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FINANCIAL SERVICES BRANCH
FINANCIAL SERVICES AND
THE TREASURY BUREAU
GOVERNMENT OF THE HONG KONG
SPECIAL ADMINISTRATIVE REGION

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By email (hytchiu@legco.gov.hk)

16 March 2018

Clerk to Bills Committee
(Attn.: Mr Hugo Chiu)
Legislative Council Secretariat
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

Dear Mr Chiu,

Bills Committee on Financial Reporting Council (Amendment) Bill 2018

Follow-up to meeting on 13 February 2018

I refer to your email dated 22 February 2018. The Administration's responses are set out in **Annex** for your follow-up action.

Yours sincerely,

A handwritten signature in black ink, appearing to be 'Billy AU', written over a circular stamp.

(Billy AU)

for Secretary for Financial Services and the Treasury

c.c.

Financial Reporting Council
Department of Justice

(Attn: Ms Florence Wong)
(Attn: Ms Mabel Cheung)
Ms Carmen Chan)

Bills Committee on Financial Reporting Council (Amendment) Bill 2018 (“the Bill”)

Response to Matters Raised by Members at the Meeting on 13 February 2018

Financial arrangement of the post-reform Financial Reporting Council (“FRC”) (Item 1 of the list of follow-up actions)

The Government estimates that the breakdown of the annual operating costs of the post-reform FRC (at 2016 price level) will be as follows —

Expenditure Items	Post-reform FRC
<i>Staff Costs</i>	
1. Top Management Team (including the Chief Executive Officer and other Executive Directors)	\$14 million ¹
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 public interest entities (“PIEs”) ² auditors, recognition of overseas auditors as PIE auditors and international relations	\$3 million
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

¹ The total staff cost of the FRC for the Chief Executive Officer and the Deputy Chief Executive Officer was \$6.5 million in 2016.

² PIE is defined in the Bill to mean a corporation with its issued shares or stocks listed in Hong Kong or a collective investment scheme with any of its interests listed in Hong Kong.

<i>Non-staff Costs</i>	
8. Rent for accommodation	\$8 million ³
9. Other expenses (including corporate communication, legal and professional services, conference and duty visits, telecommunication, printing and stationery, depreciation, contingency, etc.)	\$11 million
Total	~ \$90 million⁴

2. We consider the estimated operating costs of the FRC at the commencement of the new regulatory regime presented in paragraph 1 above justified for the following reasons –

- (a) At present, the FRC is primarily responsible for conducting independent investigations into possible auditing irregularities of listed entity auditors. Under the new regime, the FRC's functions will be substantially expanded. Its scope of work will increase by more than three-fold to cover also recurring inspections, enforcement and discipline, recognition of overseas auditors, oversight of the HKICPA's regulatory functions in respect of PIE auditors, enhanced cooperation and interface with international bodies and overseas regulators, etc.
- (b) The levy contribution from PIE auditors will account for 25% of the operating costs of the post-reform FRC under the new regime, and this proportion of funding from the audit profession is the same as that for the existing FRC⁵. 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, according to our understanding, is comparable to the total amount borne by the audit profession for the current operations of the FRC and the

³ At present, the office accommodation of the 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.

⁴ The FRC's budget in 2016 was about \$30 million.

⁵ At present, the FRC is funded through contributions made by four parties, viz. the HKICPA, the Securities and Futures Commission, the Hong Kong Exchanges and Clearing Limited 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.

HKICPA in respect of the regulation of PIE auditors⁶.

- (c) Under the new regime, the regulatory functions of inspection and disciplinary proceedings will be transferred from the HKICPA to the FRC. The 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, the FRC will put in place a system which is benchmarked against the international standard and practice in this area. As regards disciplinary proceedings, currently the HKICPA discharges this function primarily through Disciplinary Panels, and members of these Panels serve on a pro bono basis. Such a practice has been criticised by the International Monetary Fund (“IMF”) as not conducive to the development of expertise and precedents (see elaboration in paragraph 7 below). 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. The abovementioned improvements will incur additional costs as compared to the existing regime, but are worthy initiatives as they will serve to strengthen our auditor regulatory regime which will in turn further enhance investor protection.

Regulation of overseas PIE auditors (Items 3(a) and (b) of the list of follow-up actions)

3. Under the new regime, the regulatory powers of the FRC for inspection, investigation and discipline over local PIE auditors will be equally applicable to overseas PIE auditors. The range of sanctions available to the 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 such that it can no longer act as the auditor of an overseas PIE.

4. Moreover, under the new regime there must be a regulatory cooperation agreement between the FRC and the corresponding independent overseas regulator before the FRC may recognise the overseas auditor concerned. This requirement will enable the FRC to seek cooperation and assistance from these overseas regulators when necessary in performing its regulatory functions on recognised PIE auditors.

⁶ The HKICPA charged the audit profession \$7.3 million for making contribution to the FRC in 2016. In addition, the annual costs currently incurred by the HKICPA in conducting recurring inspections and carrying out disciplinary functions in respect of PIE auditors (which will be transferred to the post-reform FRC) amounted to some \$12-13 million. Therefore, the total costs borne by the audit profession for the current operations of the FRC and the HKICPA in the regulation of PIE auditors are comparable to the contribution made by PIE auditors under the new regime.

5. It is also worth noting that the relevant legislative proposal serves to close a gap in the current regulatory regime, as these overseas auditors are at present not subject to regulation by an auditor regulatory body.

Benefits of joining the International Forum of Independent Audit Regulators (“IFIAR”) and gaining international recognition for Hong Kong’s auditor regulatory regime after the reform (Item 4 of the list of follow-up actions)

6. In recent years, it has become the international standard and practice that regulatory regimes for auditors of PIEs should be independent of the audit profession and be subject to independent oversight by bodies acting in the public interest.

IMF Report

7. In 2014, the IMF completed a review of Hong Kong’s auditor regulatory regime against the relevant principles of the International Organisation of Securities Commissions (“IOSCO”)⁷ in the context of its overall review of Hong Kong’s securities market under the Financial Sector Assessment Programme. Its report recommended that Hong Kong should establish a “fully independent authority with responsibility for the oversight of the audit profession” and that such authority “should have jurisdictions over all auditors that audit companies listed in Hong Kong”. Noting that the governance of the disciplinary committee of the HKICPA “does not ensure sufficient independence, nor foster the development of expertise, and precedents, and the range of sanctions is limited”, the IMF also recommended that the independent oversight authority should be given “strong enforcement power”.

IFIAR membership

8. Hong Kong’s present auditor regulatory regime is considered by many (including the IMF as mentioned in paragraph 7 above) as a self-regulatory one which is not desirable for investor protection. It falls short of the international standard as a result of which our auditor regulator is not eligible to join the IFIAR. Meanwhile, established in 2006, the IFIAR membership has grown to 53 member jurisdictions around the world. The IFIAR’s mission is to serve the public interest and to enhance investor protection by improving audit quality globally. Its overall objective is to, among IFIAR members, –

⁷ Since 2010, the IOSCO has introduced new principles of securities regulation with an overriding objective of protecting investors, which include the principles that auditors should be subject to adequate levels of independent oversight and that the independent auditor oversight bodies must have an adequate charter of responsibilities and powers to perform their regulatory functions.

- (a) share knowledge of the evolving audit environment and the practical experience of independent audit regulatory activity;
- (b) promote collaboration and consistency in regulatory activity; and
- (c) provide a platform for dialogue with other international organisations interested in audit quality.

9. Over the past decade, the IFIAR has become an international leader in driving audit quality matters through discussion among its members on emerging regulatory issues, challenges facing the audit profession and strategic approaches to sustainable audit quality. The key benefits of Hong Kong joining the IFIAR are as follows –

(a) More effective cooperation in cross-border auditor regulation

As Hong Kong is an international financial centre with the presence of a large number of multinational companies, the provision of audit services very often involves a multi-jurisdictional perspective. Cooperation between Hong Kong and overseas audit regulators is imperative to effectively overseeing the quality of audit provided by auditors across different jurisdictions.

The IFIAR serves as the leading international forum for improving audit quality. It assists member jurisdictions in establishing public oversight and supports subsequent cooperation with international peers, both bilaterally and through the IFIAR. After joining the IFIAR, Hong Kong will be able to obtain first-hand information about various auditor regulatory approaches and practices which can provide useful reference in further improving our auditor regulatory system for investor protection and developing cooperation framework with overseas auditor regulators. It will help enhance international recognition of our financial regulatory system.

(b) Further development of the audit profession

Hong Kong's participation in the IFIAR will benefit the local audit profession. Through transforming the FRC into an independent auditor oversight body and joining the IFIAR, we will demonstrate to the international community that Hong Kong is committed to improving the overall standards of auditing and ensuring that our audit profession is working in the public interest. This will help reinforce the trust of companies and investors in the work of our auditors, which in turn will assist the further growth and development of the audit profession.

(c) Benefits for the capital market

Since the IFIAR is an influential multinational organisation admitting only regulators which are independent of the audit profession, being a member of the IFIAR signifies that Hong Kong is recognised globally as having in place a robust auditor regulatory regime. This will enhance the confidence of both international and local companies and investors in the integrity of our overall financial regulatory regime with regard to the capital market. The quality of our capital market and our status as an international financial centre are essential in attracting capital which will be conducive to job creation and long-term economic growth.

International Comparison (Items 2, 3(c) and 5 of the list of follow-up actions)

10. In response to Members' questions about the regulatory functions and funding sources of PIE auditor oversight bodies as well as the scale of PIE auditors taking up PIE engagements in the major member jurisdictions of the IFIAR, we have set out the relevant information at Appendix.

Financial Services and the Treasury Bureau

16 March 2018

Major Member Jurisdictions of the IFIAR⁸

	United States	United Kingdom	Singapore	Canada	Australia
1. Auditor regulator	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”)
2. Scope of regulation	- Auditors	- Auditors - Actuaries	- Auditors - Business entities - Corporate service providers	- Auditors	- Auditors - Securities sector - Insurance sector
3. Major auditor regulatory functions	- 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
4. Funding sources	- 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
5. Scale of Big-4 audit firms for PIE engagements	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

⁸ The information is based on the Member Profiles 2017 of the respective jurisdictions uploaded to the IFIAR website at <https://www.ifiar.org/members/member-directory/>.