.ifiar.org/IFIAR/media/Images/IFIAR-Charter-Approved-7-26-13.pdf>

⁶ <https://www.ifiar.org/IFIAR/media/Documents/General/About%20Us/Charter-changes-as-approved-on-September-15-2015.pdf>

⁷ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0043:20080321:EN:PDF>

⁸ See details here: <http://ec.europa.eu/finance/auditing/reform/>

⁹ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0056&from=EN> (amending Directive); <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:020006L0043-20140616&from=EN> (consolidated text of original 2006 and subsequent amending Directives)

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions¹⁰

The scope of the two regimes which we compare with the proposed Hong Kong regime is as follows:

- **IFIAR** is concerned with the audit of PIEs. Neither its Charter nor Core Principles define PIEs, but it is understood to align with the definition used by the IAASB and IESBA. This includes listed entities (on any exchange) together with any entities designated by local law or regulation as a PIE or for which law or regulation requires compliance with the same independence framework as a listed entity.
- **EC equivalence** is relevant to the role of a third country auditor; if a third country auditor is subject to an equivalent regime then it is exempt from direct inspection by the relevant EU audit regulator. As the role of third country auditor is only applicable to the audit of a non-EEA company with securities admitted to trading on an EEA regulated market (or, in the case of global depository receipts (GDRs), the entity whose securities are represented by GDRs admitted to trading on an EEA regulated market), the EC equivalence criteria in effect only apply to such companies and need not, strictly, be applied to other types of PIEs or entities only listed outside the EEA.

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status*
1	Quality assurance systems (Article 29 of SAD)			
1.1	<p>1. Each Member State shall ensure that all statutory auditors and audit firms are subject to a system of quality assurance which meets at least the following criteria:</p> <p>(a) the quality assurance system shall be organised in such a manner that it is independent of the reviewed statutory auditors and audit firms and is subject to public oversight</p>	<p>IFIAR Charter: [Members] must be independent of the audit profession, and engaged in audit regulatory functions in the public interest.</p> <p>IFIAR Principle 4 explanatory material: Audit regulators should at a minimum be responsible for the system and conduct of recurring inspection of audit firms undertaking audits of PIEs.</p>	<p>FRC: It is proposed that the FRC, as Hong Kong’s independent auditor oversight body under the proposed new regulatory regime, should be:</p> <ul style="list-style-type: none"> • responsible for independent oversight of the registration of LEAs • vested with the statutory powers to receive and make decisions on applications for recognising overseas auditors of specific overseas entities which have been approved for listing in Hong Kong • responsible, as now, for conducting independent investigations into relevant irregularities by LEAs • vested with direct disciplinary powers under the new regime <p>To enable the FRC to effectively discharge its inspection functions, the Government proposes providing the FRC with a number of powers, similar to the statutory powers (conferred by s32B and s32D of the Professional Accountants Ordinance (PAO)) with which the HKICPA is equipped under its practice review programme. It proposes that the statutory functions to conduct recurring inspections of LEAs in respect of their listed entity audit engagements should be transferred from the HKICPA to the FRC. The FRC’s inspection programme should follow the relevant statutory procedures with reference to the existing arrangements for HKICPA’s practice review programme (under s32C of the PAO).</p>	<p>EC – yes IFIAR – yes</p> <p>To note:</p> <ul style="list-style-type: none"> - The future FRC inspection / division and its operation / governance must be independent from the LEAs - The FRC practice reviewers will need to have the requisite independence - Note also the requirement relating to the FRC’s governance (Council to comprise solely non-practitioners) – see 3.4

¹⁰ Drawing on the Financial Services and the Treasury Bureau consultation and the related conclusions regarding its proposals to introduce an independent oversight regime for listed entity auditors

* Areas where the FRC will still need to put in place regulations / policies / procedures to ensure full compliance with the IFIAR/EC requirements are included in ‘to note’ for each relevant line item

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
1	Quality assurance systems (Article 29 of SAD)			
1.2	(b) the funding for the quality assurance system shall be secure and free from any possible undue influence by statutory auditors or audit firms;	<p>IFIAR Charter: Funding of the regulator is free of undue influence by the audit profession.</p> <p>IFIAR Principle 2 explanatory material: The audit regulator should have a stable source of funding, which is secure and free from influence by auditors and audit firms and sufficient to execute its powers and responsibilities.</p>	<p>FRC: it is proposed that the future FRC be funded by way of introducing new levies on (a) listed entities; (b) securities transactions; and (c) LEAs (one-third each).</p> <ul style="list-style-type: none"> The FRC should be able to sustain its operation without subsidy from general taxpayers The international standard that the funding of independent audit oversight bodies should be free from undue influence by the audit profession does not mean that LEAs cannot be one of the parties to fund the future operation of the FRC under the proposed regime. The Government considers that it would seem appropriate to maintain the flat fee per audit engagement approach for determining the levy on individual LEAs (rather than making it proportionate to their audit fees). To ensure the impartiality of the disciplinary process, it is proposed that any pecuniary penalty paid to or recovered by FRC would be paid by the FRC into the Government general revenue. The Government should not however be a recurrent funding source for the FRC’s operation. 	<p>EC: yes IFIAR: yes</p> <p>To note: the requirement for LEAs to pay a levy would not render the FRC subject to undue influence by the audit profession as the law will clearly stipulate that it is a statutory obligation for LEAs to pay the levy</p>
1.3	(c) the quality assurance system shall have adequate resources;	<p>IFIAR Principle 5 explanatory material: In order for audit regulators to be effective, it is a prerequisite that there is sufficient staff of appropriate competence. This also means that adequate arrangements for consultation and discussion amongst inspectors are in place.</p>	<p>FRC: to facilitate the effective performance of the inspection functions by the FRC and with reference to the existing arrangements under the PAO for HKICPA to perform such functions through delegation to its committees, it is proposed that the FRC may delegate such functions and relevant powers to committees formed under its auspices. The FRC will focus on the inspection of LEAs and be unable to delegate this (their listed entity audit engagements).</p>	<p>EC: yes IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> The FRC should ensure that the resourcing and competence of the future FRC inspection division meets the EC and IFIAR requirements around adequate quantity and expertise Its policies and procedures will also need to meet the IFIAR requirement for adequate arrangements for consultation and discussion amongst inspectors

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont’d)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
1	Quality assurance systems (Article 29 of SAD)			
1.4	(d) the persons who carry out quality assurance reviews shall have appropriate professional education and relevant experience in statutory audit and financial reporting combined with specific training on quality assurance reviews;	IFIAR Principle 5 explanatory material: The persons carrying out the reviews of quality assurance systems of audit firms should have appropriate professional training and relevant experience in auditing and financial reporting, and training in regulatory quality assurance reviews. This also means that adequate arrangements for consultation and discussion amongst inspectors are in place. New inspectors should be subject to proper supervision and appropriate training.	FRC: will have the power to assign quality assurance reviewers to conduct inspections, who would be full-time reviewers with appropriate accounting qualifications and an audit background.	EC: yes IFIAR: yes To note: – The FRC’s policies / procedures will need to ensure that the experience and training of the future FRC inspection division (including the supervision of new inspectors and arrangements for consultation between inspectors) meet the EC and IFIAR requirements.
1.5	(e) the selection of reviewers for specific quality assurance review assignments shall be effected in accordance with an objective procedure designed to ensure that there are no conflicts of interest between the reviewers and the statutory auditor or audit firm under review; (At least the following criteria shall apply to the selection of reviewers: (a) reviewers shall have appropriate professional education and relevant experience in statutory audit and financial reporting combined with specific training on quality assurance reviews; (b) a person shall not be allowed to act as a reviewer in a quality assurance review of a statutory auditor or an audit firm until at least three years have elapsed since that person ceased to be a partner or an employee of, or otherwise associated with, that statutory auditor or audit firm; (c) reviewers shall declare that there are no conflicts of interest between them and the statutory auditor and the audit firm to be reviewed.)	IFIAR Principle 6 explanatory material: Audit regulators should have in place prohibitions against conflicts of interest by its governing body and staff. IFIAR Principle 8 explanatory material: The recurring inspections should be conducted pursuant to a process comprising the selection of the audit firms to inspect, appointment of an inspection team with appropriate expertise and competence, notification to the audit firm, advance documentation request, notification of selection of audit engagements for review, meetings with management, and on-site inspection arrangements. The inspection process should be subject to appropriate internal quality control within the audit regulator to ensure high quality and consistency.	FRC: should have the power to set its policies / procedures regarding inspectors which will include relevant training / conflict of interest prohibitions / checks and balances.	EC: yes IFIAR: yes To note: The FRC’s policies /procedures regarding inspections will need to ensure the appropriate: – Independence (incl. cooling off period – three years is required for EC equivalence) – Experience and training (as per 1.4 above) – Internal FRC quality control and other relevant procedures to ensure quality, consistency and objectivity and avoid any conflicts of interest

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
1	Quality assurance systems (Article 29 of SAD)			
1.6	(f) the scope of the quality assurance review, supported by adequate testing of selected audit files, shall include an assessment of compliance with applicable auditing standards and independence requirements, of the quantity and quality of resources spent, of the audit fees charged and of the internal quality control system of the audit firm;	<p>IFIAR Principle 10 explanatory material: The risk-based inspection approach should also be reflected in both firm-wide and audit file inspection procedures. The firm-wide procedures should address the audit firm’s quality control system as reflected in the firm’s organisation, policies and procedures. ISQC 1 or similar standards should be used as a benchmark in performing firm-wide procedures. The inspection process should also include adequate testing of selected audit files in order both to determine the effectiveness of the firm’s quality control system and to assess compliance with applicable laws, rules and professional standards.</p>	<p>FRC: the Government considers that the scope of FRC inspections will cover the quality control system of LEAs (in respect of their listed entity audit engagements) and those listed entity engagements themselves. In practice, firms have one common system of internal control for all audits – listed entities and others. In conducting inspections to ensure LEAs follow applicable professional standards in performing listed entity audit engagements, the FRC will follow SMO No 1, and may also make reference to other standards followed by IFIAR members where appropriate. To enable the FRC to effectively discharge its inspection functions, the Government proposes to provide it with powers including specifying the particular professional standards in relation to which inspections are to be carried out and issuing directions to require an examination or a review, to determine whether the specified professional standards have been observed, maintained or applied by the LEAs (as per other such powers and similar to the statutory powers set out in the PAO).</p>	<p>EC: yes IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> The future FRC’s policies and procedures will need to meet the EC and IFIAR requirements relating to review scope and process The focus on LEAs’ quality control systems and relevant professional standards followed appears appropriate For IFIAR, inspections would need to be risk-based and this approach reflected in firm-wide and file inspection procedures For EC, inspectors should also consider the use of the audit firm’s resources and its fees
1.7	(g) the quality assurance review shall be the subject of a report which shall contain the main conclusions of the quality assurance review;	<p>IFIAR Principle 11: Audit regulators should have a mechanism for reporting inspection findings to the audit firm and ensuring remediation of findings with the audit firm.</p> <p>IFIAR Principle 11 explanatory material: Audit regulators should have a process that ensures that criticisms or potential defects in an audit firm’s quality control systems and issues related to an audit firm’s performance of audits that are identified during an inspection are reported to the audit firm. Audit regulators’ reporting processes should include the preparation and issuance of a draft inspection report, a process for the audit firm to respond, and the preparation and issuance of a final inspection report.</p>	<p>FRC: with reference to S32C of the PAO, it is proposed that before making a report to the FRC, a quality assurance reviewer should send the draft report to the LEA concerned and any individual named in the draft, who are entitled to make submissions or representations in writing to the quality assurance reviewer. The FRC may, having regard to the inspection report and any submissions or representations made in respect of the matters raised in the report, then take any one or more of the following actions:</p> <ol style="list-style-type: none"> conclude the inspection with no follow-up action required; make recommendations and specific requests to an LEA concerned regarding the application by it of professional standards; instruct that another inspection is required; and initiate its investigation / disciplinary processes if a suspected auditing/reporting irregularity is identified. 	<p>EC: yes IFIAR: yes</p> <p>To note: the quality assurance reviewer’s draft and the FRC’s final reports will need to contain the main conclusions of the quality assurance review (EC) and reflect any defects in the firm’s quality control systems / audits (IFIAR)</p>

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
1	<p>Quality assurance systems (Article 29 of SAD)</p> <p>1.8 (h) quality assurance reviews shall take place on the basis of an analysis of the risk and, in the case of statutory auditors and audit firms carrying out statutory audits as defined in point (a) of point 1 of Article 2 (i.e. an audit of annual financial statements or consolidated financial statements in so far as required by EU law), at least every six years;</p>	<p>IFIAR Principle 9: Audit regulators should ensure that a risk-based inspections programme is in place.</p> <p>IFIAR Principle 9 explanatory material: Audit regulators should have a process for assessing risks in the audit environment and audit risks in individual regulated firms and their audit engagements. Audit regulators should have a process for taking into account their risk assessment in allocating their inspection resources and in the inspection approaches they adopt. These processes should be commensurate with the size and complexity of the audit firms and their clients. Audit regulators should have an established minimum cycle regarding the frequency of inspections. <i>No direct equivalent in IFIAR principles regarding mandated frequency.</i></p>	<p>FRC: should have the power to set its policies / procedures regarding frequency of reviews and the inspection programme.</p>	<p>EC: yes IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> - The future FRC’s policies and procedures will need to ensure that LEAs are reviewed at least every six years (EC) / in an established minimum cycle (IFIAR) - The inspections programme must be risk-based
1.9	<p>(i) the overall results of the quality assurance system shall be published annually; and</p>	<p>IFIAR Principle 3 explanatory material: Transparency should include the publication of annual work plans and activity reports, including the outcome of inspections either in the aggregate or on a firm-by-firm basis.</p>	<p>FRC: the Government will make it a statutory requirement on the FRC to publish reports in its own name periodically to inform the public of the performance of its oversight functions (instead of requiring it to publish the periodic reports received from HKICPA as suggested during the 2014 consultation). This will not however cover the FRC’s inspection function, just its oversight functions. Note that the existing FRCO (section 20 (1) (a) states that: As soon as practicable after the end of each financial year of the Council, the Council shall submit to the Secretary a report on the activities of the Council for that financial year.</p>	<p>EC: yes IFIAR: yes</p> <p>To note: the future FRC’s policies and procedures will need to ensure that the annual work plans and activity reports / overall inspection results are published annually</p>

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
1				
1.10	<p>(j) recommendations of quality reviews shall be followed up by the statutory auditor or audit firm within a reasonable period. If the recommendations referred to in point (j) are not followed up, the statutory auditor or audit firm shall, if applicable, be subject to the system of disciplinary actions or penalties referred to in Article 30.</p>	<p>IFIAR Principle 4: Audit regulators should have comprehensive enforcement powers which include the capability to ensure that their inspection findings or recommendations are appropriately addressed; these enforcement powers should include the ability to impose a range of sanctions including, for example, fines and the removal of an audit licence and/or registration.</p> <p>IFIAR Principle 4 explanatory material: Audit regulators should at a minimum be responsible for the system and conduct of recurring inspection of audit firms undertaking audits of PIEs. Audit regulators should have the authority and ability to enforce inspection findings and recommendations. The audit regulator should have comprehensive enforcement arrangements such as fines, suspensions and the removal of an auditor’s or audit firm’s licence or registration.</p> <p>IFIAR Principle 11 explanatory material: In addition, audit regulators should have a process for ensuring that audit firms satisfactorily address inspection findings that were reported to the audit firm by the audit regulator.</p>	<p>FRC: as set out above, the FRC may, having regard to the inspection report and any submissions or representations made by LEAs in respect of the matters raised in the report, then take any one or more of the following actions:</p> <ul style="list-style-type: none"> (a) conclude the inspection with no follow-up action required; (b) make recommendations and specific requests to a LEA concerned regarding the application by it of professional standards; (c) instruct that another inspection or disciplinary processes if a suspected auditing / reporting irregularity is identified. (d) initiate its investigation / disciplinary processes if a suspected auditing / reporting irregularity is identified. <p>Regarding (d), it is proposed that the FRC should be empowered to exercise any one or more of the following disciplinary powers on a person subject to disciplinary action:</p> <ul style="list-style-type: none"> (a) to reprimand him publicly or privately; (b) to direct him to carry out remedial actions as specified by FRC; (c) to order that his name be removed from the register of LEAs, either permanently or for a period of time as specified by FRC; (d) to prohibit him from applying to be registered / approved as a regulated person for such period or until the occurrence of such event as FRC may specify; (e) to impose conditions on his registration / approval as a regulated person; (f) to order him to pay to FRC the costs and expenses in relation or incidental to the investigation reasonably incurred by FRC; and (g) to order him to pay a pecuniary penalty not exceeding the amount which is the greater of \$10,000,000; or three times the amount of the profit gained or loss avoided by the LEA as a result of the irregularity. 	<p>EC: yes IFIAR: yes</p> <p>To note: the future FRC’s policies and procedures will need to put in place a mechanism for ensuring that inspection findings are addressed (IFIAR) and within a reasonable period (EC)</p>

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont’d)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
1	<p>1.11 (k) quality assurance reviews shall be appropriate and proportionate in view of the scale and complexity of the activity of the reviewed statutory auditor or audit firm. (Member States shall require competent authorities, when undertaking quality assurance reviews of the statutory audits of annual or consolidated financial statements of medium-sized and small undertakings, to take account of the fact that the auditing standards adopted in accordance with Article 26 are designed to be applied in a manner that is proportionate to the scale and complexity of the business of the audited entity.)</p>	<p>IFIAR Principle 9 explanatory material: Audit regulators should have a process for taking into account their risk assessment in allocating their inspection resources and in the inspection approaches they adopt. These processes should be commensurate with the size and complexity of the audit firms and their clients.</p>	<p>FRC: should have the power to set its policies / procedures regarding the risk assessment process and scope of inspection.</p>	<p>EC: yes IFIAR: yes</p> <p>To note: the future FRC’s policies and procedures will need to ensure that inspections undertaken are proportionate to the scale and complexity of the LEAs; also that (for IFIAR) they take into account a risk assessment process.</p>
2	<p>2 Systems of investigations and sanctions (Article 30 of SAD)</p> <p>1. Member States shall ensure that there are effective systems of investigations and sanctions to detect, correct and prevent inadequate execution of the statutory audit.</p>	<p>IFIAR Principle 4 explanatory material: Audit regulators should have the authority and ability to enforce inspection findings and recommendations. The audit regulator should have comprehensive enforcement arrangements such as fines, suspensions and the removal of an auditor’s or audit firm’s licence or registration.</p>	<p>FRC: the present arrangement as provided in the FRCO for the FRC to be responsible for conducting independent investigations into relevant irregularities by LEAs will be continued under the new regime. However, the FRC may initiate a disciplinary process if a suspected irregularity is identified during the inspection or in handling complaints or referrals from other regulators. See also 1.7 and 1.10 for details of disciplinary powers including pecuniary penalties. The FRC is a body independent of the auditing profession and the HKICPA that currently mainly conducts independent investigations into possible auditing and reporting irregularities in relation to listed entities in Hong Kong, and to enquire into possible non-compliances with accounting requirements on the part of listed entities. Investigation and enquiry may be initiated by complaints from the public or referrals from other regulators such as the Securities and Futures Commission (SFC) or the Stock Exchange of Hong Kong (SEHK), or the FRC may initiate investigations or enquiries of complaints on its own initiative. Investigation of potential “relevant irregularities” may be initiated if the FRC believes that there are “circumstances suggesting” or “reasonable cause to believe” that there is or may be an irregularity committed by (i) an auditor in respect of an audit; or (ii) a reporting accountant in respect of the preparation of an accountant’s report. The FRC has two operating arms, the Audit Investigation Board (AIB) and the Financial Reporting Review Committee (FRRC) to conduct investigations or enquiries.</p>	<p>EC: yes IFIAR: yes</p> <p>To note: although they do not directly apply to EC equivalence, the FRC may wish to have regard to Article 30 a) to f) of the SAD regarding sanctions (relating to sanctioning powers; effective application of sanctions; publication of sanctions and measures; right of appeal; reporting of breaches and exchange of information).</p>

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

2	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
2.1 (cont'd)	Systems of investigations and sanctions (Article 30 of SAD)		<p>According to Sections 25 to 28 of the FRCO, the AIB may compel any party it considers it has relevant information to cooperate with its investigations by issuing a “requirement”. Typically, auditors are required to produce the audit working papers in relation to a listed entity if that audit is being investigated. For enquiries, the FRC exercises powers under section 43 of the FRCO.</p> <p>Upon completion of an enquiry or an investigation, a report is prepared and adopted by the Council of the FRC. The FRC is able to exercise disciplinary powers as set out in 1.10 in respect of auditing or reporting irregularities identified. Any noncompliance relevant to the Listing Rules will be referred to the SFC or the SEHK for follow-up action. The FRC may require listed entities to remove any noncompliance identified or revise its financial statements to correct such compliance; however it is not empowered to discipline or prosecute listed entities or their directors. The Council of the FRC may decide to publish the entire report or a part of it. A report will not be published if it may adversely affect any criminal proceedings before a court or magistrate; any proceedings before the Market Misconduct Tribunal; or any proceedings under Part V of the PAO. However, upon the completion of these proceedings by other regulators, the FRC may still decide to publish an enquiry or investigation report if it considers that the publication is in the interests of the investing public or in the public interest.</p>	

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
2	Systems of investigations and sanctions (Article 30 of SAD)	Article 30 of SAD)		
2.2	2. Without prejudice to Member States’ civil liability regimes, Member States shall provide for effective, proportionate and dissuasive sanctions in respect of statutory auditors and audit firms, where statutory audits are not carried out in conformity with the provisions adopted in the implementation of this Directive and, where applicable, Regulation (EU) No 537/2014. Member States may decide not to lay down rules for administrative sanctions for infringements which are already subject to national criminal law. In that event, they shall communicate to the Commission the relevant criminal law provisions.	No direct equivalent in IFIAR principles.	FRC: see 1.7 and 1.10 above for details of proposed disciplinary powers including pecuniary penalties.	<p>EC: yes IFIAR: n/a</p> <p>To note: yes re. EC is on the assumption that the FRC’s proposed sanctions meet the EC’s view of what constitutes ‘effective, proportionate and dissuasive’</p>
2.3	3. Member States shall provide that measures taken and sanctions imposed on statutory auditors and audit firms are to be appropriately disclosed to the public. Sanctions shall include the possibility of the withdrawal of approval. Member States may decide that such disclosure shall not contain personal data within the meaning of point (a) of Article 2 of Directive 95/46/EC.	IFIAR Principle 6 explanatory material: Audit regulators should ensure that appropriate arrangements are in place to protect confidential information from public dissemination.	FRC: the amendment bill will make it clear that a disciplinary decision would be made public only after the expiry of the period allowed for making an application for appeal to the independent appeals tribunal (i.e. 21 days), or if an appeal has been made, be made public only after the appeal has been determined by the independent appeals tribunal. The tribunal will be empowered to obtain evidence, including ordering a person to attend before it to give evidence, and to prohibit the disclosure of evidence it receives at any sitting which is held in private.	<p>EC: yes IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> - As set out in 1.10 above, it appears that the FRC should have the ability to withdraw approval as required for EC equivalence - The FRC appears to plan to make disciplinary decisions public, as required by the EC - The FRCO already sets out matters relating to the ‘preservation of secrecy’

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
3	<p>Principles of public oversight (Article 32 of SAD)</p> <p>1. Member States shall organise an effective system of public oversight for statutory auditors and audit firms based on the principles set out in paragraphs 2 to 7, and shall designate a competent authority responsible for such oversight.</p>	<p>IFIAR Principle 1: The responsibilities and powers of audit regulators should serve the public interest and be clearly and objectively stated in legislation.</p> <p>IFIAR Principle 1 explanatory material: The legal framework for audit oversight should set forth the audit regulator’s mandate and responsibilities, and provide the regulator with adequate powers and authority that enable the regulator to perform its audit oversight duties, including powers to address, through inspection and enforcement, compliance with the requirements for the authorisation / registration of auditors / audit firms and compliance with applicable auditing, professional and independence standards.</p>	<p>FRC: a draft amendment bill based on the consultation conclusions will be drawn up, with the aim of introducing the bill to the Legislative Council (the law-making body of the Hong Kong Special Administrative Region) in the 2016-17 legislative session. This will presumably set out the FRC’s new powers and its responsibility for the inspection, investigation and enforcement of LEAs (their listed audit engagements) and oversight responsibility for registration, continuing professional development (CPD) and standard-setting with respect to LEAs (done by HKICPA). At present, the FRC is the statutory authority for investigating into suspected relevant irregularities by LEAs. The nature of such irregularities is clearly defined in the FRCO.</p>	<p>EC: yes IFIAR: yes</p> <p>To note: The Government’s Amendment Bill will have to clearly set out the FRC’s extended powers and relevant amendments to the PAO, to ensure that the FRC’s powers are clearly and objectively stated in legislation, meet the competent authority requirements (EC) and serve the public interest (IFIAR)</p>
3.1/ 3.2				
3.3	<p>2. All statutory auditors and audit firms shall be subject to public oversight.</p>	<p>IFIAR Principle 1 explanatory material: Audit regulators should have a mandate to work in the public interest and protect investors by seeking to improve audit quality. The responsibilities and powers of audit regulators should, at a minimum, require independent oversight of the audits of public interest entities.</p>	<p>FRC: see 3.5 below for details of the FRC’s new powers (direct and regarding oversight).</p>	<p>EC: yes IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> - The FRC will have direct responsibility / oversight regarding LEAs so that IFIAR requirement is met - The FRC’s public interest and audit quality mandate / objective should be / remain clear

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
3	<p>Principles of public oversight (Article 32 of SAD)</p>			
3.4	<p>3. The competent authority shall be governed by non-practitioners who are knowledgeable in the areas relevant to statutory audit. They shall be selected in accordance with an independent and transparent nomination procedure. The competent authority may engage practitioners to carry out specific tasks and may also be assisted by experts when this is essential for the proper fulfilment of its tasks. In such instances, both the practitioners and the experts shall not be involved in any decision-making of the competent authority.</p>	<p>IFIAR Charter: [Members] must be independent of the audit profession, and engaged in audit regulatory functions in the public interest.</p> <p>IFIAR Principle 2: Audit regulators should be operationally independent.</p> <p>IFIAR Principle 2 explanatory material: Independence means the ability to undertake regulatory activity and to take and enforce decisions without external interference by those regulated. The audit regulator should be operationally independent from external political interference and from commercial or other sectoral interests, in the exercise of its functions and powers, including not being controlled in its governance by audit practitioners. The audit regulator should have a stable source of funding, which is secure and free from influence by auditors and audit firms and sufficient to execute its powers and responsibilities.</p> <p>IFIAR Principle 5: Audit regulators should ensure that their staff is independent from the profession and should have sufficient staff of appropriate competence.</p> <p>IFIAR Principle 5 explanatory material: Audit regulators should have arrangements in place to ensure that inspection staff members are independent of the profession. These arrangements will, as a minimum, include ensuring that staff members should not be practising auditors or employed by or affiliated with an audit firm, and that the arrangements are not controlled in any form by a professional body.</p>	<p>FRC: Governance – proposal for the FRC states that it should comprise not less than seven members appointed by the Chief Executive of the Hong Kong Special Administrative Region (CE), together with the CEO (ex officio member), of which at least two possess knowledge of and experience in the auditing of Hong Kong listed entities. In appointing the remaining members, the CE will continue to consider candidates who either because of their experience in accounting, finance, banking, law, administration or management, or because of their professional or occupational experience, are suitable for such appointment. There is a proposal to change the present requirement of a majority of ‘lay persons’ to a majority of ‘non-practitioners’ (to be defined as a person who is not, and has not during the previous three years been, a CPA (practising) or a partner, director, agent or employee of a practice unit). The Government proposes maintaining the present requirement for the FRC to have a Chairman and a majority of members who are independent of the audit profession. The amendment bill will also provide for the appointment of executive directors by the CE to be members of FRC, and correspondingly make it a statutory requirement that the number of executives in the Council must not exceed the number of non-executive Council members to ensure proper corporate governance.</p> <p>Funding – see 1.2 above; will be split between levies on a) listed entities, b) securities transactions, c) LEAs.</p>	<p>Governance EC: no IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> - The proposed definition of non-practitioner meets the EC’s three year cooling-off period requirement - The revised EC SAD no longer allows a minority of practitioners to be involved in the governance of the public oversight system. This may impact when the FRC seeks equivalence. The passage of time and checking the ‘cooling off’ of former auditors proposed for Council membership mean that the Council is likely to meet this test by the time equivalence could first take effect. However, as the proposed legislation includes no restrictions on future membership, there can be no guarantee that the Council would continue to meet the criteria. In order to satisfy the EC that the Council will always be suitably independent of the profession, we recommend that some mechanism be established to ensure independence - For IFIAR this is however fine as, per its Charter, only a majority of the relevant governing body must be non-practitioners (with an appropriate cooling off period for former auditors) - The FRC’s policies / procedures regarding inspections will need to ensure the appropriate independence of inspectors. The FRCO already sets out matters relating to the ‘avoidance of conflicts of interest’ <p>Funding EC: n/a IFIAR: yes (stable source of proposed funding)</p>

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
3	<p data-bbox="391 1489 414 2049">Principles of public oversight (Article 32 of SAD)</p>			
3.5	<p data-bbox="438 1691 518 2049">4. The competent authority shall have the ultimate responsibility for the oversight of:</p> <ul style="list-style-type: none"> <li data-bbox="542 1691 614 2049">a) the approval and registration of statutory auditors and audit firms; <li data-bbox="622 1691 758 2049">b) the adoption of standards on professional ethics, internal quality control of audit firms and auditing; except where those standards are adopted or approved by other Member State authorities; <li data-bbox="766 1691 805 2049">c) continuing education; <li data-bbox="813 1691 869 2049">d) quality assurance systems; and <li data-bbox="877 1691 965 2049">e) investigative and disciplinary systems. 	<p data-bbox="438 1355 702 1668"><i>No direct equivalent in IFIAR principles, but note IFIAR Charter, which states that regulators must exercise their responsibility for the system of recurring inspection of audit firms undertaking audits of PIEs either directly or through independent oversight.</i></p>	<ul style="list-style-type: none"> <li data-bbox="438 504 486 1344">a) Registration: <ul style="list-style-type: none"> <li data-bbox="462 504 502 1344">• HKICPA to manage; FRC to have oversight <li data-bbox="502 504 598 1344">b) Standard setting (professional ethics / auditing and assurance): <ul style="list-style-type: none"> <li data-bbox="526 504 598 1344">• HKICPA to issue / specify professional ethics / auditing and assurance standards (these standards are converged with the standards issued by the IESBA and the IAASB); FRC to have oversight <li data-bbox="598 504 622 1344">c) CPD: <ul style="list-style-type: none"> <li data-bbox="622 504 646 1344">• HKICPA to manage; FRC to have oversight <li data-bbox="646 504 670 1344">d) Inspection: <ul style="list-style-type: none"> <li data-bbox="670 504 702 1344">• FRC to conduct (LEAs’ listed entity engagements) <li data-bbox="702 504 758 1344">e) Investigation / enforcement: <ul style="list-style-type: none"> <li data-bbox="726 504 758 1344">• FRC to conduct re. listed entities / make decisions re. LEAs 	<p data-bbox="438 123 486 481">EC: yes IFIAR: yes</p> <p data-bbox="510 123 534 481">To note:</p> <ul style="list-style-type: none"> <li data-bbox="542 123 678 481">– IFIAR Charter requirement is met as the FRC will conduct the inspections of auditors of PIEs (as defined locally i.e. listed companies) <li data-bbox="686 123 861 481">– EC equivalence requirements are met given the FRC’s new oversight of the HKICPA for certain activities and own broadened powers re. others, relating to LEAs (i.e. PIEs as defined locally) <li data-bbox="869 123 1021 481">– Note that the FRC should however be able to reclaim those competencies from the HKICPA re. LEAs (see also below 3.5B) for EC equivalence

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
3	<p>Principles of public oversight (Article 32 of SAD)</p> <p>4(a) Member States shall designate one or more competent authorities to carry out the tasks provided for in this Directive. Member States shall designate only one competent authority bearing the ultimate responsibility for the tasks referred in this Article except for the purpose of the statutory audit of cooperatives, savings banks or similar entities as referred to in Article 45 of Directive 86/635/EEC, or a subsidiary or legal successor of a cooperative, savings bank or similar entity as referred to in Article 45 of Directive 86/635/EEC.</p> <p>Member States shall inform the Commission of their designation. The competent authorities shall be organised in such a manner that conflicts of interests are avoided.</p>	<p>IFIAR Principle 6: Audit regulators should be objective, free from conflicts of interest, and maintain appropriate confidentiality arrangements.</p> <p>IFIAR Principle 6 explanatory material: Audit regulators should maintain the highest standards of ethical conduct to provide the public with confidence in the objectivity of their decisions. Audit regulators should have in place prohibitions against conflicts of interest by its governing body and staff and ensure that appropriate arrangements are in place to protect confidential information from public dissemination.</p>	<p>See 3.5 above re. planned FRC / HKICPA duties. FRC: the FRCO already has sections relating to confidentiality and conflicts of interest.</p>	<p>EC: yes IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> - Re. EC equivalence, the FRC will have actual or oversight responsibility for all relevant areas, i.e. will effectively act as the key competent authority re. LEAs - See also 3.5B below re. reclaiming delegated responsibilities - The FRCO already sets out matters relating to the 'avoidance of conflicts of interest' (EC and IFIAR) and the 'preservation of secrecy' (IFIAR)

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
3	Principles of public oversight (Article 32 of SAD)			
3.5B	<p>4(b) Member States may delegate or allow the competent authority to delegate any of its tasks to other authorities or bodies designated or otherwise authorised by law to carry out such tasks. The delegation shall specify the delegated tasks and the conditions under which they are to be carried out. The authorities or bodies shall be organised in such a manner that conflicts of interest are avoided. Where the competent authority delegates tasks to other authorities or bodies, it shall be able to reclaim the delegated competences on a case-by-case basis.</p>	<p>No direct equivalent in IFIAR principles but note IFIAR Charter, which states that regulators must exercise their responsibility for the system of recurring inspection of audit firms undertaking audits of PIEs either directly or through independent oversight.</p>	<p>See above re. planned FRC / HKICPA duties and delegation.</p>	<p>EC: yes IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> - For EC equivalence, the FRC should be able to reclaim relevant competencies from the HKICPA re. LEAs (i.e. as regards registration, CPD and standard-setting) - IFIAR appears fine given the FRC’s new role with regard to inspection of LEAs
3.6	<p>5. The competent authority shall have the right, where necessary, to initiate and conduct investigations in relation to statutory auditors and audit firms and the right to take appropriate action. Where a competent authority engages experts to carry out specific assignments, it shall ensure that there are no conflicts of interest between those experts and the statutory auditor or the audit firm in question. Such experts shall comply with the same requirements as those provided for in point (a) of Article 29(2). The competent authority shall be given the powers necessary to enable it to carry out its tasks and responsibilities under this Directive.</p>	<p>IFIAR Principle 4 explanatory material: Audit regulators should have adequate and appropriate mechanisms for enabling information to be brought to their attention by third parties and for then dealing with such information, such as through complaints procedures or through whistle blowing arrangements. These mechanisms should act in a timely and effective manner and their results followed up through an appropriate system of investigations and penalties in relation to cases of inadequate or noncompliant execution of an audit.</p>	<p>FRC: may initiate a disciplinary process if a suspected irregularity is identified during the inspection or in handling complaints or referrals from other regulators. The FRC will continue to be responsible for conducting independent investigations into relevant irregularities by LEAs. Disciplinary action may be imposed on a LEA, a person approved to be its audit engagement authorised person and/or a person approved to be its engagement quality control reviewer, if the LEA and/or the person concerned (as the case may be) is proved to have committed an irregularity in relation to an audit engagement. In addition to other actions, the FRC may, having regard to the inspection report and any submissions or representations made in respect of the matters raised in the report, initiate its investigation/disciplinary processes with regard to LEAs and their listed entity engagements if a suspected auditing/reporting irregularity is identified. The FRC would also be required to put in place appropriate arrangements to ensure that its investigative staff would not be involved in the disciplinary process and the determination of disciplinary sanctions.</p>	<p>EC: yes IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> - The FRC will be able to both initiate and conduct investigations re. LEAs, meeting the EC requirements - Any experts it engages for specific assignments cannot be conflicted, which should be covered by the existing FRCO section on ‘Avoidance of conflicts of interest’ - For IFIAR, the FRC’s proposed investigative / enforcement powers appear appropriate. Its existing arrangements for managing complaints from third parties should also be appropriate. IFIAR requires that regulators have adequate and appropriate such mechanisms

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont'd)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
3	<p>Principles of public oversight (Article 32 of SAD)</p>			
3.7	<p>6. The competent authority shall be transparent. This shall include the publication of annual work programmes and activity reports.</p>	<p>IFIAR Principle 3: Audit regulators should be transparent and accountable.</p> <p>IFIAR Principle 3 explanatory material: The audit regulator should have public accountability in the use of its powers and resources to ensure that the audit regulator maintains its integrity and credibility. Further, the decisions and actions of the audit regulator should be subject to appropriate scrutiny and review, including appeal to a higher authority. Transparency should include the publication of annual work plans and activity reports, including the outcome of inspections either in the aggregate or on a firm-by-firm basis.</p>	<p>FRC: It will be a statutory requirement that the FRC publishes reports in its own name periodically to inform the public of the performance of its oversight functions re. registration, CPD and standard-setting (rather than requiring it to publish the periodic reports received from HKICPA). This will not however cover the FRC’s inspection function, just its oversight functions. Note that the existing FRCO section 20 (1) (a) states that: As soon as practicable after the end of each financial year of the Council, the Council shall submit to the Secretary a report on the activities of the Council for that financial year.</p> <p>Appeal to a tribunal</p> <ul style="list-style-type: none"> • A new independent appeals tribunal will be established for hearing appeals (instead of referring such appeals directly to the court system). This would help reduce the time and cost to be incurred by both the appellant and FRC/the HKICPA Registrar. • Any person who disagrees with a registration decision made by the HKICPA Registrar in respect of him – e.g. a decision to reject a registration application/ renewal application or to remove his name from the register or who is aggrieved by a disciplinary decision made in respect of him by FRC – may apply to the proposed new independent appeals tribunal for a review of the decision within 21 days after a notice of the relevant decision has been served upon him. • The independent appeals tribunal shall comprise a chairman, who should be a person qualified for appointment as a judge of the High Court and two members who are not public officers. All of them are to be appointed by the Chief Executive. • In terms of the review proceedings, it is proposed that the independent appeals tribunal: <ul style="list-style-type: none"> - may confirm, vary, reverse, set aside the relevant decisions or remit the matter to FRC/the HKICPA Registrar with any directions that it may consider appropriate; - will determine any relevant question or issue on the basis of standard of proof applicable to civil proceedings in a court of law; - will give both the applicant and FRC/the HKICPA Registrar an opportunity of being heard in reviewing a decision; and - will be empowered to obtain evidence, including ordering a person to attend before it to give evidence, and to prohibit the disclosure of evidence it receives at any sitting which is held in private. 	<p>EC: yes IFIAR: yes</p> <p>To note:</p> <ul style="list-style-type: none"> - The future FRC’s policies and procedures will need to ensure that the annual work plans and activity reports / overall inspection results are published annually

2.2 Hong Kong – IFIAR-EC gap analysis per the Government’s consultation and related conclusions (cont’d)

	EC equivalence requirements	IFIAR	Features of proposed Hong Kong audit oversight system for LEAs	Compliance status
3	Principles of public oversight (Article 32 of SAD)			
3.8	<p>7. The system of public oversight shall be adequately funded and shall have adequate resources to initiate and conduct investigations, as referred to in paragraph 5. The funding for the public oversight system shall be secure and free from any undue influence by statutory auditors or audit firms.</p>	<p>IFIAR Principle 2 explanatory material: The audit regulator should have a stable source of funding, which is secure and free from influence by auditors and audit firms and sufficient to execute its powers and responsibilities.</p>	<p>See above (1.2 and 3.4)</p>	<p>EC: yes IFIAR: yes</p>
3.9	<p><i>No direct equivalent in SAD</i> Note that the SAD itself requires EEA audit regulators to cooperate with other EEA audit regulators, subject to certain conditions, but does not impose these requirements on non-EEA regulators or on third country auditors in order to be deemed equivalent. The new Regulation (EU) 537/2013 on specific requirements regarding statutory audit of PIEs organises cooperation between EEA competent authorities through the CEAOB. The tasks of the CEAOB include contributing to the technical assessment of public oversight systems of third countries and to the international cooperation between Member States and third countries in that area, as referred to in Articles 46(2) and 47(3) of SAD. A form of cooperation ('working arrangements on the basis of reciprocity') is one of the conditions to be met under Article 47 to allow EEA auditors' working papers to be transferred to a non-EEA regulator (subject to a national security exemption) but this is not a pre-requisite for equivalence.</p>	<p>IFIAR Principle 7: Audit regulators should make appropriate arrangements for cooperation with other audit regulators and, where relevant, other third parties. IFIAR Principle 7 explanatory material: Taking into account the global nature of the financial markets, where necessary and relevant, cooperation and information sharing with other audit regulators and other third parties, including financial market regulators, is helpful to improve audit quality. Audit regulators should provide timely assistance to each other within reasonable limits. Arrangements should be in place for sharing information between audit regulators and other regulators (or between parts of the audit oversight system if it involves more than one body), and for protecting the confidentiality of such information.</p>	<p>FRC: the FRC will be vested with the statutory powers to receive and make decisions on applications for recognising overseas auditors of specific overseas entities which have been approved for listing in Hong Kong, noting that it will be best placed to make such decisions in an independent and unbiased manner. Overseas auditors who wish to enter into audit engagements with specific overseas entities approved for listing in Hong Kong shall apply to FRC for recognition in respect of such engagements. The FRC will take into account the regulatory regime of overseas regulators before entering into an agreement with them. An applicant for recognition as an overseas auditor of a specific overseas entity listed in Hong Kong must meet the following criteria: (a) the auditor is a member of a body of accountants recognised by FRC; (b) there is in force an agreement of mutual or reciprocal cooperation arrangement between the overseas regulator of the auditor and FRC; and (c) they must demonstrate to the satisfaction of FRC that they have adequate resources and possesses the capability to perform the audit of the relevant overseas entity listed in Hong Kong. The FRC will issue guidance notes on what would be taken into account in considering an application for recognition from overseas auditor.</p>	<p>EC: n/a IFIAR: yes To note:</p> <ul style="list-style-type: none"> - The future FRC's policies / procedures should set out detail on how the FRC will cooperate and share information with other audit regulators (and third parties) - There are a number of cooperative MOUs in place with domestic and overseas regulatory authorities. While the FRC cannot currently enter into MOUs with IFIAR members because it does not have inspection and enforcement powers, this is likely to be addressed by the proposed reforms (as they relate to LEAs)

Appendix: Glossary

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- Audit Regulation (AR)
- Chief Executive of the Hong Kong Special Administrative Region (CE)
- Committee of European Audit Oversight Bodies (CEAOB)
- Continuing Professional Development (CPD)
- Continuing Professional Education (CPE)
- European Audit Inspection Group (EAIG)
- European Commission (EC)
- European Economic Area (EEA)
- European Securities and Markets Authority (ESMA)
- European Union (EU)
- Financial Reporting Council (FRC / HK FRC)
- Financial Reporting Council Ordinance (FRCO)
- Hong Kong Institute of Certified Public Accountants (HKICPA)
- International Auditing and Assurance Standards Board (IAASB)
- International Ethics Standards Board for Accountants (IESBA)
- International Forum of Independent Audit Regulators (IFIAR)
- Limited Liability Partnership (LLP)
- Listed entity auditor (LEA)
- Memoranda[um] of Understanding (MOU)
- Professional Accountants Ordinance (PAO)
- Public Company Accounting Oversight Board (PCAOB or 'the Board')
- Public Interest Entity[ies] (PIE[s])
- Statutory Audit Directive (SAD)
- Stock Exchange of Hong Kong (SEHK)



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