

# **立法會**

## ***Legislative Council***

LC Paper No. CB(1)505/18-19

Ref : CB1/BC/4/17

### **Report of the Bills Committee on Financial Reporting Council (Amendment) Bill 2018**

#### **Purpose**

This paper reports on the deliberations of the Bills Committee on Financial Reporting Council (Amendment) Bill 2018 ("the Bills Committee").

#### **Background**

2. For years, Hong Kong's regulatory regime for auditors has been administered by the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is a statutory professional body established under the Professional Accountants Ordinance (Cap. 50) ("PAO"). HKICPA is empowered under PAO to, among other things set admission and registration criteria and continuing professional development ("CPD") requirements for its members; set accounting, auditing and professional ethical standards; and conduct inspections, investigations and exercise disciplinary powers where warranted over its members.

3. The Legislative Council enacted the Financial Reporting Council Ordinance (Cap. 588) ("FRCO") in July 2006 which established the Financial Reporting Council ("FRC") as an independent investigatory body of auditing and reporting irregularities in relation to listed entities.<sup>1</sup> FRC became fully operational in July 2007. While FRC may initiate investigations on possible auditing irregularities related to listed entities, as well as conduct enquiries on possible non-compliance with the financial reporting requirements by listed

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<sup>1</sup> The key functions of Financial Reporting Council ("FRC") are to: (a) conduct independent investigations into possible auditing and reporting irregularities related to listed entities; (b) enquire into possible non-compliances with financial reporting requirements on the part of listed entities; and (c) require listed entities to remove any non-compliance identified.

entities, it is not empowered to discipline. All other regulatory powers with respect to the audit profession continue to be vested with HKICPA under PAO. FRC will refer relevant cases to other parties for follow-up as necessary.<sup>2</sup>

4. According to the Administration, it has become international standard and practice that regulatory regimes for auditors of public interest entities<sup>3</sup> ("PIE auditors") should be independent of the audit profession and be subject to independent oversight by bodies acting in the public interest. Against this international trend, Hong Kong's present regulatory regime is considered by many as a self-regulatory regime. This has rendered Hong Kong not eligible to be represented on the International Forum of Independent Audit Regulators ("IFIAR"), thus hindering cooperation between Hong Kong and other jurisdictions in the regulation of auditors.<sup>4</sup> The Administration conducted a public consultation in 2014 on the reform proposals ("2014 public consultation") to solicit views on the proposal to introduce an independent oversight regime for the regulation of PIE auditors. Under the reform proposals, FRC will take up the role of an independent auditor oversight body regulating PIE auditors, and be responsible for the inspection, investigation and disciplinary functions with regard to PIE auditors under the new regulatory regime. FRC will also oversee HKICPA's functions of registration of PIE auditors and setting CPD requirements and standards on professional ethics, auditing and assurance in respect of PIE auditors.

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<sup>2</sup> Any auditing or reporting irregularities identified by FRC will be referred to the Hong Kong Institute of Certified Public Accountants ("HKICPA"), while any non-compliances relevant to the Listing Rules will be referred to the Securities and Futures Commission or the Hong Kong Exchanges and Clearing Limited for necessary action.

<sup>3</sup> Public interest entity is defined in clause 5 of the Financial Reporting Council (Amendment) Bill 2018 ("the Bill") to mean a listed corporation (equity) or a listed collective investment scheme.

<sup>4</sup> The International Forum of Independent Audit Regulators ("IFIAR") is an international organization for independent regulators of auditors established in September 2006. Its membership is restricted to regulators that are both independent of the audit profession and engaged in audit regulatory functions in the public interest. At present, IFIAR comprises independent auditor regulators from 53 jurisdictions. IFIAR has become an increasingly influential organization, which convenes to discuss issues relating to international audit quality and regulatory and market developments having an impact on auditing.

## **The Bill**

5. To take forward the reform proposals in the 2014 public consultation, the Administration introduced the Financial Reporting Council (Amendment) Bill 2018 ("the Bill") into LegCo at the Council meeting of 24 January 2018.

6. The Bill seeks to amend FRCO to enhance the independence of the regulatory regime for auditors of listed entities, regulate auditors of listed entities through registration, recognition, inspection, investigation and disciplinary sanctions, provide for a review and appeal mechanism regarding decisions made against auditors of listed entities, provide for the new composition and functions of FRC, provide for levies payable to FRC, and provide for transitional and related matters. The main provisions of the Bill are set out in **Appendix I**.

## **The Bills Committee**

7. At the House Committee meeting on 26 January 2018, Members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix II**. Under the chairmanship of Mr WONG Ting-kwong, the Bills Committee has held seven meetings to study the Bill including one meeting to receive views from 15 deputations/individuals. The Bills Committee has received a total of 26 submissions from deputations/individuals. The list of organizations/individuals who have provided views to the Bills Committee is in **Appendix III**.

## **Deliberations of the Bills Committee**

8. The main subjects deliberated by the Bills Committee are set out below:

- (a) benefits of the new regulatory regime for PIE auditors (paragraphs 9 – 10);
- (b) composition of the post-reform FRC (paragraphs 11 – 16);
- (c) financial arrangement of the post-reform FRC (paragraphs 17 – 29);
- (d) registration and recognition of PIE auditors (paragraphs 30 – 38);

- (e) inspection, investigation, and disciplinary powers of the post-reform FRC (paragraphs 39 – 46);
- (f) function and power of FRC in overseeing HKICPA's performance of functions relating to registered auditors of public interest entities (paragraphs 47 – 50);
- (g) pecuniary penalty on PIE auditors and responsible persons (paragraphs 51 – 58);
- (h) review and appeal mechanism (paragraphs 59 – 61); and
- (i) miscellaneous matters (paragraphs 62 – 64).

#### Benefits of the new regulatory regime for auditors of public interest entities

9. The Bills Committee notes that one of the objectives of implementing the new regulatory regime for PIE auditors is to enable Hong Kong to join IFIAR. Members have enquired about the benefits for Hong Kong joining IFIAR, such as the increases in new jobs for local auditors and number of entities applying for listing in Hong Kong. Members have also enquired about the possible consequences on Hong Kong if it does not implement the new regulatory regime.

10. The Administration has advised that the existing auditor regulatory regime of Hong Kong is considered by many (including the International Monetary Fund ("IMF")) as a self-regulatory regime thus is not desirable from the investor protection perspective. The existing regulatory regime also falls short of the international standard that the auditor oversight body should be independent of the audit profession thereby rendering Hong Kong's auditor regulator not eligible for joining IFIAR. In recent years, IFIAR has become an international leader in driving audit quality matters through discussions among its members on emerging regulatory issues, challenges facing the audit profession, and strategic approaches to sustainable audit quality. Hong Kong cannot participate in IFIAR's work if it is not a member of IFIAR. The Administration has stressed that joining IFIAR would strengthen Hong Kong's cooperation with other jurisdictions in cross-border regulation of auditors, particularly enabling Hong Kong to obtain first-hand information about various auditor regulatory approaches and practices. Such information is useful in further improving the Hong Kong regulatory regime for better investor protection, and to develop cooperation framework with overseas auditor regulators. Moreover, Hong Kong's participation in IFIAR will benefit the local audit profession. Joining IFIAR will demonstrate to the international community Hong Kong's commitment to improving the overall standards of

auditing and ensuring that the local audit profession is working in the public interest. This will help reinforce the trust of companies and investors in the work of the local audit profession, and in turn facilitate further growth and development of the profession. Furthermore, IFIAR membership would enhance the confidence of international and local enterprises and investors in the integrity of Hong Kong's overall financial regulatory regime with regard to the capital market. This will be essential in attracting capital to Hong Kong and conducive to job creation and long-term economic growth.

### Composition of the post-reform Financial Reporting Council

11. The proposed new section 7 of FRCO sets out the following new composition of FRC:

- (a) members of FRC will comprise the following members appointed by the Chief Executive ("CE"):
  - (i) a chairman who is a non-executive director of FRC and a non-practitioner (the proposed new section 7(1)(a));
  - (ii) a chief executive officer who is an executive director of FRC; and
  - (iii) at least seven other members who are either executive or non-executive directors of FRC;
- (b) the number of non-executive directors of FRC must exceed the number of executive directors;
- (c) out of the members appointed by CE, at least two persons should possess knowledge of and experience in PIE engagements so as to ensure sufficient expertise in FRC (the proposed new section 7(4)(a)); and
- (d) the number of members who are non-practitioners must exceed the number of members who are practitioners (the proposed new section 7(3)(a)).

### *The proportion of practitioners and non-practitioners in the Financial Reporting Council*

12. The Bills Committee notes that deputations have expressed diverse views on the proportion of practitioners and non-practitioners in FRC. While some deputations consider that at least one-third of FRC members should be

practitioners having relevant and up-to-date audit skill, knowledge and experience, other deputations suggest that the post-reform FRC should comprise solely non-practitioners which can pave the way for Hong Kong to obtain the European Commission ("EC") equivalence status.<sup>5</sup> Members have enquired whether the Administration has plans to change FRC's composition to enable Hong Kong to obtain the EC equivalence status.

13. The Administration has pointed out that various stakeholders have expressed diverse views on the composition of FRC. The proposed composition provided in the Bill is a relaxation of the present requirement in FRCO under which the majority of FRC members are "lay persons", i.e. non-accountants. A "non-practitioner", as defined in the Bill, means an individual who is not, and has not at any time within the previous three years been a certified public accountant (practicing) or a partner, director, agent or employee of a practice unit. The proposed composition would therefore enable the appointment of suitable and experienced persons to FRC while maintaining the objective that FRC should be independent of the audit profession and the Government. Hence, the proposal in the Bill has struck a proper balance. As IFIAR only requires the governing board of the independent auditor regulator to comprise a majority of non-practitioner members, the proposal in the Bill would enable Hong Kong to be eligible for IFIAR membership.

14. During the course of scrutiny of the Bill, the Administration has advised the Bills Committee that FRC has identified particular difficulties in seeking cooperation with overseas auditor regulators which are the European Union ("EU") member states. The Administration has explained that EU member states when considering cooperation (including exchange of information for regulatory purposes) with an auditor regulator outside EU, have to ensure that the non-EU jurisdictions must meet the "adequacy" test of the relevant article of the Statutory Audit Directive ("SAD") of EC. Such "adequacy" test includes, inter alia, the composition of the governing body of the regulator of the non-EU jurisdiction shall be composed of "all non-practitioners". The Administration has further pointed out that under the multilateral memorandum of understanding ("MMOU") introduced by IFIAR in April 2017 for cross-jurisdictional cooperation, the memorandum does not apply between an EU member state and a non-EU jurisdiction if the latter cannot fulfill the "adequacy" test in EC's SAD. Therefore, even after Hong Kong has been admitted as a member of IFIAR and become a party to the MMOU, the memorandum would not apply between EU member states and Hong Kong so long as FRC cannot fulfill the "adequacy" test. As the proposed

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<sup>5</sup> The European Commission equivalence status mandates the governing board of the auditor regulator to comprise solely non-practitioners.

new section 7(3)(a) of FRCO requires that FRC's governing board to comprise "a majority of non-practitioners", it means that the presence of practitioners is allowed. Hence, the Administration will introduce amendments to the proposed new section 7 of FRCO with a view to change FRC to an "all non-practitioner" governing board. Concurrently, to ensure there is sufficient expertise in FRC, a corresponding change will be made to the proposed new section 7(4)(a) of FRCO such that the threshold of members with "knowledge and experience in PIE engagements" will increase from "at least two" as provided under the Bill to "at least one-third" of the total number of members. Such members may include, for instance, former partners in audit firms who have met the three-year cooling-off period requirement (and are hence not considered practitioners). The Administration has pointed out that the proposed adjustment in the composition of FRC to "all non-practitioners" will remove an identified impediment in meeting EC's "adequacy" test and the proposed increase in the number of FRC members with "knowledge and experience in PIE engagements" would address the profession's concern about the need for sufficient expertise on FRC. The Bills Committee has no objection to the amendments proposed by the Administration.

#### *The Chairman of the Financial Reporting Council*

15. Under the proposed section 7(1)(a) of FRCO, the chairperson of FRC has to be a non-executive director of FRC and a non-practitioner. The Bills Committee has enquired about the rationale for adopting a non-executive director model for the chairmanship of FRC, and sought information on the models adopted by other comparable regulators in Hong Kong and overseas.

16. The Administration considers that the post-reform FRC chairperson should be a non-executive director. Firstly, the chairperson should not be pre-occupied by day-to-day executive responsibilities as he/she should focus on matters relating to the overall direction, policies and strategies of FRC, as well as assessing the effectiveness and efficiency of FRC in discharging its statutory duties, having regard to the international and local developments and practices. Secondly, the chairperson should be independent from the executive arm so as to enhance the internal checks and balances mechanism of FRC, such as ensuring that the executives who have participated in the investigation/inspection or disciplinary processes of a case will not take part in making a disciplinary decision of the same case. In adopting a non-executive director model for the chairmanship of FRC, the Administration has made reference to local and overseas experience. For instance, the auditor regulatory bodies in major overseas jurisdictions (e.g. the United Kingdom ("UK") Financial Reporting Council) are chaired by a non-executive director. Other local financial regulators (including the Securities and Futures Commission ("SFC"), the Mandatory Provident Fund Schemes Authority and the Insurance

Authority ("IA") are also led by non-executive chairpersons.

### Financial arrangement of the post-reform Financial Reporting Council

#### *Annual operating expenses of the post-reform Financial Reporting Council*

17. The Bills Committee notes that the annual budget of FRC will increase from the current some \$30 million to around \$90 million (at 2016 price level) upon implementation of the new regulatory regime for PIE auditors. Some members including Mrs Regina IP, Mr Christopher CHEUNG, Mr Kenneth LEUNG and Mr WU Chi-wai have expressed concern that the substantial increase in FRC's annual budget would put pressure on the levies to be payable by the parties concerned.<sup>6</sup> The Bills Committee has examined the reasons for the increase in the operating cost of the post-reform FRC.

18. The Administration has provided the estimated annual operating expenses of the post-reform FRC with the underlying assumptions of the estimates, which are set out in **Appendix IV**. The Administration considers that the estimated expenses are justified. Firstly, FRC's functions will be substantially expanded under the new regulatory regime. FRC's scope of work will increase by more than three-fold to cover also recurring inspections, enforcement and discipline, recognition of overseas auditors, oversight of HKICPA's regulatory functions in respect of PIE auditors, enhanced cooperation and interface with international bodies and overseas regulators, etc. Secondly, under the new regime, the regulatory functions of inspection and disciplinary proceedings against PIE auditors will be transferred from HKICPA to FRC. FRC will take the opportunity to improve and strengthen the mechanisms and procedures through which it discharges these new statutory functions. For inspection of PIE auditors, FRC will put in place a system which is benchmarked against the international standard and practice in this area. As regards disciplinary proceedings, currently HKICPA discharges this function primarily through Disciplinary Panels, and members of these Panels serve on a pro bono basis. Such a practice has been criticized by IMF as not conducive to the development of expertise and precedents. The post-reform FRC, on the other hand, will be supported by a team of full-time and salaried executives in dealing with disciplinary proceedings. Such arrangements can strengthen Hong Kong's auditor regulatory regime which will in turn further enhance investor protection. Thirdly, the current office premises of FRC are provided by the Companies Registry at a nominal charge of \$1 per year. The post-reform FRC has to rent office accommodation. The annual rental is estimated to be \$8 million (at 2016 price level).

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<sup>6</sup> The Bill introduces three new levies on (a) securities transactions, (b) PIEs, and (c) PIE auditors.



19. The Administration has stressed that the Bill has included a number of measures for monitoring the expenditure of FRC including the requirements for FRC's annual budget to be approved by the Financial Secretary, and FRC's financial statements to be audited by the Director of Audit and to be tabled before LegCo (the proposed amended sections 17, 19 and 20 of FRCO).

20. The Administration has pointed out that the amounts or rates of the levies to be payable by the parties concerned are specified in the Bill, and any future adjustments to such amounts or rates will have to be made by CE-in-Council by way of subsidiary legislation which is subject to negative vetting by LegCo. This arrangement will address the concern that a rise in FRC's expenses will automatically lead to an increase in the amount/rate of levies. Furthermore, the proposed new section 50D of FRCO stipulates that once the reserve of FRC has reached a level equivalent to 24 months of its operating expenses (after deducting depreciation and all provisions), FRC shall review the rate/amount of the levies and consult the Financial Secretary with a view to recommending to the CE-in-Council that the levies be reduced.

*Funding mechanism of the post-reform Financial Reporting Council*

21. At present, FRC is funded through contributions made by four parties, viz. HKICPA, SFC, the Hong Kong Exchanges and Clearing Limited ("HKEX") and the Companies Registry Trading Fund, on an equal basis under a multi-party memorandum of understanding entered into by the four parties at five-year intervals. To ensure stability of funding support, and in accordance with the "user pay" principle and the principle that the independent auditor oversight body should be operationally and financially independent of the Government, the post-reform FRC will be funded by introducing three new levies on (a) securities transactions (to be paid by sellers and purchasers in securities transactions); (b) PIEs; and (c) PIE auditors (the proposed new sections 50A to 50G and the proposed new Schedule 7 of FRCO). Contributions from the three parties will be in the ratio of 50:25:25. Details of the levies proposed in the Bill are shown in the table below.

Levy on securities transactions	Levy on PIEs	Levy on PIE auditors
0.00015% of consideration (paid by each of seller and purchaser)	4.2% of annual listing fee for a calendar year	\$12,310 for a calendar year in respect of every PIE client

22. Some members of the Bills Committee including Mr CHAN Kin-por, Mrs Regina IP, Ms Starry LEE and Mr WU Chi-wai have expressed concern

that the proposed levy for PIE auditors is on the high side thus creating a greater cost burden on small and medium-sized ("SME") PIE audit firms. Mr Christopher CHEUNG has pointed out that the securities industry has reservation over imposing levy on securities transactions which may adversely affect the competitiveness of the Hong Kong securities market. Noting that the proposed contributions from securities transactions, PIEs and PIE auditors to the relevant fund have been changed from equal sharing basis among the three parties as put forward in the 2014 public consultation document to the ratio of 50:25:25 as reflected in levy proposal made under the Bill. Mr CEHUNG has questioned the reasons for making the change and why the securities industry and local investors have not been consulted on the change. The Bills Committee has also sought information on the sources of funding of PIE auditors oversight bodies in major member jurisdictions of IFIAR.

23. The Administration has provided information on the funding sources of PIE auditors oversight bodies in major member jurisdictions of IFIAR which is set out in **Appendix V**. On the proposal of collecting levies from securities transactions, the Administration has responded that enhancement in the PIE auditor regulatory regime will better ensure the integrity of financial reports of PIEs, thereby increasing protection for investors. Thus, it is not unreasonable to charge levy on securities transactions.

24. Regarding the proposed levy on PIE auditors, the Administration has explained that the levy contribution by PIE auditors will account for 25% of the operating costs of the post-reform FRC under the new regulatory regime, and this proportion of funding from the audit profession is the same as that for the existing FRC. With the estimated annual operating costs of the post-reform FRC at around \$90 million (at 2016 price level), the contribution by PIE auditors will be around \$22.5 million. This amount is comparable to the total amount borne by the audit profession for the current operations of FRC and HKICPA in respect of the regulation of PIE auditors. As for the reasons for changing the proportion of contributions by various parties, the Administration has advised that during the engagement with the audit profession for taking forward the legislative amendment exercise after release of the consultation conclusions, the audit profession has reiterated its concern over the regulatory reform bringing about significant changes to the audit profession. Having considered the audit profession's concern about the financial implications of the new regulatory regime on them, especially on SME audit firms, the Administration has proposed for the contributions to the fund by securities transactions, PIEs and PIE auditors in the ratio of 50:25:25 respectively as reflected in the levy proposal under the Bill. The Administration considers that as a whole, the proposed funding mechanism is balanced and reasonable.

25. Section 3(1) of the proposed new Schedule 7 of FRCO in the Bill prescribes the levy on PIE auditors, using a flat fee approach, at \$12,310 for a calendar year in respect of every PIE client ("per client levy") (re. paragraph 21 above). This flat fee per client approach has been adopted by HKICPA since the establishment of FRC for collecting fees from relevant auditors as annual contribution to FRC. Over the past few years, the Administration has indicated to HKICPA that the same calculation basis would be adopted in the Bill unless the audit profession could reach a consensus on an alternative fee collection method. The Administration has informed the Bills Committee that HKICPA has recently advised that the audit profession has reached a broad consensus on an alternative calculation basis to determine the "per client levy" on PIE auditors under the new regulatory regime. According to this alternative basis, half of the levy will be based on the number of PIE clients and the other half will be based on the relevant audit fees received by the PIE auditors. HKICPA considers that this alternative calculation basis will represent a fair and reasonable calculation method reflecting the varying sizes of PIE auditors and complexities of PIE audits under the new regime.

26. To cater for the change in the calculation basis, the Administration will move amendments to section 3(1) in the proposed new Schedule 7 to FRCO to provide for the new agreed formula, i.e. the levy on a PIE auditor will be the sum of a flat fee at \$6,155 for a calendar year in respect of every PIE client and a variable fee at 0.147% of the total remuneration received by the PIE auditor for conducting audits for PIE clients in a calendar year. The proposed amendments also add a new section 3(2A) in the proposed new Schedule 7 to FRCO providing how HKICPA and FRC may ascertain the relevant information in calculating the levies payable by each PIE auditor. The Administration has stressed that notwithstanding the change in the calculation basis, the contribution by PIE auditors as a whole to the estimated annual budget of the post-reform FRC will remain at 25% of the total (i.e. \$24.75 million at 2019 price level). The Bills Committee has no objection to the proposed amendments.

27. A number of members of the Bills Committee including Mr WONG Ting-kwong, Mr Kenneth LEUNG, Mrs Regina IP, Ms Starry LEE, Mr WU Chi-wai and Mr Christopher CHEUNG consider that the Government should be one of the funding sources of the post-reform FRC. There is also a suggestion for the Government to provide a seed money for the post-reform FRC to support its operation in the initial years and to subsidize part of the proposed levies payable by the three parties. Mr Kenneth LEUNG has further suggested that the Government should provide a seed money of \$600 million to FRC.

28. The Administration has reiterated that in devising the funding mechanism for the post-reform FRC, its key considerations are stability of

funding support for FRC, the "user pay" principle and the principle that FRC as an independent auditor oversight body should be operationally and financially independent of the Government. As such, the Government should not be a recurrent funding source for the operation of the post-reform FRC. This is consistent with the aforementioned principle that FRC as an independent auditor regulator should be financially and operationally independent from the Government, and is also in line with the practices in most of the other comparable overseas jurisdictions.

29. Taking into account the need for the post-reform FRC to be provided with adequate funding in order to prepare for the transition to the new regulatory regime and to discharge its full range of statutory functions, and having considered the views of Bills Committee members and other stakeholders, CE announced in the 2018 Policy Address that, after the enactment of the Bill, the Government will inject no less than \$300 million into a seed capital for FRC. The Administration will work out the parameters within which the seed capital can be deployed (including assisting the post-reform FRC in meeting the necessary one-off and contingency expenses for its transition into a full-fledged regulatory body), and will consider making use of part of the seed money to alleviate the burden of the levy payers in the implementation of the new regulatory regime. The Bills Committee welcomes the Government's provision of seed capital for FRC.

#### Registration and recognition of auditors of public interest entities

30. At present, FRCO does not provide for registration and recognition of PIE auditors. The proposed new Part 3 of FRCO provides for the registration of local auditors by HKICPA as registered PIE auditors, and the recognition of overseas auditors and certain Mainland auditors by FRC as recognized PIE auditors. A person who undertakes or carries out any PIE engagements commits an offence if the person is not a registered or recognized PIE auditor.<sup>7</sup>

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<sup>7</sup> The offence is punishable, on conviction on indictment, to a fine of \$1,000,000 and to imprisonment for two years and, for a continuing offence, to a further fine of \$20,000 for each day during which the offence continues; and on summary conviction, to a fine of \$100,000 and to imprisonment for six months, and for a continuing offence, to a further fine of \$2,000 for each day during which the offence continues.

*Registration of auditors of public interest entities*

31. A practice unit<sup>8</sup> which applies to HKICPA to become a registered PIE auditor is required to provide in its application the names of the following three categories of persons, who, in essence, perform important roles in PIE engagements and each of these persons must be fit and proper to be certified public accountants (referred to as "responsible persons" in the Bill):

- (a) "engagement partners", viz. individuals who are authorized by the practice unit or PIE auditor to be responsible for PIE engagements carried out by the unit or auditor;
- (b) "engagement quality control reviewers", viz. individuals who are authorized by the practice unit or registered PIE auditor to oversee the engagement quality control reviews in relation to the PIE engagements carried out by the unit or auditor; and
- (c) "quality control system responsible persons", viz. individuals who are authorized by the practice unit or registered PIE auditor to be responsible for the quality control system of the unit or auditor.

32. The responsible persons will be subject to a "fit and proper" test, referred to in the proposed section 20H(2)(d) of FRCO with the Bill setting out the key factors to be considered which are modelled on the existing "fit and proper" test applied by HKICPA.<sup>9</sup> Under the proposed new section 20ZX of FRCO, the HKICPA Registrar will be the statutory registrar for PIE auditors and will be responsible for, inter alia, maintaining a new register of PIE auditors for public inspection.

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<sup>8</sup> A practice unit is defined in section 2(1) of the Professional Accountants Ordinance (Cap. 50)("PAO") to mean: (a) a certified public accountant (practising) practising accountancy on his own account pursuant to PAO; (b) a firm of certified public accountants (practising) practising accountancy pursuant to PAO; or (c) a corporate practice which is a company registered under section 28E of PAO.

<sup>9</sup> The Bill stipulates that, in determining whether a responsible person is a fit and proper person to be a certified public accountant, the HKICPA Council must have regard to the following matters—

- (a) the professional qualifications, knowledge, skill and experience of the person;
- (b) the person's reputation, character, reliability and integrity;
- (c) the person's financial status or solvency;
- (d) whether any disciplinary action has been taken against the person by the FRC or the HKICPA; and
- (e) whether the person has been convicted of any offence in Hong Kong or elsewhere.

*Recognition of overseas and Mainland auditors of public interest entities*

33. The Bills Committee notes that same as the present arrangement, under the new regulatory regime, an overseas corporation or collective investment scheme ("CIS") listed in Hong Kong or seeking to be listed in Hong Kong may seek the approval of HKEX or SFC (as the case may be) to engage an overseas audit firm to undertake its PIE engagements. If the requisite approval is obtained, the overseas corporation or CIS concerned may apply to FRC to recognize the overseas auditor it intends to engage as a recognized PIE auditor. The eligibility criteria to be a recognized PIE auditor are largely modelled on the prevailing requirements of HKEX and SFC with suitable modifications and adaptations.

34. During the scrutiny of the Bill, FRC has advised that it has found a number of implementation problems associated with the proposed new section 20ZF(2)(c) of FRCO which provides that there must be a regulatory cooperation agreement between FRC and the corresponding overseas regulator before FRC may recognize the overseas auditor concerned. Having regard to recent developments in the international arena and having reached out to its overseas counterparts, FRC has realized that there is no assurance that overseas auditor regulators will be willing to enter into bilateral cooperation agreements with other jurisdictions. Even if there are prospects of reaching a bilateral cooperation agreement, the process may well be protracted which can drive away potential corporations planning to list in Hong Kong. At the same time, FRC notes that some stakeholders have expressed concern about the possible impact of the new requirement of regulatory cooperation agreement on the timely approval of applications for initial public offerings ("IPOs") from overseas corporations which would wish to engage overseas auditors. Thus, the Administration considers that the proposed new section 20ZF(2)(c) of FRCO is unduly restrictive, and will move an amendment to remove the section from the Bill.

35. While members have not raised objection to removing the proposed new section 20ZF(2)(c) of FRCO from the Bill, Mr Kenneth LEUNG is concerned whether deleting the provision would make it more difficult for FRC to enter into regulatory cooperation agreements with other overseas regulators. The Administration has advised that it is not envisaged that the situation will arise as overseas regulators will examine the robustness of Hong Kong's auditor regulatory regime in deciding whether to conclude regulatory cooperation agreements with Hong Kong. Notwithstanding the deletion of the proposed new section 20ZF(2)(c) section, the Administration will ask FRC to pursue mutually agreed regulatory cooperation mechanism with respective overseas regulators as far as possible.

36. As regards auditors in the Mainland, the Bills Committee notes that Hong Kong and the Mainland have entered into a reciprocal arrangement ("the Reciprocal Arrangement") in 2009 to enable Mainland-incorporated companies listed or seeking to be listed in Hong Kong to engage any one of the specified Mainland audit firms which have been assessed as meeting specific conditions to audit the companies' financial statements using Mainland auditing standards ("specified Mainland audit firms").<sup>10</sup> There are currently 11 specified Mainland audit firms. The Bill proposes to allow FRC to recognize the Mainland audit firms as PIE auditors if certain conditions are satisfied. According to the Administration, the said specified Mainland audit firms will be recognized by FRC as recognized PIE auditors automatically upon the commencement of the new regulatory regime. The Administration has also pointed out that the Reciprocal Arrangement was signed between five signatory parties from Hong Kong (i.e. the Financial Services and the Treasury Bureau, SFC, HKEX, FRC and HKICPA) and the relevant Mainland authorities (i.e. the Ministry of Finance ("MoF"), the China Securities Regulatory Commission and the Chinese Institute of Certified Public Accountants), and any substantial changes to the Reciprocal Arrangement must be agreed by the five signatories from Hong Kong.

*Transitional arrangement for existing auditors of public interest entities*

37. The Bills Committee notes that deputations have stressed the need to ensure smooth transition of existing PIE auditors to the new regulatory regime, and to provide guidelines on the transitional arrangement as well as the eligibility criteria and procedures for the registration or recognition of PIE auditors.

38. The Administration has advised that the proposed new Part 7 of FRCO has set out the transitional arrangements for auditors who have been appointed to undertake a PIE engagement before the commencement of the Bill. In gist, the transitional provisions provide for any PIE engagements which has started before and is still on-going on or after the day on which the Financial Reporting Council (Amendment) Ordinance 2018 comes into operation, the auditor may notify HKICPA or FRC (as the case may be) of its intention to continue to carry out the engagement during the transitional period. On sending such notification, the auditor will be taken to be a PIE auditor. The name of those who are taken to be registered or recognized PIE auditors will be put onto the PIE auditors register, and the auditors concerned will be subject to the inspection, investigation and disciplinary mechanisms under the new regulatory regime. During the transitional period, these auditors may file applications for

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<sup>10</sup> The Reciprocal Arrangement also applies to Hong Kong companies and Hong Kong audit firms.

registration or recognition as PIE auditors under the new regime. HKICPA and FRC will provide clear guidelines to the auditors concerned on the transitional arrangement and the eligibility criteria and procedures for the registration or recognition of PIE auditors.

### Inspection, investigation, and disciplinary powers of the post-reform Financial Reporting Council

#### *Powers of the Financial Reporting Council under the new regulatory regime*

39. The Bills Committee notes the audit industry's concern about concentration of powers in the post-reform FRC as it will be vested with inspection, investigation and disciplinary powers under the new regulatory regime. Some depositions have suggested that the Bill should expressly provide for the segregation of FRC's functions and responsibilities concerning inspection, investigation and disciplinary sanction, in particular to ensure FRC's disciplinary mechanism will be independent of its inspection and investigation processes.

40. The Bills Committee has studied the regulatory powers of major PIE auditors oversight bodies of IFIAR member jurisdictions, the details of which are set out in **Appendix V**. The Administration has advised that FRC's powers under the new regulatory regime are similar to those of comparable regulators overseas. The PIE auditors oversight bodies in the United States ("US"), the UK, Singapore, Canada and Australia all have inspection, investigation and disciplinary powers.

41. Regarding views on the segregation of FRC's functions and responsibilities, the Administration has responded that it completely agrees that FRC should segregate respective executives responsible for inspection, investigation, disciplinary proceedings and disciplinary sanction. Following the release of the public consultation conclusions in June 2015, the Administration has been discussing with FRC and HKICPA the specific details of the new regulatory regime in response to the concerns of the audit profession. To address the audit profession's concerns over FRC's disciplinary powers, FRC will put in place a series of administrative arrangements including that the executives who have participated in the investigation/inspection or disciplinary processes of a case would not take part in making a disciplinary decision of the case.



*Regulatory powers over registered and recognized auditors of public interest entities*

42. The Bills Committee has enquired how FRC can maintain consistency in the regulation of registered and recognized PIE auditors. The Bills Committee also notes the views from deputations that there should be equally robust regulation of local and overseas PIE auditors in order to maintain a level playing field for various practitioners in the market.

43. The Administration has explained that under the new regulatory regime, the regulatory powers of FRC for inspection, investigation and disciplinary sanction over local PIE auditors will be equally applicable to overseas PIE auditors. The range of sanctions available to FRC in case of disciplinary actions against overseas PIE auditors will also be the same as that for local PIE auditors, which includes revocation or suspension of the recognition status of the overseas auditor concerned. Moreover, under the new regulatory regime, FRC would endeavor to seek co-operation and assistance from overseas regulators when necessary in performing its regulatory functions in respect of recognized PIE auditors.

*Disciplinary mechanism of the post-reform Financial Reporting Council*

44. The Bills Committee has examined FRC's disciplinary mechanism under the new regulatory regime including the factors FRC will take into account before initiating disciplinary proceedings. The Bills Committee further notes the concern of some deputations that FRC may abuse its inspection and investigation powers to subject auditors to unnecessary disciplinary proceedings.

45. The Administration has advised that FRC's inspections over PIE auditors are primarily intended to monitor auditors' compliance with professional standards. Where improvements are required to safeguard or enhance audit quality, FRC will seek to agree an action plan with each firm inspected to achieve the improvements needed. FRC will assess periodically the adequacy of the progress made by the firm in addressing its findings. On occasions including situations where a breach of ethics is clearly identified, matters arising from FRC's inspections may result in the consideration of disciplinary sanctions being imposed against a PIE auditor and/or a registered responsible person of a PIE auditor in accordance with the Bill. During FRC's inspection process, FRC is able to seek advice from persons independent of FRC and with experience in PIE auditing. FRC's disciplinary processes can also be initiated as a result of an investigation. Under the proposed section 23 of FRCO, FRC may initiate an investigation, inter alia, if it has reasonable cause to believe that a PIE auditor has breached a professional standard. After an investigation, if FRC considers that a

PIE auditor and/or a registered responsible person of a PIE auditor has/have committed such a breach, FRC will initiate the disciplinary processes. To ensure clarity and transparency in FRC's operation, FRC will formulate guidelines setting out the thresholds and circumstances under which misconduct identified during inspection and/or investigation should be referred to the disciplinary department for follow-up. The Administration has confirmed that if a prosecution instituted against a person as a result of FRC's investigation does not result in a conviction, the person concerned will not be required to bear the costs and expenses of FRC's investigations.

46. Some members including Mr Kenneth LEUNG and Ms Starry LEE are concerned if front-line staff members of a PIE auditor, who are not the responsible person of a PIE auditor, would be subject to disciplinary sanctions under the new regulatory regime. The Administration has advised that only the practice unit per se and the responsible persons of a registered PIE auditor will be subject to the disciplinary sanctions of FRC. HKICPA will process applications for registered PIE auditors prudently and it is not envisaged that a front-line staff member of a PIE auditor will be registered as its responsible person.

Function and power of the Financial Reporting Council in overseeing the Hong Kong Institute of Certified Public Accountants' performance of functions relating to registered auditors of public interest entities

47. The proposed section 9(b) of FRCO provides FRC with a function to oversee HKICPA's performance of certain functions relating to registered PIE auditors (viz. registration of PIE auditors, establishing and maintaining the PIE auditors register, setting CPD requirements for registered PIE auditors, and setting standards on professional ethics, auditing and assurance practices for registered PIE auditors). The proposed section 10(1A) of FRCO stipulates FRC's powers for performing the oversight function under the proposed section 9(b), and the proposed section 10(1B) provides that HKICPA must comply with any direction given by FRC under section 10(1A)(c). The Bills Committee has enquired about the purpose of the oversight function and how FRC will carry out the oversight function.

48. The Administration has explained that the oversight model proposed in the Bill is the outcome of the tripartite meetings between the Administration, FRC and HKICPA which was reflected in the public consultation document in 2014. The proposed model was supported by the overwhelming majority of respondents during the public consultation. The three parties have agreed that the framework of the oversight model should be provided in the legislation, whilst the operational details of the arrangement should be set out in an agreement made between FRC and HKICPA ("the Agreement").

49. The Bills Committee has enquired about the framework and outline of the Agreement, and the timetable for concluding the Agreement. The Administration has advised that FRC and HKICPA have commenced discussion on the Agreement, which is expected to be concluded before commencement of the Bill. The Agreement will cover various aspects including:

- (a) the types of information FRC may require HKICPA to produce for the oversight function and the likely circumstances under which FRC would exercise this power;
- (b) the information to be included in the periodic reports of HKICPA and the frequency of submission of such reports to FRC;
- (c) the scope, criteria, work flow and procedures of the assessment to be carried out by FRC on HKICPA; and
- (d) the circumstances under which FRC would issue written directions to HKICPA and the relevant procedures involved.

50. As regards the consequences on HKICPA for non-compliance with FRC's request or direction given under the proposed section 10(1A) of FRCO, the Administration has advised that the proposed section 10(1A) provides for a light-handed oversight model by empowering FRC to:

- (a) request HKICPA to provide relevant information and periodic reports on its performance of a specified function;
- (b) conduct assessment on HKICPA's performance of a specified function; and
- (c) if satisfied that it is in the public interest to do so, give HKICPA written directions on the performance of a specified function.

The above are the specific powers that may be exercised by FRC for overseeing HKICPA's performance of specified functions in respect of PIE auditors as stipulated in the proposed section 9(b). The Administration has explained that its policy intention is that once a written direction is issued by FRC to HKICPA, the latter must comply with the direction for protecting the public interest. This is provided in the proposed section 10(1B). In view that HKICPA is a statutory professional body which shoulders some of the regulatory functions in the new regulatory regime, the Administration believes that HKICPA will cooperate with FRC if any such written direction is issued.

Pecuniary penalty on auditors of public interest entities and responsible persons

*Pecuniary penalty proposed in the Bill*

51. Under the proposed new sections 37D(3)(b)(iv) and 37E(3)(b)(iii) of FRCO, FRC may order a person who is or was a PIE auditor or a registered responsible person of a registered PIE auditor and has committed a misconduct to pay a pecuniary penalty.<sup>11</sup> The maximum pecuniary penalty is the greater of \$10 million, or three times the amount of the profit gained or loss avoided as a result of the misconduct. The proposed new section 37H of FRCO provides that FRC must not impose a pecuniary penalty unless (a) it has published, in the Gazette and in any other manner it considers appropriate, guidelines ("the Guidelines") to indicate the way in which it exercises the power to impose the penalty; and (b) it has had regard to the Guidelines in imposing the penalty. The Guidelines are not subsidiary legislation.

52. The Bills Committee has enquired about the details of the Guidelines and FRC's progress in developing the Guidelines. Nothing that the industry (particularly SME audit firms) has expressed concern that the proposed maximum penalty level of \$10 million (in the proposed new sections 37D(3)(b)(iv)(A) and 37E(3)(b)(iii)(A) of FRCO) is very high, some members including Mrs Regina IP, Ms Starry LEE, Mr Kenneth LEUNG and Mr CHAN Chun-ying have requested the Administration to address the industry's concern. Mr Kenneth LEUNG has urged the Administration to reduce the proposed maximum penalty level of \$10 million in the Bill.

53. FRC has advised that it is committed to issuing the Guidelines as soon as practicable after the enactment of the Bill and certainly prior to the commencement of the Bill. In developing the Guidelines, FRC will also engage relevant stakeholders throughout the process. The major principles FRC will adhere to in exercising the power to impose a pecuniary penalty on a PIE auditor or a registered responsible person and in determining the level of penalty include the seriousness of the misconduct committed, whether the penalty is proportionate to the misconduct, effective deterrent to future misconduct, financial resources of the practice unit or an individual, and whether the amount of pecuniary penalty would have the likely effect of putting a practice unit or an individual in financial jeopardy. The details of such principles are set out in **Appendix VI**.

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<sup>11</sup> The pecuniary penalty received must be paid into the general revenue as provided in the proposed new section 37J(6) of FRCO. The term "misconduct", in relation to PIE auditors and registered responsible persons, is provided in the proposed new sections 37A to 37C of FRCO.

54. As regards the suggestion of reducing the proposed maximum penalty level of \$10 million, the Administration has advised that there have long been views in the community that the maximum disciplinary pecuniary penalty under the current regime (i.e. \$500,000 as provided in PAO) is not sufficient to ensure a proportionate disciplinary sanction for misconduct committed by auditors, thus undermining the effectiveness of disciplinary sanction. Furthermore, IMF has criticized the situation as it considers that the sanctions under Hong Kong's current auditor regulatory regime are very limited, and recommended that the future independent auditor oversight body should be given strong enforcement power. The Administration has taken into full consideration the views of various stakeholders in formulating the level of maximum pecuniary penalty proposed in the Bill which should reflect the severity of the non-compliance. Besides, the Administration has made reference to other Hong Kong financial regulatory regimes and the auditor regulatory regimes of some overseas jurisdictions (such as the US and the UK) in devising the proposal in the Bill. The respective regulatees under the purviews of SFC and IA are subject to the same maximum pecuniary penalties in respect of misconduct committed. It should also be noted that the UK Financial Reporting Council does not impose any limit on the pecuniary penalty, and the pecuniary penalties imposed by six disciplinary orders issued during 2011 to 2017 have exceeded the proposed HK\$10 million in the Bill. Further, the US auditor oversight body may impose a maximum pecuniary penalty of over USD 20 million for serious violation committed by an audit firm. The Administration has reiterated that FRC is required under the Bill to issue the Guidelines and have regard to the Guidelines in imposing the pecuniary penalty. At the request of the Bills Committee, the Administration has provided information on the level of pecuniary penalty imposed by PIE auditors oversight bodies of IFIAR's member jurisdictions, which is in **Appendix V**.

*Mr Kenneth LEUNG's proposal to reduce the proposed maximum penalty level of \$10 million*

55. Mr Kenneth LEUNG has indicated that he will consider moving three alternative amendments to the proposed new sections 37D(3)(b)(iv)(A) and 37E(3)(b)(iii)(A) of FRCO to reduce the proposed maximum penalty level from \$10 million stated in the said provisions to \$1 million, \$5 million, or \$8 million. Mr LEUNG has stressed that his proposed amendments are to address the concern of SME audit firms about the financial burden on the firms as they usually have an average cash flow of \$1 million to \$2 million. The high level of penalty would impact on the continual survival of SME audit firms. He has further pointed out that as shown in **Appendix V**, the PIE auditors oversight bodies in Canada and Australia do not impose fines but only exercise certain administrative penalties, such as cancelation or suspension of audit firms'

registration, reprimand the firm, public censure, termination of audit engagement of firms, etc. The auditor oversight body of Singapore may impose a pecuniary fine on an auditor or an audit firm which has committed misconduct but the maximum fine is SGD100,000 (approximately HK\$600,000). As regards the need to align the maximum levels of pecuniary penalties imposed by other financial regulators in Hong Kong, Mr LEUNG considers that auditing is a unique professional service. The inherent risks auditors are facing and the nature and types of misconduct commonly alleged against auditors are different from those of other types of regulated businesses. It would be inappropriate to apply the same level of maximum pecuniary penalty to regulatees of all financial sectors.

56. Ms Starry LEE acknowledges the concerns of SME audit firms over the proposed maximum penalty level of \$10 million which is higher than that in some overseas auditor regulatory regimes including Singapore. Mr Christopher CHEUNG has stressed the important role auditors played in ensuring the integrity of financial reports of listed companies or companies applying for listing, thus protecting the interest of investors at large. PIE auditors charge high fees for audit engagements. Therefore, the level of sanctions imposed on misconduct of PIE auditors should be commensurate with the scale of audit engagement. Mr CHAN Chun-ying has pointed out that the Bill applies to PIE auditors of various scales. It would be inappropriate to reduce the proposed maximum level of pecuniary penalty solely to address the concern of SME audit firms. While the sanction of pecuniary penalty on PIE auditors under the new regulatory regime is non-criminal in nature, banks in Hong Kong are subject to criminal sanctions for their misconduct under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615). Mr CHAN Kin-por notes that the proposed maximum level of pecuniary penalty in the Bill is on a par with that for insurance intermediaries under the Insurance Ordinance (Cap. 41). In comparison with insurance intermediaries, the consequences of PIE auditors' misconduct could cause more harm to investors. Mr CHAN Chun-ying and Mr CHAN Kin-por further consider that instead of reducing the proposed maximum penalty level of \$10 million in order to address the SME audit firms' concern about the heavy financial burden on them, FRC should give assurance that it would adhere to the Guidelines in imposing the pecuniary penalty including the principle of not putting a practice unit or individual in financial jeopardy.

57. The Administration has responded that the proposed maximum level of pecuniary penalty of \$10 million was put forward in the public consultation document in 2014, and has been fully deliberated since the 2014 public consultation. As regards the maximum levels of pecuniary penalties adopted by PIE auditors oversight bodies overseas, the UK regime does not impose any limit on the pecuniary penalty level. There have been comments in recent years for increasing the level of penalty actually imposed in disciplinary cases

in the UK regime. The UK is an overseas jurisdiction with a capital market most comparable to that of Hong Kong. The maximum pecuniary penalty in the US auditor regulatory regime is much higher than that proposed for Hong Kong. It may not be appropriate to make a direct comparison between the Hong Kong PIE auditor regulatory regime with that of Australia, Canada and Singapore as the features of the regimes and sizes of the capital markets of these jurisdictions are different from those of Hong Kong. The Administration has reiterated that the Bill provides that FRC must issue the Guidelines and FRC must have regard to the Guidelines in imposing the pecuniary penalty.

58. Mr Kenneth LEUNG has reiterated the concern of SME audit firms over the proposed maximum penalty level of \$10 million. He has pointed out that there are other sanctions available to FRC (e.g. suspension or revocation of registration) for misconduct committed by PIE auditors, and such sanctions would provide sufficient deterrence. Moreover, it is not relevant to refer to the UK regime when setting the maximum level of pecuniary penalty for the Hong Kong regime. He is aware that since 2008, the auditors in the UK have been allowed under the Companies Act to place a cap through the execution of a liability limitation agreement with an audit client to limit the amount of compensation payable under any civil claim arising out of an audit. Such a cap arrangement is absent in Hong Kong, and hence auditors are subject to a much higher pecuniary exposure. Mr Kenneth LEUNG has indicated that he would move his proposed amendments to the proposed new sections 37D(3)(b)(iv)(A) and 37E(3)(b)(iii)(A) of FRCO in his own name. Subject to the ruling by the President of LegCo that his proposed amendments are admissible, he will move the amendments in the order of \$1 million, \$5 million and \$8 million.

#### Review and appeal mechanism

59. The Bill establishes a new independent review tribunal ("the Tribunal") which has the jurisdiction to make determinations on any review against decisions of HKICPA and FRC relating to registration and recognition of PIE auditors respectively, as well as the disciplinary decisions of FRC. The proposed new Part 3C of and Schedule 4A to FRCO contain the detailed provisions relating to the Tribunal. In gist, the Tribunal consists of a chairman<sup>12</sup> and two ordinary members who are drawn from a Tribunal panel

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<sup>12</sup> The chairman must be a former Justice of Appeal of the Court of Appeal, a former judge, a former recorder or a former deputy judge of the Court of First Instance, or a person eligible for appointment as a judge of the High Court.

appointed by CE and are not public officers.<sup>13</sup> Once a PIE auditor files an application for review against a decision of HKICPA or FRC, the decision will not take effect until after the review has been determined or the application has been withdrawn. A party who is dissatisfied with a determination made by the Tribunal may, with leave, appeal to the Court of Appeal.

60. The Bills Committee has enquired whether practitioners can be appointed as ordinary members of a Tribunal and whether there are qualification requirements for the ordinary members. Some members have suggested that certain requirements be specified for the ordinary members to avoid potential conflict of interest.

61. The Administration has explained that as the nature of cases to be handled by a Tribunal will vary, the Bill does not specify qualification requirements for the ordinary members of the Tribunal so that CE can appoint persons with the appropriate expertise to serve as Tribunal members. Whilst the Bill does not prohibit the appointment of practitioners as ordinary members of the Tribunal, the Administration will carefully assess whether such appointment will compromise the independence of the Tribunal. The Administration's policy intent is that where a Tribunal considers necessary, it can seek the advice of external experts to assist its work. As such, there will be no need to appoint practitioners as ordinary members to a Tribunal.

### Miscellaneous matters

#### *Commencement date of the Bill*

62. Clause 1 of the Bill provides that the Bill, if passed, will come into operation on 1 August 2019. The Administration has advised that in order to provide flexibility and allow time for FRC to complete preparation for the implementation of new functions and powers under the new regulatory regime, it will propose to amend the commencement of the Financial Reporting Council (Amendment) Ordinance 2018 (which the Administration also proposes to amend by renaming it as Financial Reporting Council (Amendment) Ordinance 2019)<sup>14</sup> ("2019 Amending Ordinance") to a day to be appointed by the Secretary for the Financial Services and the Treasury by a notice published in

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<sup>13</sup> The Secretary for Financial Services and the Treasury will, on the recommendation of a Tribunal's chairperson, appoint two panel members as the ordinary members of the Tribunal.

<sup>14</sup> The amendment is proposed as it transpired at a Bills Committee meeting that the Bill might resume its Second Reading debate in January 2019.



the Gazette.<sup>15</sup> The Bills Committee has no objection to the proposed amendments.

*Negotiation with the Mainland on access to audit working papers of recognized auditors of public interest entities*

63. Mr Kenneth LEUNG has enquired about the progress of negotiation between FRC and the relevant Mainland regulators on a cooperation agreement which, inter alia, allows FRC to seek non-confidential audit working papers of recognized PIE auditors in the Mainland, and whether the agreement can be concluded before commencement of the Bill.

64. The Administration has pointed out that FRC and MoF have been discussing a cooperation agreement on access to audit working papers kept in the Mainland. MoF recognizes the importance of allowing access by FRC to relevant audit working papers and is considering suitable measures on cross-boundary cooperation in this area. There has been good progress in the discussion. In order to enable the post-reform FRC to carry out its statutory duties effectively, FRC has agreed with MoF that the cooperation agreement will cover FRC's regulatory functions under the new regulatory regime, namely, inspection, investigation and discipline, as well as the use of relevant audit working papers for FRC's disciplinary hearings. Discussion between FRC and MoF will continue with a view to concluding the agreement as soon as possible. Prior to the conclusion of the agreement, FRC will not request audit firms to produce the relevant audit working papers kept in the Mainland. The Administration will closely monitor the development and maintain liaison with all relevant stakeholders.

**Amendments to be moved by the Government**

65. Apart from the proposed amendments explained in paragraphs 14, 26, 34 and 62 above, the Administration will move amendments to make technical amendments to the Bill. The Bills Committee has examined the amendments to be proposed by the Administration to the Bill and raised no objection.

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<sup>15</sup> The Administration will propose amendments to the Bill with the effect that the proposed transitional period would begin on the day on which section 23 of the 2019 Amending Ordinance comes into operation ("2019 Amending Ordinance commencement date"). According to the Administration, the said section 23 mainly concerns the registration and recognition of PIE auditors. The Administration considers it desirable for the 2019 Amending Ordinance commencement date to tie in with the day on which the said section comes into operation.

66. The Bills Committee will not propose amendments to the Bill. Mr Kenneth LEUNG has indicated that he will move amendments to the proposed new sections 37D(3)(b)(iv)(A) and 37E(3)(b)(iii)(A) of FRCO (the details are set out in paragraphs 55 to 58 above).

### **Resumption of Second Reading debate**

67. The Bills Committee has no objection to the resumption of the Second Reading debate on the Bill at the LegCo meeting of 30 January 2019.

### **Consultation with the House Committee**

68. The Bills Committee reported its deliberations to the House Committee on 18 January 2019.

Council Business Division 1  
Legislative Council Secretariat  
23 January 2019

### **The main provisions of the Financial Reporting Council (Amendment) Bill 2018**

According to the Administration, the major provisions of the Bill are as follows :

1. Part 1 sets out preliminary provisions such as the short title and provides for the commencement of the Bill;
2. Part 2 contains amendments to the Financial Reporting Council Ordinance (Cap. 588) ("FRCO"). The main provisions of this Part are set out as follows –
  - (a) Clauses 4, 5 and 6 provide for the definitions of some key terms, including responsible person, public interest entities ("PIE"), non-PIE, PIE auditor, non-PIE auditor, PIE engagement and non-PIE engagement;
  - (b) Clause 9 amends FRCO to provide for the composition of the Financial Reporting Council ("FRC") under the new regime;
  - (c) Clauses 11 and 12 amend FRCO to provide for the new functions and powers of FRC under the new regime, including overseeing the performance by the Hong Kong Institute of Certified Public Accountants of the functions in relation to PIE auditors;
  - (d) Clause 23 introduces new provisions in FRCO to provide for the registration of local auditors and recognition of overseas auditors (including Mainland auditors) as PIE auditors under the new regime;
  - (e) Clause 26 introduces new provisions in FRCO to provide for the powers of FRC in conducting recurring inspections on PIE auditors under the new regime;
  - (f) Clauses 31 and 32 provide for the circumstances under which an investigation may be carried out. Clause 35 amends FRCO to update and modify the relevant provisions in relation to FRC's investigation powers to align them with the legislation of other financial regulatory regimes in Hong Kong;

- (g) Clause 48 introduces new provisions in FRCO to provide for –
  - (i) the powers of FRC in imposing disciplinary sanctions against PIE auditors and their responsible persons; and
  - (ii) the set-up of an independent review and appeal mechanism regarding registration, recognition and disciplinary decisions under the new regime;
- (h) Clause 62 introduces new provisions in FRCO to stipulate that new levies will be imposed on securities transactions, PIEs and PIE auditors;
- (i) Clause 75 introduces new provisions in FRCO to provide for the transitional and savings provisions in FRCO;
- (j) Clause 77 introduces a new Schedule 1A to prescribe what are specified engagements to be carried out by a PIE auditor ("PIE engagements")<sup>1</sup> and non-PIE engagements under the new regime;
- (k) Clause 80 introduces new Schedules 3A and 3B to prescribe –
  - (i) the non-delegable functions of FRC; and
  - (ii) the level of fees payable for various matters under FRCO;
- (l) Clause 82 introduces a new Schedule 4A to provide for the composition and operation of the Public Interest Entities Auditors Review Tribunal; and
- (m) Clause 85 introduces a new Schedule 7 to prescribe the rate or amount of the levies payable to FRC; and

3. Part 3 contains the related and consequential amendments to other relevant items of legislation, including the Professional Accountants Ordinance (Cap. 50).

(Source : paragraph 29 of the Legislative Council Brief on the Bill)

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<sup>1</sup> The specified engagements to be carried out by a public interest entities ("PIE") auditor include (a) preparation of auditor's reports on annual financial statements of PIEs; (b) preparation of accountants' reports in listing documents of PIEs or entities applying to be PIEs; and (c) preparation of accountants' reports in circulars issued by PIEs in connection with a very substantial acquisition or a reverse takeover.

**Bills Committee on Financial Reporting Council (Amendment) Bill 2018**

**Membership list\***

**Chairman** Hon WONG Ting-kwong, GBS, JP

**Deputy Chairman** Hon Kenneth LEUNG

**Members**

Hon James TO Kun-sun  
Hon Starry LEE Wai-king, SBS, JP  
Hon CHAN Kin-por, GBS, JP  
Hon Mrs Regina IP LAU Suk-yee, GBS, JP  
Hon WU Chi-wai, MH  
Hon Dennis KWOK Wing-hang  
Hon Christopher CHEUNG Wah-fung, SBS, JP  
Dr Hon Junius HO Kwan-yiu, JP  
Hon CHAN Chun-ying, JP  
Hon CHEUNG Kwok-kwan, JP  
Hon Kenneth LAU Ip-keung, BBS, MH, JP

(Total : 13 members)

**Clerk** Ms Connie SZETO

**Legal Adviser** Miss Evelyn LEE

\* Changes in membership are shown in Annex.

**Bills Committee on Financial Reporting Council (Amendment) Bill 2018**

**Changes in membership**

<b>Member</b>	<b>Relevant date</b>
Hon LUK Chung-hung	Up to 15 March 2018
Hon Charles Peter MOK, JP	Up to 10 July 2018

**Bills Committee on Financial Reporting Council (Amendment) Bill 2018**

**List of organizations/individuals from which the Bills Committee  
has received views**

1. Asian Corporate Governance Association
2. The Association of Chartered Certified Accountants
3. Baker Tilly Hong Kong Limited
4. BDO Limited
5. Consumer Council
6. CPA Australia Ltd
7. Crowe Horwath (HK) CPA Limited
8. Deloitte Touche Tohmatsu
9. Ernst & Young
10. Hong Kong Bar Association
11. Hong Kong Institute of Certified Public Accountants
12. The Hong Kong Institute of Chartered Secretaries
13. Hong Kong Investment Funds Association
14. Hong Kong Take the Lead Institute
15. KPMG
16. Mandatory Provident Fund Schemes Authority
17. Mid-tier Firm Alliance
18. PricewaterhouseCoopers
19. Securities and Futures Commission
20. The Society of Chinese Accountants & Auditors
21. USS Investment Management Ltd
22. Mr LEE Lapman
23. Mr LEUNG Kwok-hung

**Estimated annual operating expenses of  
the post-reform Financial Reporting Council ("FRC")**

<b>Expenditure Items</b>	<b>Amount</b> (at 2016 price level)	<b>Remarks</b>
<b>Staff Costs</b>		
1. Top Management Team (including the Chief Executive Officer and other Executive Directors)	\$14 million <sup>1</sup>	The number of staff of the post-reform FRC is expected to be around 70, which is about three times of the existing FRC. The majority of the staff will be professional executives responsible for the inspection, investigation and disciplinary functions in respect of PIE auditors, as well as carrying out professional independent oversight over the HKICPA's regulatory functions under the new regime. The remaining staff will be responsible for administration and clerical/secretarial matters of the operation of the FRC.
2. Investigation	\$15 million	
3. Inspection	\$15 million	
4. Discipline	\$9 million	
5. Oversight of the Hong Kong Institute of Certified Public Accountants ("HKICPA")'s regulatory functions in respect of auditors of public interest entities ("PIE auditors"), recognition of overseas auditors as PIE auditors and international relations	\$3 million	The Administration envisages that there will be four to five levels of the professional executives within the FRC, namely (on a descending order of rank), Executive Director, Senior Director/Director, Associate Director and Manager.  The range of salaries for each professional executive will depend on his/her personal experience and capability.
6. Administration (including finance, public relations, human resources, information technology, general administration, secretarial services, etc.)	\$9 million	
7. Other staff-related expenses (including mandatory provident fund contribution, insurance, staff recruitment, staff training and development, etc.)	\$6 million	

<sup>1</sup> The total staff cost of the Financial Reporting Council ("FRC") for the Chief Executive Officer and the Deputy Chief Executive Officer was \$6.5 million in 2016.



<b>Expenditure Items</b>	<b>Amount</b> (at 2016 price level)	<b>Remarks</b>
<b><i>Non-staff Costs</i></b>		
8. Rent for accommodation	\$8 million <sup>2</sup>	The reference for the estimate was the level of rents for Grade A commercial buildings in Kowloon Bay/Kwun Tong in 2016, inclusive of all miscellaneous fees (e.g. rates, Government rent, management fees, utilities, etc.) (i.e. around \$50 per square feet).
9. Other expenses (including corporate communication, legal and professional services, conference and duty visits, telecommunication, printing and stationery, depreciation, contingency, etc.)	\$11 million	The proportion of non-staff costs accounted for 14% of the total recurrent expenditure of the existing FRC in 2016. Therefore, the Administration considers the estimated amount of \$11 million (around 12% of the total operating costs) for other operating costs of the post-reform FRC to be reasonable and justified.
<b>Total</b>	<b>~ \$90 million<sup>3</sup></b>	

[Source: paragraph 3 of LC Paper No. CB(1)1190/17-18(02)]

<sup>2</sup> At present, the office accommodation of FRC is provided by the Companies Registry at a rental value of \$1 per annum. The present provision is around 4,000 sq ft. at the Queensway Government Offices.

<sup>3</sup> FRC's budget in 2016 was about \$30 million.

## Appendix V

### Comparison on Major Member Jurisdictions of the International Forum of Independent Audit Regulators<sup>1</sup>

	United States	United Kingdom	Singapore	Canada	Australia
<b>1. Auditor regulator</b>	Public Company Accounting Oversight Board ("PCAOB")	Financial Reporting Council ("UK FRC")	Accounting and Corporate Regulatory Authority ("ACRA")	Canadian Public Accountability Board ("CPAB")	Australian Securities and Investments Commission ("ASIC")
<b>2. Scope of regulation</b>	- Auditors	- Auditors - Actuaries	- Auditors - Business entities - Corporate service providers	- Auditors	- Auditors - Securities sector - Insurance sector
<b>3. Major auditor regulatory functions</b>	- Registration of auditors - Inspection - Setting of standards in auditing and professional ethics - Investigation - Discipline	- Registration of auditors - Inspection - Setting of standards in accounting, auditing and professional ethics - Oversight over professional accountancy bodies - Investigation - Discipline	- Registration of auditors - Inspection - Setting of standards in auditing and professional ethics - Investigation - Discipline	- Registration of auditors - Inspection - Investigation - Discipline	- Registration of auditors - Inspection - Investigation - Discipline
<b>4. Funding sources</b>	- Listed entities - Listed entity auditors - Broker-dealers	- Listed entities - Listed entity auditors - Other entities under regulation (e.g. actuarial and insurance profession)	- Listed entity auditors - Other business entities under regulation	- Listed entities - Listed entity auditors	- Industries being regulated. For auditor regulation, funding comes from levy on listed entity auditors

<sup>1</sup> The information is based on the Member Profiles 2017 of the respective jurisdictions uploaded to the International Forum of Independent Audit Regulators website at <https://www.ifiar.org/members/member-directory/>.

	United States	United Kingdom	Singapore	Canada	Australia
<b>5. Scale of Big-4 audit firms for PIE engagements</b>	The Big-4 audit firms audited approximately 50% of the 7,200 listed entities (representing about 96% of the total market capitalisation)	The Big-4 audit firms audited approximately 74% the 2,000 listed entities (representing about 96% of the total market capitalisation)	The Big-4 audit firms audited approximately 60% of the 767 entities listed on the Singapore Exchange (representing about 60% of the total market capitalisation)	The Big-4 audit firms audited approximately 60% of Canada's listed entities (representing more than 90% of the total market capitalisation)	The Big-4 audit firms audited over 95% of the listed entities by market capitalisation
<b>6. Maximum limit of pecuniary penalty</b>	<ul style="list-style-type: none"> <li>- For general violation: USD136,052 for a natural person; or USD2,721,050 for an audit firm.</li> <li>- For serious violation: USD1,020,394 for a natural person; or USD20,407,871 for an audit firm.</li> <li>- Five out of 137 disciplinary orders against auditors issued by the PCAOB between 2011 and 2017 where the pecuniary penalties imposed were in excess of the equivalent of HK\$10 million.</li> </ul>	<ul style="list-style-type: none"> <li>- No limit on pecuniary penalty imposed.</li> <li>- Six out of 13 disciplinary orders against auditors issued by the UK FRC between 2011 and 2017 where the pecuniary penalties imposed were in excess of the equivalent of HK\$10 million.</li> </ul>	<ul style="list-style-type: none"> <li>- An auditor: SGD10,000.</li> <li>- An audit firm: SGD100,000.</li> </ul>	- CPAB does not issue fines but exercises disciplinary functions at three levels: Requirements, Restrictions and Sanctions. These may include public censure; termination of audit engagements of a firm; prohibition of acceptance of new audit clients or assignment of designated professionals to audit engagements; and termination of a firm's qualification for auditing listed issuers.	- ASIC does not issue fines but exercises disciplinary functions by initiating the following: cancel or suspend an audit firm's registration; admonish or reprimand the firm; and/or require the firm to give an undertaking.

[Source: Appendix to LC Paper No. CB(1)687/17-18(02) and Annex to LC Paper No. CB(1)1062/17-18(01)]

**Major principles the Financial Reporting Council intends to adhere to in exercising the power to order an auditor of public interest entity or a registered responsible person to pay a pecuniary penalty and to determine the level of pecuniary penalty**

- (a) In order to determine whether a pecuniary penalty is appropriate, the factors to be considered will normally include whether:
  - (i) deterrence can be achieved by a reprimand alone;
  - (ii) the regulated person(s) has derived any financial gain or benefit (including avoidance of loss) as a result of the misconduct;
  - (iii) the misconduct involved, caused or risked the loss of significant sums of money;
  - (iv) a pecuniary penalty was ordered in similar previous cases.
- (b) In cases where the Financial Reporting Council ("FRC") considers that a pecuniary penalty is appropriate, it should aim to impose a pecuniary penalty that:
  - (i) is proportionate to the misconduct and all the circumstances of the case;
  - (ii) will act as an effective deterrent to future misconduct;
  - (iii) will promote public confidence in the regulation of PIE audits and in the way in which misconduct is addressed.
- (c) In undertaking this assessment, FRC will normally take into consideration:
  - (i) the nature, extent and importance of the standards or regulations breached;
  - (ii) the seriousness of the misconduct;
  - (iii) in the case of a practice unit, its size/financial resources and financial strength, for example as indicated by the total turnover of the practice unit and the effect of a pecuniary penalty on its business;
  - (iv) in the case of an individual, his financial resources and annual income and the effect of a pecuniary penalty on that individual and his future employment;
  - (v) the upper limit on the pecuniary penalty that FRC can impose.

- (d) When deciding the level of pecuniary penalty to impose, FRC should:
  - (i) when considering a regulated person's financial resources, establish whether there are any arrangements that would result in part or all of any pecuniary penalty being paid or indemnified by insurers, or by a practice unit or employer. The existence of any such arrangements should not be a ground for increasing any pecuniary penalty beyond the level that would otherwise be considered appropriate by FRC; and
  - (ii) disregard the possibility that the regulated person(s) may be liable for the costs of the case.
- (e) Having arrived at a figure for the pecuniary penalty based on the nature and seriousness of the misconduct, FRC should consider whether the amount of the pecuniary penalty should be adjusted:
  - (i) to take account of any aggravating and mitigating factors;
  - (ii) to ensure the pecuniary penalty has the necessary deterrent effect;
  - (iii) to reflect any discount for admissions and/or early disposal; and/or
  - (iv) to avoid the likely effect of putting a practice unit or individual in financial jeopardy.

[Source: paragraph 3 of Annex B to LC Paper No. CB(1)771/17-18(02)]