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Legislative Council

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Bills Committee on Financial Reporting Council (Amendment) Bill 2021

Background brief

Purpose

This paper provides background information on the Financial Reporting Council (Amendment) Bill 2021 ("the Bill"), and summarizes the major views and concerns expressed by members of the Panel on Financial Affairs ("FA Panel") when the Panel was consulted on the relevant legislative proposals at the meeting on 5 July 2021.

Background

Establishment and roles of the Financial Reporting Council

2. The Financial Reporting Council Ordinance (Cap. 588) ("FRCO") enacted in July 2006 provides for the establishment of FRC to take charge of investigation of complaints concerning public interest lodged against auditors. FRC was established in December 2006 and became fully operational in July 2007.

3. The roles of FRC at its inception were to: (a) conduct independent investigations into possible auditing and reporting irregularities in relation to listed entities through the Audit Investigation Board; and (b) enquire into possible non-compliances with accounting requirements on the part of listed entities through a Financial Reporting Review Committee.[1] As FRC was not

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[1] Section 22(2) of the Financial Reporting Council Ordinance (Cap. 588) ("FRCO") provides that the Audit Investigation Board ("AIB") is to consist of the Chief Executive Officer of the Financial Reporting Council ("FRC") (as an ex-officio member and chairman of AIB) and at least one other member appointed by FRC. Section 39 of FRCO provides that the Chief Executive shall, in consultation with FRC, appoint a Financial Reporting Review Panel ("FRRP") of at least 20 suitable persons (including at least three Panel Convenors). If FRC decides to conduct an enquiry into a non-compliance with financial reporting requirements of a listed entity, it may appoint a Financial Reporting Review Committee consisting of a Panel Convenor as the Chairman and at least four other members of FRRP to conduct the enquiry.

empowered to discipline when it was established, it had signed Memoranda of Understanding with the Hong Kong Institute of Certified Public Accountants ("HKICPA") and financial regulators on the protocols for referring cases/complaints to FRC for investigation or conduct of enquiry, as well as for referring auditing or reporting irregularities identified by FRC to the relevant parties for follow-up.[2]

Financial Reporting Council (Amendment) Ordinance 2019

4. Against the international trend for auditor regulatory regimes to be independent of the audit profession and be subject to independent oversight by bodies acting in the public interest, the Administration introduced the Financial Reporting Council (Amendment) Bill 2018 ("the Amendment Bill 2018") into the Legislative Council ("LegCo") in January 2018 to reform FRC by establishing a new regulatory regime for auditors of public interest entities[3] ("PIEs") ("the regulatory regime for PIE auditors").[4] The Bill was passed by LegCo at the meeting of 30 January 2019 and enacted as the Financial Reporting Council (Amendment) Ordinance 2019 ("the Amendment Ordinance 2019"). The Amendment Ordinance 2019 commenced operation on 1 October 2019.[5]

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2 The financial regulators include the Securities and Futures Commission ("SFC"), the Hong Kong Exchanges and Clearing Limited ("HKEX"), the Hong Kong Monetary Authority and the Insurance Authority. By the Memoranda of Understanding signed, auditing or reporting irregularities identified by FRC will be referred to the Hong Kong Institute of Certified Public Accountants ("HKICPA"); non-compliances relevant to the Listing Rules will be referred to SFC or HKEX, and cases involving criminal offences will be referred to the Police or the Independent Commission Against Corruption for necessary follow-up actions.

3 Public interest entities ("PIE") refer to listed corporations (equities) or listed collective investment schemes.

4 According to the Administration, the scope of the new regulatory regime was limited to PIE auditors instead of the entire audit profession because the new regime would entail substantial changes to the existing regulatory regime for auditors. The Administration thus considered it prudent to adopt a step-by-step approach in proceeding with the reform on the audit profession having regard to, among other factors, the implications of the reform on the profession and its impact on FRC's manpower requirement.

5 The Financial Reporting Council (Amendment) Ordinance 2019 (Commencement) Notice was tabled before the Legislative Council at the meeting of 22 May 2019. By the Notice, the Secretary for Financial Services and the Treasury ("SFST") has appointed 1 October 2019 as the day on which the Financial Reporting Council (Amendment) Ordinance 2019 ("the Amendment Ordinance 2019"), except sections 62 and 85 (concerning payment and calculation of levies payable to FRC by specified parties), comes into operation. SFST has also appointed 1 January 2022 as the day on which sections 62 and 85 of the Amendment Ordinance 2019 come into operation.

5. Following the commencement of the Amendment Ordinance 2019, FRC has become an independent oversight body for regulating PIE auditors and is vested with direct powers of inspection, investigation and disciplinary concerning these auditors.[6] FRC also has powers to recognize overseas PIE auditors, and oversee the performance of HKICPA's functions of (a) registration of local PIE auditors; (b) establishing and maintaining the PIE auditors register; and (c) setting continuing professional development ("CPD") requirements, standards on professional ethics, as well as auditing and assurance practices for registered local PIE auditors. The Amendment Ordinance 2019 also provides for the new composition of FRC,[7] an appeal mechanism regarding decisions made against PIE auditors, and levies payable to FRC.[8]

The Financial Reporting Council (Amendment) Bill 2021

6. According to the Administration, the international trend on accounting profession regulation is to vest the regulatory powers with a regulatory body

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[6] FRC can initiate investigations to ensure that misconduct on the part of PIE auditors and registered responsible persons are detected, which will be referred to the Department of Discipline to consider appropriate follow-up actions including imposition of sanctions or referral to other regulators or law enforcement agencies for conduct falling within their jurisdiction. Furthermore, FRC has the power to direct an inspector to carry out an inspection in relation to PIE engagements for ascertaining whether the PIE auditor has complied with, or is likely to be able to comply with, provisions of FRCO or a professional standard.

[7] Section 7 of FRCO stipulates that FRC is to consist of: (a) a chairperson, who is a non-executive director of FRC; (b) a chief executive officer, who is an executive director of FRC; and (c) at least seven other members, who are either executive or non-executive directors of FRC. The section also provides that:

(a) all members of FRC must be non-practitioners and the number of non-executive directors of FRC must exceed the number of executive directors; and
(b) at least one-third of the members of FRC must be appointed from among persons who appear to the Chief Executive to be suitable for appointment, because of their knowledge and experience in public interest entity engagements.

[8] Before the commencement of the Amendment Ordinance 2019, FRC was jointly funded by the Companies Registry Trading Fund, SFC, HKEX and HKICPA on an equal share basis. A new funding model is introduced under the new regulatory regime for PIE auditors. FRC is funded by three new levies on (a) securities transactions (to be paid by sellers and purchasers in securities transactions); (b) PIEs; and (c) PIE auditors. Contributions from the three parties are in the ratio of 50:25:25. To facilitate FRC's transition to the new regulatory regime, the Chief Executive announced in the 2018 Policy Address to provide no less than $300 million as a seed capital for FRC. The Financial Secretary announced in the 2019-2020 Budget to increase the seed capital to $400 million in order to help FRC migrate to the new regulatory regime, and to exempt the levies for the first two years upon the implementation of the new regime. The $400 million seed capital was approved by the Legislative Council in the context of the Appropriation Bill 2019.

independent from the trade to ensure impartiality. Most comparable overseas accounting jurisdictions have already given expanded power to their respective independent regulators which oversee the accounting profession to ensure that professional accounting services are duly regulated. The Administration considers that a further reform to develop FRC into a full-fledged independent regulatory and oversight body for the accounting profession ("the further reform") will make Hong Kong's regulatory regime more in line with the international standard and practice and reinforce Hong Kong's status as an international financial centre and business hub. The Administration further points out that as practice units and certified public accountants ("CPAs")[9] in general continue to be regulated under the Professional Accountants Ordinance (Cap 50) ("PAO") except for their engagements under the PIE auditor regulatory regime as specified in FRCO, individual practice units and CPAs are subject to separate inspections by FRC and HKICPA in accordance with FRCO and PAO respectively for their quality control systems which are likewise applicable for both PIE engagements and all other engagements. The arrangement has led to inefficient use of resources and unnecessary compliance burden. Moreover, while FRC has assumed regulatory functions over local PIE auditors, HKICPA is still responsible for the registration which results in a fragmented approach in regulation. The Administration envisages that the further reform can reduce compliance burden and enhance efficiency in regulation.

7. The Bill was published in the Gazette on 16 July 2021 and received its First Reading at the LegCo meeting of 21 July 2021. In gist, the Bill will implement the further reform by:

(a) empowering FRC to issue practising certificates to CPAs and register CPA firms, corporate practices and local PIE auditors;[10]

(b) expanding FRC's current powers of inspection, investigation and discipline over PIE auditors to cover practice units and CPAs; and

(c) expanding FRC's oversight powers to cover HKICPA's functions of (i) ascertaining qualification for registration as CPAs by conducting examinations; (ii) registering CPAs; (iii) arranging for mutual or reciprocal recognition of accountants; (iv) setting CPD requirements,

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9 Only practice units may perform statutory audits. As defined in section 2 of the Professional Accountants Ordinance (Cap 50), a practice unit is (a) a certified public accountant ("CPA") (practising) practising accountancy on his own account; (b) a firm of certified public accountants (practising) practising accountancy; or (c) a corporate practice.

10 FRC will be responsible for issuing practising certificates to qualified CPAs while HKICPA will continue to be responsible for registration of CPAs subject to FRC's oversight.

and issuing or specifying standards on professional ethics, and accounting, auditing and assurance, for CPAs; and (v) providing training for qualifying as and CPD of CPAs.

8. The main provisions of the Bill are explained in paragraph 26 of the LegCo Brief (File Ref: ACCT/2/1/2C issued on 14 July 2021), and set out in paragraphs 4 to 12 of the Legal Service Division Report on the Bill (LC Paper No. LS98/20-21). The Bill, if passed, would come into operation on a day to be appointed by the Secretary for Financial Services and the Treasury by notice published in the Gazette. The major provisions in the Bill are as follows:

(a) <u>Clause 5</u> provides for the new and revised definitions of key terms and subjects all registration and disciplinary decisions made by FRC to the review and appeal mechanism;

(b) <u>Clauses 12 and 13</u> amend FRCO to provide for the new functions and powers of FRC under the new regime;

(c) <u>Clause 14</u> introduces a new provision in FRCO for the set-up of an advisory committee under FRC to provide advice to FRC;

(d) <u>Clause 19</u> introduces new provisions in FRCO for the direct powers of FRC to issue practising certificates to CPAs and register CPA firms and corporate practices;

(e) <u>Clauses 20 to 41</u> amend FRCO to provide for the direct powers of FRC to register PIE auditors;

(f) <u>Clause 42</u> introduces new provisions in FRCO to provide for the powers of FRC to conduct recurring inspections on practice units and carry out investigations on practice units and CPAs; and

(g) <u>Clause 64</u> introduces new provisions in FRCO to provide for the powers of FRC to impose disciplinary sanctions against practice units and CPAs.

Major views and concerns expressed by members of the Panel on Financial Affairs

9. The Administration briefed FA Panel on the legislative proposals for implementing the further reform at the meeting on 5 July 2021. The major views and concerns expressed by Panel members are summarized in the ensuing paragraphs.

Necessity of the further reform

10. Members in general supported the further reform which they considered would make Hong Kong's accounting regulatory regime more in line with the international standard and practice and reinforce Hong Kong's status as an international financial centre and business hub. Some members enquired about the major issues/problems of the existing regulatory regime which the further reform sought to tackle and requested the Administration to elaborate on the practices of regulatory regimes for the accounting profession of comparable overseas jurisdictions.

11. The Administration advised that the international trend on accounting profession regulation was to vest the regulatory powers with a regulatory body independent from the trade to ensure impartiality. The direction of the proposed further reform was in line with the practices of many comparable overseas accounting jurisdictions. For instance, Australia and Singapore had set up independent regulators (i.e. the Australian Securities and Investments Commission and the Accounting and Corporate Regulatory Authority respectively) with inspection, investigation and discipline powers over the accounting profession. The United Kingdom's Financial Reporting Council regulated the accounting profession through supervision of recognized professional bodies. The United States' independent regulator, namely State Boards of Accountancy, also had oversight power over practice units and CPAs. In addition, the United Kingdom had plans to set up a new independent regulator (i.e. the Audit, Reporting and Governance Authority) and reclaim the powers of registration of PIE auditors from the recognized professional bodies to strengthen regulation of the accounting profession.

Stakeholder engagement

12. Some members enquired about the major views and concerns received during the Administration's engagement with stakeholders on the further reform and proposed measures to address the concerns. These members also pointed out that a number of practitioners in the accounting profession had considered the proposed implementation timetable of the further reform aggressive, and urged

the Administration to step up its efforts in engaging various stakeholders and addressing their concerns.

13. The Administration advised that the accounting profession was mainly concerned about the implementation timetable and transitional arrangements of the reformed new regime, the regulatory arrangements for practice units and CPAs which were currently not subject to the regulatory regime for PIE auditors, and whether there would be sufficient channels for the profession to reflect its views to the post-reform FRC. To allay the industry's concern about the implementation timetable and transitional arrangements of the reformed new regime, the Administration would implement the new regime in phases. The Administration was currently actively engaging various stakeholders. The broad regulatory framework of FRC under the reformed new regime would be set out in the Bill. The implementation details of the regime would be drawn up in parallel for further engagement with stakeholders in the next stage. Among them, the transitional arrangements would be stipulated in the subsidiary legislation to be tabled before LegCo for negative vetting (tentatively in 2022) after passage of the Bill.

14. Regarding the profession's concern about the new regulatory arrangements for accounting professionals and practices currently not subject to FRC's regulation, the Administration stressed that the further reform only sought to transfer certain powers of HKICPA to FRC, and that FRC would adopt the principle of proportionality when exercising its expanded powers over the accounting profession. For all the regulatees to be newly handled by FRC, including many small and medium practices which did not carry out PIE engagements, the regulatory scope and requirements applicable to them and the consequences of non-compliance under the reformed new regime would remain comparable to those currently provided in PAO. On the mechanism of the post-reform FRC for soliciting the views of the accounting profession, the Administration advised that a statutory advisory committee consisting of practitioners, service users and other stakeholders of the profession would be established to provide advice to FRC.

15. As regards members' enquiry about the views on the further reform expressed by practice units of different sizes, the Administration said that the three main categories of practice units had expressed different views. Practice units solely working on PIE engagements and those working on both PIE and non-PIE engagements generally welcomed the direction of the further reform, while those solely working on non-PIE engagements had raised more concerns. The Administration had assured the firms working on non-PIE engagements that the regulatory scope and requirements applicable to them would remain largely the same as in the existing regime under PAO.

Funding arrangement of the post-reform Financial Report Council

16. Members enquired about the funding arrangement for the post-reform FRC. Some members pointed out that under the regulatory regime for PIE auditors, FRC was empowered to impose a levy on securities transactions (to be paid by sellers and buyers of the securities transactions)[11] on the ground that enhancement in the PIE auditor regulatory regime could better ensure the integrity of financial reports of listed companies and thereby increase protection for investors. These members questioned the justification for using the levy on securities transactions to fund FRC's expanded responsibilities which would mainly relate to the regulation of non-PIE auditors, and considered that the move was inconsistent with the user-pay principle adopted in the existing funding arrangement for FRC.

17. The Administration reiterated that it had been engaging various stakeholders on the proposed further reform, and was aware that the industry had views about possible changes in FRC's funding arrangement. The Administration would review FRC's funding arrangement under the reformed new regime on the premise that no additional compliance burden would be created to the accounting profession.

18. Some members enquired whether the seed capital of $400 million provided by the Government to FRC in October 2019 would be sufficient in meeting FRC's expenditure before it commenced collecting levies on 1 January 2022. The Administration pointed out that about half of the seed capital would have been used when FRC started collecting levies on 1 January 2022. As FRC would fund its operating expenditure with income from levies then, it was envisaged that the unspent seed capital could help fund FRC's expanded functions in the initial years of the further reform.

Governance and work of the Financial Report Council under the reformed new regime

19. Some members raised enquiries on whether the post-reform FRC would recruit practitioners in the accounting profession for carrying out its inspection, investigation and disciplinary functions over practice units, and how the further reform would enhance the cooperation of various regulators in the regulation of the accounting profession.

20. The Administration advised that while all members of the FRC Board must be non-practitioners, at least one third of them were appointed because of their knowledge and experience in PIE engagements. Besides, many executive members of FRC were former practitioners, and possessed the necessary

[11] See footnote 8 for details of the levy on securities transactions.

knowledge and experience in accounting engagements for implementation of the regulatory work under the reformed new regime. Moreover, a statutory advisory committee consisting of relevant stakeholders would be established to provide advice to FRC. On FRC's cooperation with other regulators, the Administration believed that the cooperation mechanism among FRC, the Securities and Futures Commission and the Hong Kong Exchanges and Clearing Limited would likely be further enhanced under the reformed new regime.

Latest development

21. At the House Committee meeting on 23 July 2021, Members agreed to form a Bills Committee to study the Bill.

Relevant papers

22. A list of relevant papers is in the **Appendix**.

Council Business Division 1
Legislative Council Secretariat
11 August 2021

Appendix

List of relevant papers

Date	Event	Papers/Minutes of meeting
30 January 2019	The Legislative Council ("LegCo") passed the Financial Reporting Council (Amendment) Bill 2018	Report of the Bills Committee on Financial Reporting Council (Amendment) Bill 2018 (LC Paper No. CB(1)505/18-19) Legislative Council Brief (File Ref: ACCT/2/1/2C) Legal Service Division Report (LC Paper No. LS25/17-18)
22 May 2019	The Financial Reporting Council (Amendment) Ordinance 2019 (Commencement) Notice was tabled before LegCo	The Notice Report of the Subcommittee (LC Paper No. CB(1)1209/18-19)
8 June 2021	The Secretary for Financial Services and the Treasury revealed in his blog the Administration's plan to further reform the regulatory regime of accounting profession	SFST's blog
5 July 2021	FA Panel was consulted on further reform of the regulatory regime of accounting profession	Administration's paper (LC Paper No. CB(1)1051/20-21(03)) Background brief prepared by the Legislative Council Secretariat (LC Paper No. CB(1)1051/20-21(04))
21 July 2021	The Financial Reporting Council (Amendment) Bill 2021 received its First reading	Legislative Council Brief (File Ref: ACCT/2/1/2C) Legal Service Division Report (LC Paper No. LS98/20-21)