

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

**Recent Developments**

**PURPOSE**

This paper briefs the Bills Committee on –

- (a) the announcement in the 2018 Policy Address to inject no less than \$300 million into a seed capital to facilitate the smooth transition of the Financial Reporting Council ("FRC") from the existing regulatory regime to the new regime; and
- (b) the Government's major proposed amendments to the Bill to address a number of issues recently identified or brought up by stakeholders concerning the regulation of overseas auditors and the basis for calculating the levy on auditors under the new auditor regulatory regime.

**SEED CAPITAL**

2. In previous meetings of the Bills Committee, some Members proposed that the Government should provide seed money to support the post-reform FRC's operation in the initial years and to subsidise part of the proposed levies payable by various parties. Under the new regulatory regime proposed by the Bill, the functions of the FRC will be enhanced to become a full-fledged independent oversight body for auditors of listed entities. 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.

3. Having considered the views of Bills Committee Members and other stakeholders, the Chief Executive 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 the FRC.

4. We will work out the parameters within which the seed capital can be deployed. These will include assisting the post-reform FRC in meeting the

necessary one-off and contingency expenses for its transition into a full-fledged regulatory body. In response to the suggestion by Members of the Bills Committee and other stakeholders, we will also consider making use of part of the seed money to alleviate the burden of the levy payers in the implementation of the new regime.

## **PROPOSED AMENDMENTS TO THE BILL**

### **Background**

#### *Regulation of overseas auditors*

5. The Bill provides that under the new regime it will be an offence for an overseas auditor to undertake specified public interest entity (“PIE”) engagements<sup>1</sup> without being “recognised” by the FRC as a PIE auditor<sup>2</sup>. Under the proposed new section 20ZF, to grant a recognition application, the FRC must be satisfied that a number of requirements have been fulfilled. One of the requirements (under the proposed new section 20ZF(2)(c)) is that “*an agreement of mutual or reciprocal cooperation is in force between the FRC and the overseas regulatory organisation*” of the relevant overseas auditor.

6. Currently, a small number of PIEs in Hong Kong are engaging overseas auditors<sup>3</sup>. With the implementation of the new regime, these overseas auditors must be recognised by the FRC as PIE auditors in order to continue their PIE engagements with the overseas corporations concerned. Likewise, any overseas corporations seeking to be listed in Hong Kong in future and planning to engage overseas auditors would need to observe the recognition requirements.

7. Recently, in preparing for transition into the new regime, the FRC has become aware that there are implementation problems associated with the aforementioned section 20ZF(2)(c) requiring the FRC to enter into a cooperation agreement with the relevant overseas regulator before it can recognise an overseas auditor. Having researched into recent developments in

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<sup>1</sup> Under the Bill, a PIE is defined as a corporation with issued shares or stocks listed in Hong Kong or a collective investment scheme with interest listed in Hong Kong. The specified engagements to be carried out by a PIE auditor are prescribed in the proposed new Schedule 1A.

<sup>2</sup> There are similar provisions in the Bill requiring local auditors to be registered with the Hong Kong Institute of Certified Public Accountants in order to undertake PIE engagements.

<sup>3</sup> These overseas auditors are from nine overseas jurisdictions (Canada, Italy, Japan, Luxembourg, Malaysia, Russia, Singapore, the United Kingdom and the United States).

the international arena and reached out to its overseas counterparts, the FRC realised there is no assurance that overseas auditor regulators would be willing to enter into bilateral cooperation agreements with other jurisdictions because there are legal, practical or other considerations in play. At the same time, there is concern from other stakeholders about the possible impact of the requirement on the timely approval of applications for initial public offerings from overseas corporations which would wish to engage overseas auditors.

8. We note that there will be particular difficulties associated with auditor regulators of the European Union (“EU”) member states. In considering cooperation with a regulator outside the EU, including exchange of information for regulatory purposes, the relevant article of the Statutory Audit Directive (“SAD”) of the European Commission (“EC”) requires that the regulator concerned shall have been declared “adequate”. To meet this “adequacy” test, *inter alia*, the composition of the governing body of the regulator concerned shall meet the requirement equivalent to that for auditor regulators in the EU, i.e. it shall be composed of all non-practitioners<sup>4</sup>. This requirement of an “all non-practitioner” governing board of the regulator was put into effect in June 2016<sup>5</sup>.

#### *Basis for calculating the levy on PIE auditors*

9. Under the Bill, the proposed levy on PIE auditors is \$12,310 for a calendar year in respect of every PIE client<sup>6</sup>. This flat fee per client approach has been adopted by the Hong Kong Institute of Certified Public Accountants

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<sup>4</sup> A “non-practitioner” is defined in the Bill as a person who is not, or has not within the previous three years been–

- (a) a certified public accountant (practising); or
- (b) a partner, director, agent or employee of a practice unit.

This definition which is modelled on the existing arrangement of the EU will allow appointment of experienced personnel from the audit profession who have met the relevant cooling-off period requirement.

<sup>5</sup> One of the objectives of the auditor regulatory reform is to enable Hong Kong to be eligible for the membership of the International Forum of Independent Audit Regulators (“IFIAR”), which is an influential multinational organisation in cooperation of regulators of auditors. Hong Kong is currently not eligible to be a member because the FRC is not a full-fledged independent regulator for auditors. The IFIAR introduced a multilateral memorandum of understanding (“MMOU”) in April 2017 for cross-jurisdictional cooperation. However, there is a “non-application” clause which provides that the MMOU does not apply between an EU member state and a non-EU jurisdiction if the latter cannot fulfil the adequacy requirement in the EC SAD. Therefore, even after Hong Kong has been admitted as a member of the IFIAR and become a party of the MMOU, the MMOU would not apply between EU member states and Hong Kong so long as the FRC cannot fulfil the adequacy requirement.

<sup>6</sup> It refers to a PIE for which a PIE auditor has carried out an engagement for preparing an auditor’s report of the PIE’s annual financial statements.

(“HKICPA”) since the establishment of the FRC for collecting fees from relevant auditors as annual contribution to the FRC<sup>7</sup>. We understand that the HKICPA’s decision to collect fees by this simple and straightforward approach was made after due consultation with members and consideration of other calculation bases. Over the past few years, we have indicated to the 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.

10. The HKICPA recently informed us that the profession has just reached a broad consensus on an alternative calculation basis to determine the levy on PIE auditors under the new 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<sup>8</sup>. The 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 regulatory regime. It should be noted that notwithstanding the revision in the calculation basis for individual PIE auditors, 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).

## **Proposal**

11. In view of the above, we propose to put forward the following amendments –

- (a) To remove the proposed new section 20ZF(2)(c). As explained in paragraphs 7 to 8 above, there are practical difficulties for the FRC to enter into cooperation agreements with overseas regulators, at least in some of the cases, for reasons beyond the FRC’s control. Even if there are prospects of reaching an agreement, the process may well be protracted which can drive away potential corporations planning to list in Hong Kong. Moreover, apart from the issues concerning EU member states as mentioned above, according to the FRC’s research there will also be hurdles in entering into

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<sup>7</sup> At present, the FRC is funded through an ad hoc agreement of four parties, viz. the HKICPA, the Securities and Futures Commission, the Hong Kong Exchanges and Clearing Limited and the Companies Registry Trading Fund, who negotiate and sign a multi-party Memorandum of Understanding at 5-yearly intervals.

<sup>8</sup> This new calculation basis of levy will be applicable to all local and non-Hong Kong auditors.

cooperation agreements with non-EU jurisdictions due to such constraints as local laws and regulations, domestic policies on data protection etc. In view of such realities, section 20ZF(2)(c) will be unduly restrictive. The deletion of this statutory requirement notwithstanding, we will ask the FRC to pursue mutually agreed regulatory cooperation mechanism with respective overseas regulators as far as possible;

- (b) To amend the provisions concerning the composition of the governing board of the FRC. The proposed new section 7(3)(a) requires that the FRC governing board must comprise “a majority of non-practitioners”, meaning that the presence of practitioners is allowed. Even with the deletion of the proposed new section 20ZF(2)(c), we need to remove obstacles which would prevent the FRC from seeking the cooperation of overseas regulators as far as possible. As explained in paragraph 8 above, the presence of practitioners on the FRC governing board will definitely be a hurdle on this front, at least for EU member states. Hence, we propose to amend the requirement to an “all non-practitioner” governing board. Concurrently, to ensure there is sufficient expertise on the FRC governing board, we propose to make a corresponding change to the proposed new section 7(4)(a) such that the threshold of members with “knowledge and experience in PIE engagements” will increase from “at least two” as currently provided for in the Bill to “not less than 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). This would address the profession’s concern about the need for sufficient expertise on the FRC. The adjustment of the composition of the governing board to “all non-practitioners” will remove an identified impediment to meeting the EC’s “adequacy” test. There are other requirements prescribed by the EC (such as professional secrecy and personal data protection) for the assessment on “adequacy” to be conducted by the EC. The Government has been in touch with the EC to better understand the requirements. The EC has agreed to continue the dialogue in the process of Hong Kong's preparation for the “adequacy” test;
- (c) To amend the formula of calculating the levy on PIE auditors.

Section 3(1) of the proposed new Schedule 7 of the Bill currently prescribes the levy on PIE auditors, using a flat fee approach, at \$12,310 for a calendar year in respect of every PIE client. To cater for a possible alternative calculation basis as recently put forth by the HKICPA, we propose to make suitable amendments to the formula, once the HKICPA has provided us with the relevant details. Based on the information we have received from the HKICPA so far, the formula will be amended to the effect that 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 a designated percentage<sup>9</sup> of the total remuneration received by the PIE auditor for conducting audits for PIE clients in a calendar year; and

- (d) To amend the commencement date of the Bill. In view of the latest developments and to allow time and flexibility for the FRC to complete the necessary preparatory work, we propose to amend the commencement date of the Amendment Ordinance from 1 August 2019 to a day to be appointed by the Secretary for the Financial Services and the Treasury by a notice published in the Gazette.

## **Next Steps**

12. Apart from the major amendments set out in paragraph 11 above, there are some other technical or textual amendments. Members will be briefed on these technical/textual amendments during the clause-by-clause examination by the Bills Committee. We will translate the proposed amendments into draft Committee Stage Amendments which will be circulated to Members for examination once available.

## **Financial Services and the Treasury Bureau** **25 October 2018**

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<sup>9</sup> The HKICPA is working out the designated percentage which will be included in the draft Committee Stage Amendments to be circulated to Members for examination when ready.