

**For discussion
on 1 March 2021**

Legislative Council Panel on Financial Affairs

**Financial Reporting Council
Budget for the Financial Year 2021-22**

PURPOSE

This paper highlights the main features of the budget of the Financial Reporting Council (“FRC”) for 2021-22.

BACKGROUND

2. Under the new auditor regulatory regime which commenced operation on 1 October 2019, the FRC has become an independent oversight body for regulating auditors of public interest entities (“PIEs”)¹. It is responsible for the inspection, investigation and disciplinary functions with regard to PIE auditors and also exercises independent oversight over the Hong Kong Institute of Certified Public Accountants’ statutory functions of registration, setting requirements for continuing professional development, and setting standards on professional ethics, auditing and assurance in respect of PIE auditors.

3. Pursuant to section 17(3)(a) of the Financial Reporting Council Ordinance (“FRCO”), the estimates of the FRC’s income and expenditure for the first financial year under the new regime (i.e. 1 October 2019 to 31 March 2021)² were approved by the Financial Secretary (“FS”). In accordance with section 17(3)(b) of the FRCO, the FRC submitted its estimates of the income and expenditure for the second financial year under the new regime (i.e. 1 April 2021 to 31 March 2022) to the FS for approval.

¹ PIEs refer to corporations with issued shares or stocks listed in Hong Kong or collective investment schemes with interests listed in Hong Kong.

² According to section 17(2) of the FRCO, the first financial year of the FRC under the new auditor regulatory regime begins on the commencement date of the Financial Reporting Council (Amendment) Ordinance 2019 (“Amendment Ordinance”) and ends on the 31 March immediately after the first anniversary of that commencement date. Therefore, the first financial year of the FRC under the new regime spans across 18 months from 1 October 2019 to 31 March 2021.

In line with the practice of other financial regulators, the Government has prepared this paper to brief Members on the main features of the FRC's budget for 2021-22.

FUNDING OF THE FRC

4. As announced in the 2019 Budget, a seed capital of \$400 million has been injected to the FRC to help it migrate to the new auditor regulatory regime and to exempt the levies³ as promulgated in the Amendment Ordinance for the first two years upon the commencement of the new regime. The new levies will be collected starting from 1 January 2022.

BUDGET FOR 2021-22

5. A copy of the budget of the FRC for 2021-22 is at [Annex](#), the main features of which are set out in paragraphs 6 to 13 below.

Income

6. The total estimated income for 2021-22 is about \$121.57 million, comprising about \$77.99 million of Grant income⁴, \$1.79 million of interest and other incomes, and \$41.79 million of levies income (collected in January to March 2022). The FRC has adopted the following assumptions in projecting the estimated levies income –

³ The three levies are:

- (1) the levies payable for a sale and purchase of securities –
 - (a) for the seller – 0.00015% of the consideration for the sale; and
 - (b) for the purchaser – 0.00015% of the consideration for the purchase;
- (2) the levies payable by a PIE for a calendar year – 4.2% of the prepaid annual listing fee; and
- (3) the levies payable by a PIE auditor for a calendar year –
 - (a) \$6,155 x the number of PIEs for which the auditor is carrying out, as at 31 December of the preceding calendar year, a specified engagement; and
 - (b) 0.147% of the total remuneration paid to the auditor, in the preceding calendar year, by the PIEs for which the auditor carried out specified engagements.

⁴ According to the FRC's financial reporting method, the amount of seed capital (i.e. Government Grant) disbursed in the financial year is recognised as "Grant income" in the financial statement for offsetting the operating expenditure funded by the seed capital.

- (a) the average securities market turnover will be \$123 billion per day;
- (b) the annual increase in number of PIEs will be 149 with unchanged average annual listing fee per PIE; and
- (c) the annual increase of engagements will be in line with the increase in number of PIEs, i.e. 149.

Operating Expenditure

7. The estimated operating expenditure for 2021-22 is about \$104.57 million. The major expenditure item is “staff salaries, bonuses, variable pay and Mandatory Provident Fund contributions” which is estimated at about \$77.39 million, calculated on the basis of the existing remuneration level (i.e. a salary freeze) and bonus scheme of the FRC with no salary increment factored in.

Manpower Plan

8. The FRC does not propose any new headcount in the budget. The headcount for 2021-22 will remain the same as the forecast headcount for the end of the 2019-21 financial year at 59.

Capital Expenditure

9. The estimated capital expenditure for 2021-22 is about \$6.29 million, covering expenses on IT equipment and development of IT systems, office equipment, and office renovation and furniture.

Reserve Funds

10. The total sum of reserve funds of the FRC by 31 March 2022 is estimated at about \$260.09 million. According to Part 4A of the FRCO on the levies arrangement which will commence operation on 1 January 2022, the FRC may, after consultation with the FS, recommend to the Chief Executive-in-Council that the rate or amount of levies be reduced if the reserves of the FRC are more than twice its estimated operating expenses for that financial year. Since a large component of the estimated reserve funds of the FRC is the unspent Government Grant (i.e.

\$194.27 million) which will be used for specific purposes⁵, and the FRC will have only started collecting levies for three months by the end of 2021-22, it is considered that no adjustment to the rate or amount of levies is required.

COMPARISON OF THE 2019-21 APPROVED BUDGET WITH THE UPDATED FORECAST

Income

11. The forecast income for 2019-21 is \$122.73 million, comprising about \$112.23 million of Grant income, \$9.50 million of interest and other incomes, and \$1 million from recovery of costs of investigation. There was no estimated income in the FRC's 2019/21 approved budget⁶.

Operating Expenditure

12. The forecast operating expenditure is \$122.73 million, which is less than the approved budget of \$124.39 million by \$1.66 million (1.33%).

Capital Expenditure

13. The forecast capital expenditure is about \$14.45 million, which is less than the approved budget of \$17.10 million by about \$2.65 million (15.50%).

THE GOVERNMENT'S VIEWS

14. We have studied in detail the FRC's proposed budget for 2021-22. We note that the FRC, after reviewing its resources requirement for effective performance of its expanded function under the new regime and the prevailing market conditions, has proposed zero-growth in manpower

⁵ Upon the commencement of the collection of levies, the unspent Government Grant will only be used to manage any unexpected changes in the market situations which may lower levies income; support the expenses incurred by possible litigations; and address other exigencies of circumstances. It will not be used to fund the operating expenditure.

⁶ Since the timing of injection of the seed capital had not yet been confirmed at the time of preparation of the 2019-21 budget, no estimation on Grant income and related interest was provided in the budget.

and a pay freeze for its staff in 2021-22.

15. Meanwhile, the FRC's operation will continue to be funded mainly by the seed capital in the first nine months of the upcoming financial year before the new levies commence on 1 January 2022. We encourage the FRC to continue its efforts in implementing the new regulatory regime through effective utilisation of available resources and prioritization of work.

ADVICE SOUGHT

16. Members are invited to note the proposed budget of the FRC for 2021-22.

**Financial Services Branch
Financial Services and the Treasury Bureau
February 2021**

Financial Reporting Council
Budgeted Income and Expenditure Statement
For the period from 1 April 2021 to 31 March 2022 (the “Period”)
(Expressed in Hong Kong dollars)

	Note	Proposed budget Apr 2021 to Mar 2022 HK\$	Forecast Oct 2019 to Mar 2021 HK\$	Approved budget Oct 2019 to Mar 2021 * HK\$
Income				
Levies income	1	41,788,000	-	-
Grant income	2	77,993,000	112,233,000	-
Interest & other incomes	3	1,789,000	9,496,000	-
Recovery of costs of investigation	4	-	1,000,000	-
		<u>121,570,000</u>	<u>122,729,000</u>	-
Expenditure				
Staff salaries, bonuses, variable pay and MPF	5	(77,392,000)	(80,796,000)	(92,090,000)
Staff training and development	7	(782,000)	(621,000)	(550,000)
Other staff expenses	8	(2,390,000)	(2,261,000)	(2,940,000)
Premises expenses	9	(11,912,000)	(18,461,000)	(16,570,000)
Legal fees	10	(500,000)	(1,299,000)	(1,300,000)
Conference and duty visits	11	(770,000)	(285,000)	(1,120,000)
Corporate communication expenses	12	(1,106,000)	(1,714,000)	(1,400,000)
Information and systems services	13	(852,000)	(1,105,000)	(782,000)
Other operating expenses	14	(1,452,000)	(1,188,000)	(1,558,000)
Project expenses (IT security study & Performance appraisal revamp)		-	(2,065,000)	-
Depreciation	15	(3,503,000)	(3,802,000)	(4,230,000)
Contingency	16	-	-	(1,000,000)
Total recurring operating expenditure		<u>(100,659,000)</u>	<u>(113,597,000)</u>	<u>(123,540,000)</u>
Expenditure for the new regime				
Relocation expenses		-	(55,000)	(200,000)
Recruitment expenses for new functions	6	(430,000)	(3,377,000)	(400,000)
Training for new functions		-	-	(250,000)
Total expenditure before non-executive directors' fees		<u>(101,089,000)</u>	<u>(117,029,000)</u>	<u>(124,390,000)</u>
Non-executive directors' fees		<u>(3,480,000)</u>	<u>(5,700,000)</u>	
Total expenditure		<u>(104,569,000)</u>	<u>(122,729,000)</u>	
Operating Surplus/(Deficit)		<u>17,001,000</u>	-	

* The approved budget for 2019-2021 addresses only expenditure.

1. Levies Income

1.1 Details of the levies payable by sellers and purchasers of securities, PIEs and PIE auditors to the FRC are set out in Sections 50A to 50G of the Financial Reporting Council Ordinance (FRCO). The collection of the levies will commence on 1 January 2022. The levies will be recorded as income on an accrual basis.

1.2 Levies payable by sellers and purchasers of securities

1.2.1 Under Section 1 of Schedule 7 of the FRCO, the levy payable for a sale and purchase of securities is calculated at 0.00015% of the consideration of the sale for the seller and 0.00015% of the consideration of the purchase for the purchaser.

1.2.2 Assumption of Market Turnover

The average securities market turnover of Main Board and GEM is around HK\$125.7 billion / day for the first 9 months of 2020¹. For the preparation of the budget, \$123.0 billion / day has been used as an assumption basis for estimation of the average securities market turnover.

1.2.3 The unpredictable nature of market turnover leads an unavoidable degree of uncertainty in the annual budget compilation. Any fluctuation of HK\$10 billion in average daily turnover will have an impact of around HK\$1.9 million in our income in FY2021/22.

1.3 Levies payable by PIEs

1.3.1 Under Section 2 of Schedule 7 of the FRCO, the levy payable by a PIE for a calendar year is calculated at 4.2% of the prepaid annual listing fee which is determined by reference to the nominal value of the securities which are or are to be listed on the Exchange.

1.3.2 In 2019, the total annual listing fee income of the HKEX² was \$760 million. For budgeting purpose, it has been assumed that the number of PIEs will continue to increase by an annual amount of 149 (representing around 90% of the average increase in the number of PIEs in 2019 and 2018) and the average annual listing fee per PIE will remain unchanged.

¹ HKEX Monthly Market Highlights,
https://www.hkex.com.hk/Market-Data/Statistics/Consolidated-Reports/HKEX-Monthly-Market-Highlights?sc_lang=en&select={2EA751A5-CB84-41A8-B99D-9C8BC53AA367}

² HKEX 2019 Annual Report

1.4 Levies payable by PIE auditors

1.4.1 The levy payable by a PIE auditor for a calendar year is the sum of (a) \$6,155 x N; and (b) 0.147% of TR. N is the number of PIEs for which the auditor is carrying out a specified engagement as at 31 December of the preceding year; and TR is the total remuneration paid to the auditor in the preceding calendar year by the PIE for which the auditor carried out the specified engagements.

1.4.2 From our research concerning annual reports published by PIEs for their financial year ended in 2019, there are 2,331 specified engagements (N) in 2019 and the average total remuneration (TR) per specified engagement is approximately \$5.6 million. For budgeting purpose, it has assumed that the number of specified engagements will grow in line with the number of PIEs as mentioned in paragraph 1.3.2, i.e. 149 / year.

1.5 Levies income assumption

The following key assumptions have been used in calculating the levies income estimates:

	FY2021/22 (3 months from 1 Jan 2022)
Levy payable by:	
Sellers and purchasers of securities	
• Average daily market turnover	\$123.0 billion
• Levy rate on sellers	0.00015%
• Levy rate on purchasers	0.00015%
PIEs	
• Average annual listing fee / PIE	\$310,330
• No. of PIEs	2,896
PIE auditors	
• No. of specified engagements (N)	2,629
• Average total remuneration (TR) per specified engagement	\$5.6 million

1.6 The budgeted levies income is determined as follows:

	FY2021/22 (3 months from 1 Jan 2022) \$ million
Payable by	
• Sellers and purchasers of securities	22.9
• PIEs	9.4
• PIE auditors	9.5
Total	41.8

2. Grant income

- 2.1 In August 2019, the FRC received a grant of \$400 million from the Government of HKSAR to be utilised, during the period of migration to the New Regime, to cushion the FRC against short-term fluctuations in the levy income, to fund one-off capital and non-recurrent expenses, to allow the FRC to gradually expand its manpower taking into account its actual operational needs, and to provide a buffer for other exigencies of circumstances. There were no unfulfilled conditions or other contingencies attaching to the grant.
- 2.2 The grant is recognised as deferred income in the statement of financial position initially and is recognised as income on a systematic basis in the statement of comprehensive income over the periods in which the FRC recognises as expenses the related costs, including depreciation on capital expenditure, for which the grant is intended to compensate.
- 2.3 The FRC's operating expenditure will be financed by levies from 1 January 2022.
- 2.4 The budgeted grant income in FY2021/22 represents the FRC's operating expenditure net of interest income in the 9 months from 1 April 2021 to 31 December 2021 and the depreciation in the 3 months from 1 January 2022 to 31 March 2022 on capital expenditure that has been or is to be financed by the grant. The estimated balance of the grant (after deducting the full amount of capital and operating expenditure funded from the grant) as at 31 March 2022 is \$194 million.

3. Interest Income and Other Income

- 3.1 Cash held by the FRC not for immediate use, including the general fund, the balance of government grant and operating surplus if any, will be placed in fixed deposits to generate interest income.
- 3.2 Other income represents application fees received for recognition of overseas auditors.

4. Recovery of Costs of Investigation

- 4.1 Auditing irregularities in relation to PIE engagements completed before 1 October 2019 would be referred to the HKICPA for disciplinary action. Provisions under sections 37 and 50 of the FRCO as in force immediately before 1 October 2019 and section 35 of the Professional Accountants Ordinance for the award of costs and expenses to the FRC by the Magistracy, the Court and the Disciplinary Committees (of the HKICPA) continue to apply to these cases. Given the low levels of recovery in past years, and the fact that we are beholden to the HKICPA timetable and success of prosecution, no income in relation to the award of costs and

expenses has been included in the budget, which is consistent with prior years.

5. Staff Salaries, Bonuses, Variable Pay and MPF

5.1 Budgeted salaries, bonuses, variable pay and MPF are analyzed in terms of headcount and by functions below:

Department	Headcount	\$
Corporate functions:		
CEO Office	2.00	5,665,000
Legal	3.00	4,423,000
Finance & Administration	10.25	7,862,000
	15.25	17,950,000
Regulatory functions:		
Investigation & Compliance	17.75	22,685,000
Inspection	15.00	17,979,000
Oversight, Policy & Governance	6.00	8,222,000
Discipline	5.00	10,556,000
	43.75	59,442,000
Total	59.00	77,392,000

5.2 Salaries, bonuses and variable pay are calculated based on the existing remuneration level and bonus scheme of the FRC, with no salary increment in the budgeted period. As in prior years, a cash incentive bonus pool is provided at 2.5% of the annual salary for all staff, excluding CEO & staff who are eligible for variable pay. Any actual payment will be determined at the discretion of the Board.

5.3 The amount of MPF contributions is based on 5% of the budgeted amount of salaries and bonuses.

6. Staff Recruitment Expenses

6.1 Recruitment expenses in relation to staff for the new functions are shown under the expense item "Expenses for the new regime".

7. Staff Training and Development

7.1 This includes professional training in financial reporting, auditing, legal, inspection, and investigation skills including report writing skills and other related fields to ensure the FRC can maintain a highly proficient team to discharge its statutory functions.

7.2 In 2019, Willis Towers Watson assisted the FRC to develop a Competency Framework for staff. To effectively recruit, retain and develop the FRC staff, development of staff competencies including core competencies (e.g. time management, stress management and communication skill) and leadership competencies under the Competency Framework are needed.

7.3 The budgeted amount of staff training and development expenses are analyzed below.

	\$
Technical and leadership training	389,000
Development of staff competency	344,000
Reference materials	49,000
	<u>782,000</u>

8. Other staff expenses

8.1 The budgeted amount of other staff expenses is \$2,390,000, of which 82% relates to insurance and health check subsidy. The budgeted insurance premium amount is determined with reference to the premium rate of the existing insurance policies.

	\$
Medical insurance and dental plan	1,327,000
Life insurance	274,000
Employees' compensation insurance	44,000
Professional membership fee	160,000
Staff welfare	200,000
Health check subsidy	325,000
Recruitment expenses for staff replacement	60,000
	<u>2,390,000</u>

9. Premises Expenses

9.1 The budgeted premises expenses are summarized as follows.

	\$
Rental	
Interest on the lease liability	1,441,000
Depreciation charge – Right-of-use asset	8,236,000
	<u>9,677,000</u>
Property management fee	677,000
Air-conditioning charge	769,000
Government rates	459,000
Office cleaning	330,000
	<u>11,912,000</u>

- 9.2 The FRC entered into the lease agreement for the office premises on 24/F Hopewell Centre with fixed rental for 4 years. The lease term is from 1 September 2019 to 31 August 2023 with an option to extend for a further term of 2 years.
- 9.3 Monthly rental for the first 4-year term is \$747,348, which is equivalent to \$49 per sq.ft. based on the lettable floor area of 15,252 sq. ft.
- 9.4 The amount of interest on lease liability reduces year-on-year because the lease liability is amortized at a constant rate of return on the reducing balance method. It will not vary the amount of cash payments to the landlord.
- 9.5 The budgeted amounts of property management fee, air-conditioning charge, Government rates and office cleaning cost are assumed to remain at the current level.

10. Legal Fees

- 10.1 The legal fees represent the budgeted costs for obtaining external legal advice (such as advice from senior counsels) for operational matters.

11. Conference and Duty Visits

- 11.1 The budgeted conference and duty visits are analyzed below:

	\$
Duty visits	
Liaison with Mainland authorities	360,000
Liaison with overseas regulators	140,000
Inspection in Mainland China	270,000
	770,000
	770,000

12. Corporate Communications Expenses

12.1 The budgeted corporate communications expenses are analyzed below:

	\$
Forum and corporate events ^{Note 1}	409,000
Promotion and public education ^{Note 2}	120,000
Press briefings and publications of reports ^{Note 3}	<u>470,000</u>
	999,000
Annual report	<u>107,000</u>
	<u><u>1,106,000</u></u>

Note 1: Include a regional forum on regulation of financial reporting

Note 2: Represents costs for publication of eNews

Note 3: 9 reports including interim and final reports for investigation and inspection functions, 2 research reports and 3 policies/guidelines

13. Information and System Services

13.1 Annual expenses on information and system services have gradually become material. From FY2021/22, it will be reported under a separate line instead of being grouped under other operating expenses.

13.2 The budgeted expenses for information and system services are summarized below:

	\$
Data connection	214,000
IT system maintenance fees	200,000
News search service	85,000
Subscription to financial news & other e-magazines	172,000
Computer peripherals, accessories, user licenses	85,000
Extra air-conditioning for the server room	<u>96,000</u>
	<u><u>852,000</u></u>

13.3 Data connection expenses represent the costs for broadband connection to the server room at the FRC office and the offsite backup server, telephone service, VPN user license and video conferencing software license. IT system maintenance fees are the annual maintenance fee payable to the vendors or external developers of the application systems of the FRC after the warranty period.

14. Other Operating Expenses

14.1 The budgeted other operating expenses are summarized below:

	\$
Postage and printing	308,000
Insurance (professional liability, office)	516,000
Meetings and entertainment	63,000
Stationery	193,000
Office supplies	124,000
Utilities	111,000
Miscellaneous office consumables	89,000
Maintenance fees	24,000
Records management	24,000
	<u>1,452,000</u>

15. Depreciation

15.1 Depreciation charge represents the amounts calculated to write off the carrying values of leasehold improvements, office equipment and furniture and fixtures on a straight-line basis over their estimated useful lives as follows:

Leasehold improvements:	6 years (over the assumed lease period of 6 years) or over the remaining lease term
Furniture:	10 years
Office equipment:	7 years
IT equipment:	3 years
IT infrastructure & database system:	5 years

16. Contingency

16.1 No contingency provision has been set aside in the budget.

17. Inflation

17.1 When there are no specific data and/or quotes on which to estimate our future costs, inflation rate is assumed 0.0%, based on the underlying inflation rate in August 2020 (i.e. 0.1%) as released by the Government of the HKSAR on 21 September 2020.

18. General Fund

The movement of the General Fund is as follows:

	HK\$
Estimated balance as at 1 April 2021	48,814,000
Budgeted operating surplus for FY2021/22	17,001,000
Estimated balance as at 31 March 2022	<u>65,815,000</u>

19. Capital Expenditures

19.1 The budgeted capital expenditures for IT equipment, system development and office renovation are as follows:

	\$
<u>For new regime and financed by Government Grant</u>	
• IT equipment & system development	4,877,000
• Office equipment	100,000
• Office renovation and furniture	1,088,000
	<u>6,065,000</u>
<u>Not financed by Government Grant</u>	
• IT equipment replacement	220,000
Total	<u>6,285,000</u>
Forecast capital expenditures for 2019/21	<u>14,445,000</u>
Approved budgeted capital expenditures for 2019/21	<u>17,100,000</u>

19.2 IT Equipment and System Development

The budgeted capital expenditure for IT Equipment and System Development include IT equipment costs (hardware and software), the cost for the procurement of a human resources management system (HRMS) and the costs for the development of a system for recognition of overseas auditors, and the workflow and record management systems for the inspection and disciplinary functions.

	\$
Computer equipment for new staff	177,000
HRMS	1,300,000
System for recognition of overseas auditors; respective workflow and record management systems for the inspection and disciplinary functions	3,400,000
	<hr/>
	4,877,000
IT equipment replacement	220,000
Total	<hr/> <hr/>
	5,097,000

19.3 Office Equipment

The budgeted capital expenditure for office equipment represents the enhancement of the audio-video system at the boardroom for video conferencing.

19.4 Office Renovation and Furniture

The budgeted capital expenditure for office renovation and furniture mainly relates to the modification work of the office layout of FRC's office premise and new furniture towards the end of FY2021/22 for potential expansion.