



**Hong Kong Institute of Certified Public Accountants
Submission to the Panel on Administration of Justice
and Legal Services Meeting on 27 March 2006 at 4:30 pm**

Limited Liability for Professional Practices

HKICPA comments on the LC Paper No. CB(2)1371/05-06(01)

Introduction

1. The Hong Kong Institute of Certified Public Accountants ("Institute") is deeply disappointed that the Administration has concluded on the issue of Professional Liability Reform for the remainder of the Chief Executive's term of office without consulting the Institute as we requested in our letter to the Department of Justice on 24 November 2005. Had the Administration consulted the Institute, we would have been pleased to have explained the issues further and assisted in any necessary studies.
2. The Institute fully agrees with the Administration's view that "the full cost of wrong doing should be borne by the wrong doers". What the Institute does not support is the full cost of wrong doing being borne by only one party to the offence, while other culpable parties may have their liability effectively limited or ignored. It seems inequitable that the profession is facing increasing liabilities while others in the business community, including directors, financial advisors, analysts, valuers and sponsors, may avoid the consequences of their actions through incorporation (whereas auditors remain personally liable even if their practice is incorporated) and are not required to hold insurance (thus limiting the incentive to sue them).
3. Our proposal for liability reform covers issues of economic loss only. We are not seeking changes to personal injury liability or wholesale tort reform.



4. The issues we wish to bring to your attention can be summarised under four headings:
 - (i) Professional liability reform is in the public interest.
 - (ii) Reform is urgent and should not be delayed.
 - (iii) The proposed liability reform does not affect consumer rights.
 - (iv) Pro forma legislation is already available.

Professional Liability Reform is in the Public Interest

5. The Institute reiterates its belief that Hong Kong's liability framework has not evolved in step with developments in the economic, financial and litigious environment in which the Institute's members are currently practising. It is no longer appropriate to the nature of work performed by professionals in Hong Kong. Hong Kong has transformed itself over the last ten years from a local financial centre to a global financial centre and is one of the world's largest markets in terms of funds raised. This increasing globalization results in the need for an appropriate liability framework for the business community and other risks arising from cross border transactions.
6. The increased internationalization of commerce has resulted in the development of an increasingly litigious environment globally while Hong Kong does not provide the legal protections available in other similar jurisdictions. This is especially important in that Hong Kong is the focus of fund raising for Mainland enterprises, creating an increase in the volume and scale of assurance work whilst the liability framework remains unchanged. Further, adequate insurance cover is becoming increasingly scarce and practices large and small are refusing work as the risks outweigh the rewards.

7. All of the above factors raise the potential for the collapse of one or more of the major accounting firms, with the consequential impact on Hong Kong's reputation and status as a global financial centre.
8. Commerce is an international activity with rapidly developing international accounting and auditing standards. Most sophisticated jurisdictions have or are introducing liability reforms as is shown in the following table. If Hong Kong is left behind, Hong Kong will become less attractive to talented individuals necessary for high-level financial activity, which will inevitably reduce Hong Kong's competitiveness as a global financial centre.

	Australia	Canada & Bermuda	UK	Other EU Countries (Notes 1 and 2)	USA	Hong Kong	Singapore
Proportionate Liability	✓	✓	✓ Proposed	✓	✓		
Ability to limit liability contractually	✓			✓	✓		
Limited Liability Partnerships		✓	✓	✓	✓		✓
Corporate Practices	✓		✓	✓		✓	✓
Statutory Liability cap	✓			✓			

Note 1: The 8th Directive of the European Union provides that all member states should introduce liability reform provisions in their member states.

Note 2: EU Countries include Germany and Italy and very recently Belgium, Denmark and Spain.

9. From the table above, Hong Kong is notably short of support for its professions compared to its international counterparts. As a key market globally for IPOs and with Mainland-related enterprises expecting bigger fund raisings in the next 5 years, the Hong Kong financial markets are poised to grow rapidly with consequent benefits for Hong Kong generally.



Hong Kong cannot afford to be out of step with the other major capital markets.

The Urgency of Reform

10. There has been an increased level of risk arising from assurance work such as:
 - The audits of subsidiaries of US SEC registrants;
 - Compliance evaluations in relation to internal controls brought about by the US Sarbanes-Oxley Act;
 - Compliance evaluations in relation to internal controls requested by directors of Hong Kong listed companies due to new Corporate Governance requirements;
 - Increasing listing of Mainland companies who use Hong Kong as the primary market;
 - Requests to reporting accountants by sponsors of listing companies to produce “Long Form” reports due to changes in Listing Rules;
 - Assisting in the extraction of financial information for publication in the public interest; and
 - Requests to reporting accountants by listed issuers to report on profit forecasts and projections (involving valuation of assets or businesses) as required by Listing Rules.

11. It is inequitable that those benefiting from the additional risk embodied in the extensive assurance activities are able to limit their liability. For example, companies planning to list and their sponsors have the benefit of limited liability. Further, regulators are increasingly relying on the professional accountant’s opinion. In contrast, those providing assurance are frequently being held responsible for the quality of underlying information as well as their assurance opinions on the quality of that information. That is, more is being asked of the profession without any compensating support. This inequity must be urgently addressed before professionals start to wonder whether the risk inherent in the work outweighs the rewards.



Proportionate Liability Does Not Affect Consumer Rights

12. We disagree that our proposals would have the effect of shifting liability from professional service providers to the consumers as incorrectly stated in paragraph 6 of the DoJ paper submitted to the Panel. Proportionate liability does not impact consumers' rights. Rather, it affects negligent parties by allocating liability in proportion to the share of responsibility for the economic loss caused. Under proportionate liability, auditors would still be responsible for the consequences of their actions and would not be shifting this to consumers.
13. The proposals would mean only that the courts would award damages against a negligent auditor for that proportion of the company's loss that reflects the extent of the auditor's responsibility for the damage suffered. It is not in Hong Kong's interest and not economically efficient or equitable for a market to operate on the expectation that all financial deficiencies will be compensated by any one party (in this case, the auditors who may have performed only a limited role). Proportionate liability provides an equitable result without affecting the rights of the plaintiff.
14. We acknowledge that the introduction of proportionate liability may have the effect that the consumer may not be able to recover the full extent of court-awarded damages. However, we do not agree that this should mean that professionals should automatically fill that shortfall simply because of their deeper pockets. Professionals such as auditors should not be the de facto insurers of all business transactions in which they play a part. Rather, we recommend that the consumer be protected through other means where appropriate.
15. Where the consumer is a member of the business community, it is reasonable to expect that that consumer is able to assess the risk of the transaction at issue and, if the risk is deemed acceptable, carry some of that risk. Where the consumer is not a member of the business community – the so-called “man on the street” – then the introduction of provisions such as a de-minimus cap would serve to protect them.



16. The Institute is not proposing wholesale tort reform. The Institute is proposing that there are areas in which the principle of joint and several liability should continue to operate with normal consequences. These include both personal injury actions and where the defendant has been found by the Court to have caused the damage or loss as a result of fraud, dishonesty or willful default.

Pro forma Legislation is Already Available

17. In respect of proportionate liability, the Institute's proposals are either already set out in existing legislation in Australia, Bermuda and other jurisdiction or require relatively simple modifications to the Companies Ordinance. Relevant material has already been provided to the Administration.
18. In relation to the introduction of a Limited Liability Partnership, the Law Society of Hong Kong has already prepared a draft ordinance for consideration by the Administration.

Summary

19. We note that paragraph 7 of the DoJ paper submitted to this Panel refers to the fact that the professional sectors have been given "a degree of protection under the law". It goes on to refer to the need to balance the protection of the professions by safeguarding the interests of consumers and service users.
20. First, we do not understand what this protection, referred to in the Paper, is in the context of professional liability reform. Second, we believe the Institute has played a significant part in many respects in addressing consumer interest and public expectations including our efforts in bringing about Hong Kong's convergence with international financial reporting and auditing standards, supporting the conduct of Investigation and Discipline of alleged misconduct of auditors by having a majority of lay persons in these



regulatory processes. The Institute has also been a strong supporter of the development of the Financial Reporting Council to further strengthen the regulation of auditors.

21. However, this appears to have been a one-way street. We believe that the balance of protection has in fact swung too far against the profession in recent years. For example, the Securities and Futures Commission has even considered in its recent consultation papers whether professionals should be liable to claims for damages from purchasers in secondary markets, even if the purchasers did not read or rely on the prospectus connected with the original issue of securities in the primary market.

22. We urge a reconsideration of the Administration's decision. Professional liability reform is too important to Hong Kong to defer until some unspecified future time. Accordingly, we welcome the suggestion in the letter from the Department of Justice to the Hon. Mandy Tam on 10 March 2006 that we should meet with the Financial Services and Treasury Bureau to discuss this matter further. Depending on the outcome of this Panel, we will be contacting them to urge a reconsideration of the Administration's decision.

Hong Kong Institute of CPAs
21 March 2006