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FINANCIAL SERVICES AND
THE TREASURY BUREAU
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By email (hytchiu@legco.gov.hk)

6 April 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 20 March 2018

I refer to your email dated 21 March 2018. The Government's responses to Items 1 and 2 of the list of follow-up actions are set out in Annex A and the Financial Reporting Council's responses to Items 3 and 4 of the list of follow-up actions are set out in Annex B. We will provide the response to Item 5 of the list of follow-up actions as soon as possible.

Yours sincerely,

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

(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”)

**The Government’s Responses to Matters Raised by Members
at the Meeting on 20 March 2018**

Financial arrangement of the Financial Reporting Council (“FRC”) (Items 1 and 2 of the list of follow-up actions)

Since its establishment, the FRC has been funded through an ad hoc agreement amongst four parties, i.e. the Hong Kong Institute of Certified Public Accountants (“HKICPA”), the Securities and Futures Commission, the Hong Kong Exchanges and Clearing Limited and the Companies Registry Trading Fund. These four parties negotiate and sign a multi-party Memorandum of Understanding on the funding arrangement at 5-yearly intervals. In devising the funding mechanism for the post-reform FRC which will become a full-fledged regulator in respect of auditors of public interest entities (“PIEs”), our key considerations are stability of funding support for the FRC, the “user pay” principle and the principle that the FRC as an independent auditor oversight body should be operationally and financially independent of the Government. Accordingly, during the public consultation in 2014 we proposed that the post-reform FRC should be funded through three new levies to be imposed upon securities transactions, PIEs and PIE auditors respectively on a roughly equal basis. This funding proposal was retained in the consultation conclusions released in 2015.

2. Subsequently, upon release of the consultation conclusions, we have continued to engage the audit profession as we take forward the legislative amendment exercise. During this engagement process, we have duly noted the concern that the reform would bring about significant changes to the audit profession, and have taken on board a number of views and suggestions from the profession in formulating our detailed legislative proposals. For the funding mechanism, having considered the concern from the audit profession about the financial implications of the new regime on them, especially on the small and medium sized audit firms, we have proposed in the Bill that the contributions from securities transactions, PIEs and PIE auditors should be in the ratio of 50:25:25 respectively, with the detailed computation of each of the levies as set out in the table below. Taken as a whole, we consider this funding mechanism balanced and reasonable.

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
For a transaction valued at \$100,000, seller and purchaser each required to pay a levy of \$0.15	A listed corporation required to pay a levy of around \$4,000 to \$50,000 per year	Annual levy for Big-4 firms: Around \$2.6 million to \$4.9 million Annual levy for other audit firms: \$12,310 to around \$1.4 million

3. We have received suggestions that the Government should be one of the funding sources of the FRC under the new regime. On this, we maintain the view that 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 the 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. At the same time, the Government is fully aware of the need for the post-reform FRC to be provided with adequate funding in order to prepare for the transition to the new regime and to discharge its full range of statutory functions. We will carefully consider the views and suggestions received before finalising the funding mechanism.

Financial Services and the Treasury Bureau

6 April 2018

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

**The Financial Reporting Council (“FRC”)’s Responses to Matters Raised by Members
at the Meeting on 20 March 2018**

Factors to be considered by the FRC before initiating disciplinary processes (Item 3 of the list of follow-up actions)

Our inspections are primarily intended to monitor auditors’ compliance with professional standards. Where improvements are required to safeguard or enhance audit quality, we will seek to agree an action plan with each firm inspected to achieve the improvements needed. We will assess periodically the adequacy of the progress made by the firm in addressing our findings. On occasion, matters arising from our inspections may result in the consideration of disciplinary sanctions being imposed against a public interest entity (“PIE”) auditor and/or a registered responsible person of a PIE auditor in accordance with the Bill. Such occasion would include situations where a breach of ethics is clearly identified.

2. FRC’s disciplinary processes can also be initiated as a result of an investigation. Under the proposed section 23 of the Financial Reporting Council Ordinance (Cap. 588), the FRC may initiate an investigation if it has reasonable cause to believe that a PIE auditor has breached a professional standard. After an investigation, if the FRC considers that a PIE auditor and/or a registered responsible person of a PIE auditor has/have committed such a breach, the FRC will initiate the disciplinary processes.

Guidelines on how the FRC will impose pecuniary penalty (Item 4 of the list of follow-up actions)

3. The FRC is committed to issuing the Guidelines as soon as practicable after the Bill is enacted and certainly prior to the proposed commencement of the Bill on 1 August 2019. In exercising the power to order a PIE auditor or a registered responsible person to pay a pecuniary penalty and to determine the level of pecuniary penalty, we intend to adhere to the following principles:

I. In order to determine whether a pecuniary penalty is appropriate the factors to be considered will normally include whether:

- (a) deterrence can be achieved by a reprimand alone;
 - (b) the regulated person(s) has derived any financial gain or benefit (including avoidance of loss) as a result of the misconduct;
 - (c) the misconduct involved, caused or risked the loss of significant sums of money;
 - (d) a pecuniary penalty was ordered in similar previous cases.
- II. In cases where Council considers that a pecuniary penalty is appropriate, it should aim to impose a pecuniary penalty that:
- (a) is proportionate to the misconduct and all the circumstances of the case;
 - (b) will act as an effective deterrent to future misconduct;
 - (c) will promote public confidence in the regulation of PIE audits and in the way in which misconduct is addressed.
- III. In undertaking this assessment, Council will normally take into consideration:
- (a) the nature, extent and importance of the standards or regulations breached;
 - (b) the seriousness of the misconduct;
 - (c) 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;
 - (d) 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;
 - (e) the upper limit on the pecuniary penalty that Council can impose.
- IV. When deciding the level of pecuniary penalty to impose, Council should:
- (a) 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 Council; and

(b) disregard the possibility that the regulated person(s) may be liable for the costs of the case.

V. Having arrived at a figure for the pecuniary penalty based on the nature and seriousness of the misconduct, Council should consider whether the amount of the pecuniary penalty should be adjusted:

(a) to take account of any aggravating and mitigating factors;

(b) to ensure the pecuniary penalty has the necessary deterrent effect;

(c) to reflect any discount for admissions and/or early disposal; and/or

(d) to avoid the likely effect of putting a practice unit or individual in financial jeopardy.

Pursuant to the proposed section 37J(6), any money paid to or recovered by the FRC under the pecuniary penalty order must be paid into the general reserve.

Financial Reporting Council

6 April 2018