



8 December 2010

By E-mail to: markt-greenpaper-audit@ec.europa.eu

Our Ref.: ECGP/CJ

European Commission
Brussels
Belgium

Dear Sirs,

GREEN PAPER
Audit Policy: Lessons from the Crisis

The Hong Kong Institute of Certified Public Accountants ("the Institute") is the only statutory licensing body of accountants in Hong Kong responsible for professional training, development and regulation of the accountancy profession. The Institute sets auditing and assurance standards, ethical standards and financial reporting standards in Hong Kong.

The Institute shares the wish of other professional bodies and stakeholders to achieve a global consensus on measures and initiatives in the area of statutory audit, with the aim of enhancing confidence in financial information produced for global capital markets. We support the constructive debate instigated by the European Commission (EC) in publishing this Green Paper. In view of the amount of discussion and consultation that has been generated around various aspects of audits and auditors over the last few years it is very useful to have a single consultation that brings together many of those matters.

Responses to the specific questions in the Green Paper are attached at **Annex 1**. The following comments set out the Institute's views on matters of principle to set out the context in which detailed responses have been given.

The Institute believes that audit is critical to the effective operation of capital markets and that quality of audit should be central to any consideration of changes to audit policy or framework. Audit is however only one element and should not be considered in isolation but in the context of the underlying reporting and governance frameworks that affect entities subject to audit.

The Institute is not aware of evidence that failure of the current audit model was a causal factor in the global financial crisis. However, we support continuous review and improvement in respect of the role and quality of corporate governance, financial reporting, securities regulation and audit. The audit profession is constantly looking at ways to evolve, maintain its relevance and add value in the face of changing market situations and stakeholder expectations. Change must be based on objective



assessment and introduced following rigorous and timely research, cost-benefit assessment and broad consultation and, above all, be in the public interest. An objective of changes to audit policy, models and frameworks should always be to improve audit quality.

The audit profession is actively involved in debates at the global level on "the future of audit" that have raised many interesting questions on the suitability of the current audit model and what the audit of the future may entail. The Institute believes that the audit profession is receptive to and often the instigator of change. However, change must be considered in the round, for example if the scope of audit is expanded and auditor reporting becomes directed at a wider range of stakeholders there must be a corresponding acknowledgment that issues around increased exposure to litigation and liability need to be addressed.

The Institute notes and supports the Commission's recognition that audit is a global service with implications in the global environment. Audits of significant listed entities are approached by audit firms on a global basis. Consideration of changes to audit policy must take into account global and local factors and implications.

The Institute suggests that the focus of the debate on audit policy and in particular the questions raised about auditor oversight and regulation should be on audits of listed companies and other public interest entities. The Green Paper includes some commentary and questions on SMEs and SMPs and while these are important sectors that should not be overlooked care must be taken to ensure that changes made to address audits of listed companies and other public interest entities do not result in disproportionate and detrimental consequences for SMEs and SMPs.

The Institute will be interested in the results of the consultation and the potential implications for audit and auditors on a national and global level. The Institute would be very pleased to participate in the forum that is planned by the Commission to take place in February 2011 to discuss the responses to the Green Paper.

If you require any clarification on the above comments or responses to specific questions please do not hesitate to contact me at chris@hkiipa.org.hk.

Yours faithfully,

Chris Joy
Executive Director

CJ/dy
Encl.

Hong Kong Institute of CPAs

Responses to questions in EC Green Paper, Audit Policy: Lessons from the Crisis

- (1) Do you have general remarks on the approach and purposes of this Green Paper?

See general comments in covering letter.

- (2) Do you believe that there is a need to better set out the societal role of the audit with regard to the veracity of financial statements?

The Institute supports continuing efforts to encourage debate to clarify the role of audit and stakeholder expectations. A clear understanding of the value of audit is an essential base for consideration of possible changes to the current audit model and the scope of audit. The Institute supports consideration of different audit models to meet stakeholder expectations. However, changes in the scope of audit should consider the implications on auditor liability and equal consideration should be given to ensuring that scope amendments do not result in excessive liability burdens.

- (3) Do you believe that the general level of "audit quality" could be further enhanced?

The Institute believes that in general there is no fundamental problem with audit quality and implications that audit quality is not what it could be must be backed up with evidence. The audit profession continues to hold quality as paramount and continues to explore ways in which the quality of audit can be improved. The Institute supports this stance and works actively with its members and firms to support and develop audit quality.

- (4) Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such a purpose?

The current audit model is not designed to provide comfort on the financial health of companies but results in an opinion on the truth and fairness of a set of financial statements. Audit provides a view on historical information. The current audit model is fit for this purpose. If the financial reporting model changes to include disclosures on financial health and other matters then the audit profession should look to providing additional and appropriate assurance on such disclosures. As indicated above (Question 2) the Institute supports open and rational debate on the future role of audit.

- (5) To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to users?

The Institute supports full and open dialogue between all stakeholders to facilitate a common understanding and appreciation of the role of audit. However, disclosure of detailed methodology may not achieve this objective and may encourage focus on detail of procedures rather than higher level principles and objectives. Transparency of disclosure and reporting is further addressed in responses to Questions 7 and 8.

- (6) Should "professional scepticism" be reinforced? How could this be achieved?

Professional skepticism is required to be exercised for every audit and is addressed in the ISAs. Professional skepticism is a state of mind and cannot be taught like many areas of technical expertise. It is an attribute that is developed through experience and development within a strong professional and ethical environment.

- (7) Should the negative perception attached to qualifications in audit reports be reconsidered? If so, how?

A qualified audit report inevitably gives a negative message. There has been considerable debate about the form of the audit report and auditor communication with stakeholders e.g. IOSCO consultation on auditor communication, that has not yet reached a conclusion. Considering whether the form and content of the audit report should be amended will necessarily have to address wider issues such as the scope and role of audit and disclosure responsibilities of company management. This matter is also linked to the comments made in response to Question 5.

- (8) What additional information should be provided to external stakeholders and how?

The primary responsibility for providing information to stakeholders is with those charged with governance of the entity subject to audit. If the scope of such disclosure is expanded there will need to be careful consideration of the type and degree of assurance that auditors can provide over this information. There is potentially much additional information that auditors could provide assurance on for the benefit of different stakeholders. The Institute believes that the profession is willing to take on this challenge in the right reporting and legal environment.

- (9) Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved?

The Institute supports the need for regular dialogue between all parties involved in management, governance and audit of an entity. Audit committees should be supported by the provision of guidance on their roles and responsibilities.

- (10) Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?

The Institute is of the view that as reporting frameworks change to accommodate such matters as CSR then there is need for debate on how the role of audit should also evolve to provide appropriate assurance on new areas of reporting. There is already considerable work being done on assurance frameworks around CSR and Integrated Reporting. The Institute supports such developments and believes that changes should be the result of a market led approach rather than a statutory requirement.

- (11) Should there be more regular communication by the auditor to stakeholders? Also, should the time gap between the year end and the date of the audit opinion be reduced?

The issue of communication between auditors and stakeholders has been referred to in the answers to previous questions. What is communicated and by whom should be determined by the conclusions of debate on the role of audit and respective responsibilities of auditors and those charged with governance. The timing of reporting is driven by market deadlines and is addressed primarily by market regulators. Significant reductions in reporting deadlines will result in more pressure on companies to meet market demands and may have a negative impact on quality of financial reporting.

- (12) What other measures could be envisaged to enhance the value of audits?

Please refer to previous comments on the role of audit and the relevance of the current audit model.

- (13) What are your views on the introduction of ISAs in the EU?

Hong Kong converged with ISAs in 2005 and HKSAAs remain converged with ISAs. The Institute fully supports the work done by the IAASB in developing a robust and coherent set of auditing standards and believes that adoption across all jurisdictions would be a positive step that would recognize the global nature of business and auditing.

- (14) Should ISAs be made legally binding throughout the EU? If so, should a similar endorsement approach be chosen to the one existing for the endorsement of International Financial reporting Standards (IFRS)? Alternatively, and given the current widespread use of ISAs in the EU, should the use of ISAs be further encouraged through non-binding legal instruments (Recommendation, Code of Conduct)?

The Institute supports the adoption of ISAs. The method of adoption is an internal matter for the EU on which the Institute has no view. The Institute would recommend that any legally binding approach does not result in making the process of updating or changing standards unduly cumbersome.

- (15) Should ISAs be further adapted to meet the needs of SMEs and SMPs?

The Institute is of the view that ISAs are written at a level of principle and in a way that allows them to be adopted effectively for audits of all types of entity. ISAs are scaleable and can be used effectively in the audit of SMEs therefore no further adaptation is necessary.

- (16) Is there a conflict in the auditor being appointed and remunerated by the audited entity? What alternative arrangements would you recommend in this context?

The Institute does not believe that appointment and remuneration by the audited entity in itself creates a conflict for the auditor. Existing governance models include significant safeguards e.g. appointment at the AGM and role of

the audit committee that are effective in minimising conflicts. In considering alternative arrangements due consideration must be given to the potential down side of separating appointment and remuneration from the audited entity.

- (17) Would the appointment by a third party be justified in certain cases?

In principle the Institute does not believe that appointment of auditors by a third party would be justified or necessary. It does acknowledge that there may be some extreme situations involving public interest issues where appointment by a third party may be appropriate.

- (18) Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?

This question suggests that there should be mandatory rotation of audit firms after a specified period of time. The Institute does not support this view. An Italian study has concluded that mandatory rotation actually increases concentration in the audit market with audits moving within the Big 4 or from smaller firms to the Big 4 – but not in the other direction. The Institute would also be concerned that an imposed severance of auditor/auditee relationship may have negative implications for audit quality and that enforced changes of auditor may result in increased costs for companies.

- (19) Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?

The Institute does not agree that the provision of non-audit services by audit firms should be prohibited. Provisions in the IFAC Code of Ethics and requirements of ISAs regarding the need for independence and the consideration of threats and safeguards provide a robust and effective framework to ensure auditors remain independent. The Institute would also disagree with the idea floated in the Green Paper of "pure audit firms". The Institute believes that the use of expert consultants by multi-disciplinary firms in complex audits enhances quality by bringing expertise to bear on specialist areas. On a wider point the Institute is concerned that to restrict firms to the provision of audit services only would be detrimental to the quality of the profession by reducing its attractiveness to quality entrant candidates. The Institute is also concerned that such prohibition would have a disproportionate negative effect on the business of SMPs.

- (20) Should the maximum level of fees an audit firm can receive from a single client be regulated?

The Institute does not believe that the maximum amount of fees from a single should be determined by regulation. The existing provisions within the IFAC Code of Ethics identifies the potential threat to independence by high levels of fees and require safeguards to be implemented to address such threats, or for the engagement to be declined or terminated where effective safeguards cannot be implemented.

- (21) Should new rules be introduced regarding the transparency of the financial statements of audit firms?

The Institute supports transparency in all forms of reporting. However, the Institute has reservations about focusing on transparency in financial reporting by firms if the overall objective is to enhance audit quality. Efforts should be concentrated on increasing transparency of what has been done in the audit process and how audit provides value to stakeholders. The UK FRC has published an Audit Firm Governance Code which may be a good model to follow in promoting consistency in governance and transparency by audit firms around the world.

- (22) What further measures could be envisaged in the governance of audit firms to enhance the independence of auditors?

Auditor independence is governed by requirements set out in ethical, quality control and auditing standards and is monitored by oversight bodies and regulators. The Institute's view is that these arrangements are sufficiently robust to ensure auditor independence. The Institute is aware of the Audit Firm Governance Code published in the UK that includes the requirement for provision of INEDs.

- (23) Should alternative structures be explored to allow audit firms to raise capital from external sources?

The Institute is of the view that restricting ownership of audit firms to a majority of registered auditors, as is the case in Hong Kong and other significant jurisdictions provides comfort as to the competence and independence of audit firms. There is no wish to change the current situation in Hong Kong which is prescribed in legislation. The Institute believes that if other jurisdictions do explore ways to allow capital to be raised from other sources with the aim of allowing more firms into the market for listed company audits there should be no compromise of audit quality or the integrity of the audit profession as a result. The Institute has responded to IOSCO consultation on this subject in a consistent manner.

- (24) Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?

The Institute is of the view that many issues around group audits raised in the Green paper have been addressed by the IAASB in the development and issue of (clarified) ISA 600. This standard incorporates much improved and extended requirements and guidance in the conduct of group audits. The Institute suggest that audit firms are given time to apply ISA 600 before evaluating its effectiveness and considering the need for any further promulgations on the conduct of group audits.

- (25) Which measures should be envisaged to improve further the integration and cooperation on audit firm supervision at EU level?

This is an EU-specific question and the Institute has no suggestions on integration of supervision at EU level. As a matter of principle the Institute

does encourage co-operation between national regulators and consistency in approach to regulation.

- (26) How could increased consultation and communication between the auditor of large listed companies and the regulator be achieved?

The Institute is of the view that communication between auditors and regulators is essential. The Green Paper refers to communication between securities regulators rather than audit regulators. To efficiently regulate markets regulators should be in regular dialogue with auditors and companies to ensure all parties work together to contribute to transparency of market activities.

- (27) Could the current configuration of the audit market present a systemic risk?

The Institute agrees that concentration of listed company audits in the Big 4 may suggest greater market risk in the event of the failure of one of those firms. However, the concentration is itself market driven and the Institute does not support regulatory intervention in the market for audit services. In Hong Kong the issue of market concentration may not be as acute as in other jurisdictions. Around fifty audit firms are engaged in audit of Hong Kong listed companies. At 1 December 2009 the Big 4 audited 65% of Hong Kong listed companies (by number).

- (28) Do you believe that the mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non systemic audit firm could act as a catalyst for dynamising the audit market and allowing small and medium-sized firms to participate more substantially in the segment of larger audits?

The Institute is not aware of evidence to support the argument that joint audits increase the participation of smaller firms in listed company audit work. That there are very few joint audits in jurisdictions where they are an option would suggest that companies see them as a less effective and efficient than a sole appointment. Two high profile corporate failures (BCCI and Parmalat) both involved joint audit arrangements. The Institute would also be concerned that defining firms as "systemic" or "non-systemic" could in itself reinforce the perceived bias towards the Big 4.

- (29) From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?

The Institute does not support mandatory rotation of audit firms after a specified period of time. An Italian study has concluded that mandatory rotation actually increases concentration in the audit market with audits moving within the Big 4 or from smaller firms to the Big 4 – but not in the other direction. The Institute would be concerned that an imposed severance of auditor/auditee relationship may have negative implications for audit quality. Mandatory rotation of auditors for banks was introduced in Singapore a few years ago but withdrawn when it became apparent that the requirement was building inefficiencies into the system.

- (30) How should the "Big Four Bias" be addressed?

As noted in the answer to Question 27 the market share of the Big 4 is smaller in Hong Kong than many other jurisdictions and in China the authorities are encouraging the growth and development of large "local" firms. The Institute would not support regulatory intervention in appointment of auditors.

- (31) Do you agree that contingency plans, including living wills, could be key in addressing systemic risks and the risks of firm failure?

Contingency plans could be an important element, but only one element, of protecting the market against the consequences of a catastrophic failure of a major audit firm. Other matters to consider would include extending the principle and process of liability capping to other jurisdictions.

- (32) Is the broader rationale for consolidation of large audit firms over the past two decades (i.e. global offer, synergies) still valid? In which circumstances; could a reversal be envisaged?

The basic premise of audit firms looking for ways to provide quality service to global clients is still valid. The suggestion that consolidation of audit firms over the last two decades could or should be reversed is not practical.

- (33) What in your view is the best manner to enhance cross border mobility of audit professionals?

This question addresses specific EU market issues. The Institute has no comment.

- (34) Do you agree with "maximum harmonisation" combined with a single European passport for auditors and audit firms? Do you believe this should also apply for smaller firms?

This question addresses specific EU market issues. The Institute has no comment.

- (35) Would you favour a lower level of service than an audit, a so called "limited audit" or "statutory review" for the financial statements of SMEs instead of a statutory audit? Should such a service be conditional depending on whether a suitably qualified (internal or external) accountant prepared the accounts?

As addressed in Question 15 the Institute believes that "an audit is an audit" and that ISAs are sufficiently scaleable to be applied to audits of all sizes of entity. The term "limited audit" is not helpful as it suggests there could be a two tier system. In jurisdictions where statutory audit is not mandatory for all companies there should be scope and demand for other assurance services offering a different form of assurance than audit. In Hong Kong this is not an issue as all companies are required to have a statutory audit.

- (36) Should there be a "safe harbour" regarding any potential future prohibition of non-audit services when servicing SME clients?

As noted in the answer to Question 19 the Institute is not in favour of the

prohibition of non-audit services.

- (37) Should a "limited audit" or "statutory review" be accompanied by less burdensome internal quality control rules and oversight by supervisors? Could you suggest examples of how this could be done in practice?

As noted in the answer to Question 35 the Institute is not in favour of creating a two tier audit system. If an audit is carried out it should be subject to consistent standards of internal quality control as set out in ISQC 1. As mentioned in the covering letter the Institute is of the view that the efforts of regulators and oversight bodies should be focused on auditors of listed companies and other public interest entities.

- (38) What measures could in your view enhance the quality of the oversight of global audit players through international co-operation?

The Institute believes that there should be co-operation and consistency of practice across national oversight bodies and regulators. IFIAR is currently undertaking work in this respect. The Institute believes that the ultimate aim should be mutual reliance between national bodies to enhance the efficiency and quality of global oversight.