

# **立法會**

## ***Legislative Council***

LC Paper No. CB(1)1051/20-21(04)

Ref: CB1/PL/FA

### **Panel on Financial Affairs**

**Meeting on 5 July 2021**

### **Background brief on the further reform of the Financial Reporting Council**

#### **Purpose**

This paper provides background information on the Financial Reporting Council ("FRC"), and summarizes the major views and concerns expressed by Members on the work of FRC in recent years and the implementation of the new regulatory regime for auditors of public interest entities<sup>1</sup> ("PIEs") since October 2019.

#### **Background**

##### Establishment, roles and organization structure 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

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<sup>1</sup> Public interest entities ("PIE") refer to listed corporations (equities) or listed collective investment schemes.

entities through a Financial Reporting Review Committee.<sup>2</sup> As FRC was not 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.<sup>3</sup>

4. 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.

5. FRC has established several committees to advise on various aspects of its work. An independent Process Review Panel was established in November 2008 for reviewing the handling of cases by FRC to ensure its

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<sup>2</sup> 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.

<sup>3</sup> 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.

actions and decisions adhere to internal procedures and guidelines. An Honorary Advisory Panel was formed in December 2012 to advise FRC on its operations and any professional, technical and strategic issues it faces. An organization chart of FRC is given in the **Appendix I**.

Implementation of a new regulatory regime for auditors of public interest entities under the Financial Reporting Council (Amendment) Ordinance 2019

6. 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 PIE auditors ("the regulatory regime for PIE auditors"). The Bill was passed by LegCo at the meeting of 30 January 2019 and was enacted as the Financial Reporting Council (Amendment) Ordinance 2019 ("the Amendment Ordinance 2019"). The Amendment Ordinance 2019 commenced operation on 1 October 2019.<sup>4</sup>

7. 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.<sup>5</sup> 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 requirements, standards on professional ethics, as well as auditing and assurance practices for registered local PIE auditors. The Amendment

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<sup>4</sup> 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.

<sup>5</sup> 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.

Ordinance 2019 also provides for the new composition of FRC,<sup>6</sup> an appeal mechanism regarding decisions made against PIE auditors, and levies payable to FRC<sup>7</sup>.

### **Major views and concerns expressed by Members**

8. Since the establishment of FRC in 2006, the Administration and FRC have been conducting annual briefings for the Panel on Financial Affairs ("FA Panel") on FRC's work. FA Panel was also consulted on the Administration's proposal to establish the new regulatory regime for PIE auditors in 2014 and 2015. The major concerns and views expressed by Panel members during discussions at FA Panel meetings in recent years and Members when scrutinizing the Amendment Bill 2018 are summarized in the ensuing paragraphs.

#### Benefits of the regulatory regime for auditors of public interest entities

9. The Bills Committee on Financial Reporting Council (Amendment) Bill 2018 noted that one of the objectives of implementing the new regulatory regime for PIE auditors was to enable Hong Kong to join the International Forum of Independent Audit Regulators ("IFIAR"). Members enquired about the benefits for Hong Kong joining IFIAR, such as the increases in new jobs for local auditors and number of entities applying for listing in Hong Kong. Members also enquired about the possible consequences on Hong Kong if it did not implement the new regulatory regime.

10. The Administration advised that the existing auditor regulatory regime of Hong Kong was considered by many (including the International Monetary Fund) as a self-regulatory regime thus was not desirable from the investor protection perspective. The existing regulatory regime also fell short of the

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<sup>6</sup> The new composition of FRC is set out in paragraph 4 of the background brief.

<sup>7</sup> 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.

international standard that the auditor oversight body should be independent of the audit profession thereby rendering Hong Kong's auditor regulator not eligible for joining IFIAR. In recent years, IFIAR had become an international leader in driving audit quality matters. Hong Kong could not participate in IFIAR's work if it was not a member of IFIAR. The Administration stressed that joining IFIAR would strengthen Hong Kong's cooperation with other jurisdictions in cross-border regulation of auditors, particularly enabling Hong Kong to obtain first-hand information about various auditor regulatory approaches and practices. Moreover, Hong Kong's participation in IFIAR would help reinforce the trust of companies and investors in the work of the local audit profession, and in turn facilitate further growth and development of the profession. Furthermore, IFIAR membership would enhance the confidence of international and local enterprises and investors in the integrity of Hong Kong's overall financial regulatory regime with regard to the capital market. This would be essential in attracting capital to Hong Kong and conducive to job creation and long-term economic growth.

Necessity and scope of the new regulatory regime for auditors of public interest entities

11. When the Administration consulted FA Panel on the proposal to establish the new regulatory regime for PIE auditors at meetings in July 2014 and July 2015, some members expressed concern that the proposed expansion of FRC's regulatory remit might lead to over-concentration of powers in FRC. Some members also enquired about the rationale for limiting the scope of the new regulatory regime to PIE auditors instead of the entire audit profession.

12. The Administration explained that entrusting FRC with the role of an independent audit oversight body in lieu of setting up a new statutory body would address the concern that the regulatory framework could become cumbersome after the reform. Regarding the proposed new powers for FRC, the Administration pointed out that there was no international requirement in auditor regulation to vest the disciplinary power in a body independent of the independent auditor regulator. In fact, in the United States and Canada, the inspection, investigation and disciplinary powers were all vested with their independent auditor regulators. Given that FRC was independent of the audit profession, it would not be unfair to PIE auditors if FRC was empowered to exercise inspection, investigation and disciplinary powers under the new regime. There would be checks and balances to ensure fairness and due process when FRC discharged its new functions.

13. As for the scope of the new regulatory regime, the Admiration advised that since the new regulatory regime for PIE auditors would entail substantial changes to the existing regulatory regime for auditors, it would be prudent for the Government 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.

#### International collaborations of the Financial Reporting Council

14. Some members enquired at the FA Panel meeting in May 2020 about the progress of Hong Kong's application for membership of IFIAR. Some members also suggested that FRC should liaise with the European Union ("EU") in pursuing the European Commission ("EC") adequacy status.

15. In respect of the application for membership of IFIAR, FRC advised that it had formally submitted the application in November 2019 and was closely following up the matter with the IFIAR Secretariat. The IFIAR Secretariat conducted an on-site review of FRC as part of the application process in October 2019, and was briefed on the governance structure and operations of FRC, the legal powers and regulatory functions of FRC under the Amendment Ordinance 2019, as well as the proposed inspection methodology.

16. As regards the pursuit of EC adequacy status, FRC explained that obtaining the status was a prerequisite to the transfer of audit working papers and inspection and investigation reports between FRC and auditor regulators of EU member states. Such status would lead to enhanced global confidence in Hong Kong's independent auditor regulatory system and increased collaboration opportunities with auditor regulators of EU member states. The Administration and FRC advised that Hong Kong had discussed the matter with the EU during the recent EU-Hong Kong Annual Structured Dialogue. The Administration would follow up the matter with the EU through the Hong Kong Economic and Trade Office in Brussels.

#### Quality of auditors of public interest entities in Hong Kong

17. At the FA Panel meeting in March 2021, some members sought FRC's assessment on the quality of audit engagements performed by firms in Hong Kong in comparison with those in other major financial centres.

18. FRC advised that the quality of Hong Kong's PIE auditors was on a par with that of other comparable jurisdictions including the United Kingdom. FRC published its interim inspection report on PIE auditors in Hong Kong in

December 2020. The issues and deficiencies identified in the report were similar to those found in other comparable jurisdictions. The final inspection report<sup>8</sup> would be released in due course, which would shed more light on the quality of PIE auditors in Hong Kong, and could form a better basis for making comparisons of the auditing profession of Hong Kong with that of other jurisdictions.

### **Latest development**

19. The Secretary for Financial Services and the Treasury, in his blog on 8 June 2021, revealed the Administration's plan to further reform the regulatory regime of accounting profession by expanding the powers of FRC in respect of inspection, investigation and discipline of PIE auditors to cover all auditors as the next step of reform to further enhance the independence of the regulatory regime.

20. The Administration will brief FA Panel on the legislative proposal to further develop FRC into a full-fledged independent regulatory and oversight body for the accounting profession at the meeting on 5 July 2021.

### **References**

21. A list of relevant papers is at **Appendix II**.

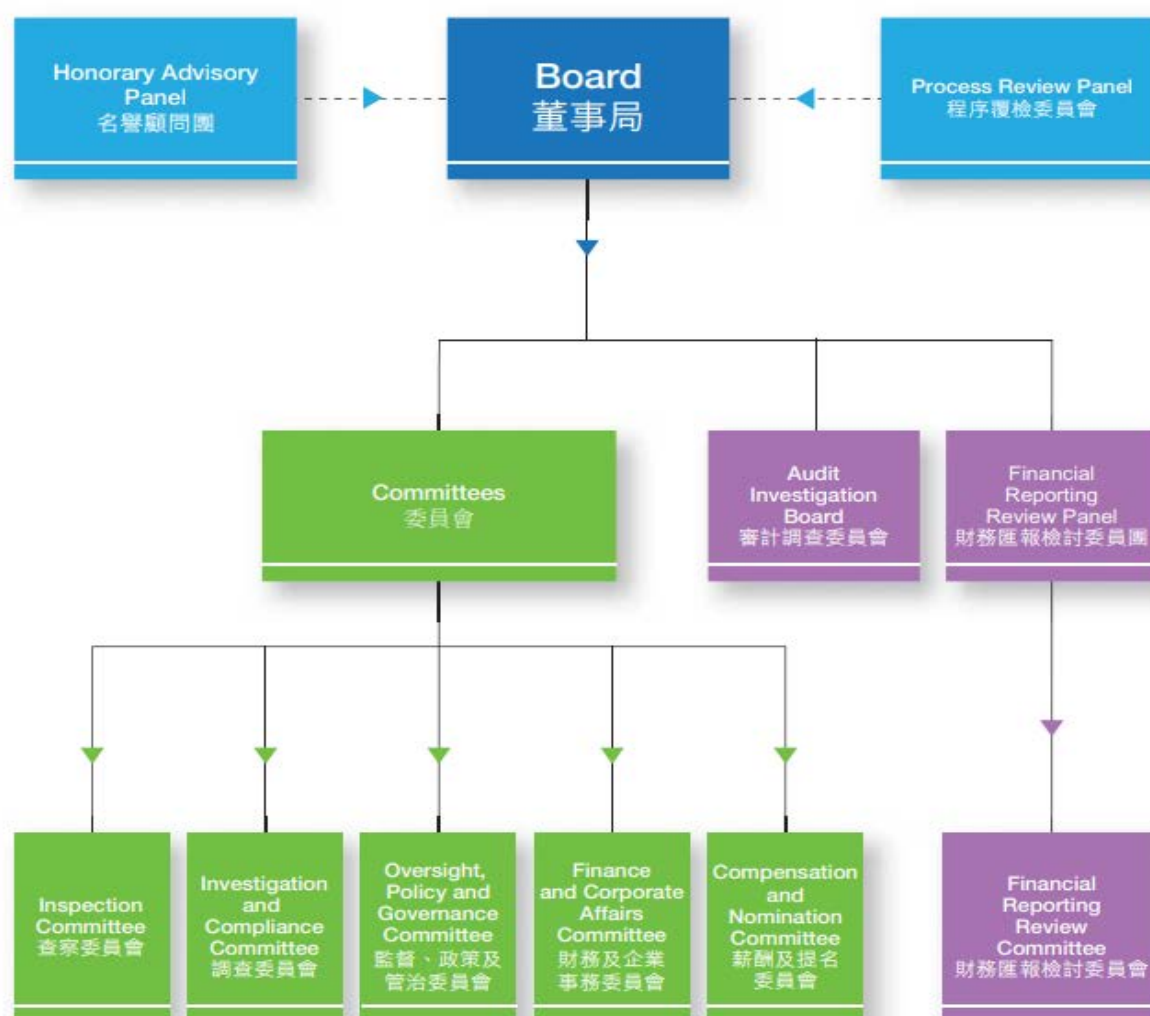
Council Business Division 1  
Legislative Council Secretariat  
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<sup>8</sup> The Annual Inspection Report was published in June 2021. It is available at the website of FRC at: [https://www.frc.org.hk/en-us/Documents/Publications/periodic-reports/2020\\_Annual\\_Inspection\\_Report\\_English.pdf](https://www.frc.org.hk/en-us/Documents/Publications/periodic-reports/2020_Annual_Inspection_Report_English.pdf)

## Organization structure of the Financial Reporting Council

Governance Structure  
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Source: Financial Reporting Council Annual Report 2019



## Appendix II

### List of relevant papers

Date	Event	Papers/Minutes of meeting
7 July 2014	The Panel on Financial Affairs ("FA Panel") discussed the proposals to improve the regulatory regime for listed entity auditors	<a href="#"><u>Powerpoint presentation materials at the meeting</u></a> (LC Paper No. CB(1)1762/13-14(01))  <a href="#"><u>Administration's paper</u></a> (LC Paper No. CB(1)1668/13-14(01))  <a href="#"><u>Minutes</u></a> (LC Paper No. CB(1)1998/13-14)  <a href="#"><u>Administration's follow-up paper</u></a> (LC Paper No. CB(1)1913/13-14(02))
4 May 2015	FA Panel discussed the work of the Financial Reporting Council ("FRC") since April 2014	<a href="#"><u>Powerpoint presentation materials at the meeting</u></a> (LC Paper No. CB(1)833/14-15(02))  <a href="#"><u>FRC's paper</u></a> (LC Paper No. CB(1)780/14-15(03))  <a href="#"><u>Minutes</u></a> (LC Paper No. CB(1)1070/14-15)
6 July 2015	FA Panel discussed the consultation conclusions on the proposals to improve the regulatory regime for listed entity auditors	<a href="#"><u>Powerpoint presentation materials at the meeting</u></a> (LC Paper No. CB(1)1069/14-15(04))  <a href="#"><u>Administration's paper</u></a> (LC Paper No. CB(1)1034/14-15(08))  <a href="#"><u>Minutes</u></a> (LC Paper No. CB(1)1258/14-15)

Date	Event	Papers/Minutes of meeting
23 May 2016	FA Panel discussed the work of FRC since April 2015	<a href="#">Powerpoint presentation materials at the meeting</a> (LC Paper No. CB(1)955/15-16(01))  <a href="#">Administration's paper</a> (LC Paper No. CB(1)918/15-16(03))  <a href="#">Minutes</a> (LC Paper No. CB(1)1142/15-16)
5 June 2017	FA Panel discussed the work of FRC since April 2016	<a href="#">Powerpoint presentation materials at the meeting</a> (LC Paper No. CB(1)1078/16-17(02))  <a href="#">Administration's paper</a> (LC Paper No. CB(1)1030/16-17(04))  <a href="#">Minutes</a> (LC Paper No. CB(1)1356/16-17)
17 January 2018	Hon Kenneth LEUNG raised an oral question on "Compliance with laws and regulations of different jurisdictions by Hong Kong accounting firms"	<a href="#">Hansard</a> (pages 5147- 5156)
15 May 2018	FA Panel discussed the work of FRC since April 2017	<a href="#">Powerpoint presentation materials at the meeting</a> (LC Paper No. CB(1)967/17-18(01))  <a href="#">Administration's paper</a> (LC Paper No. CB(1)926/17-18(03))  <a href="#">Minutes</a> (LC Paper No. CB(1)1305/17-18)

Date	Event	Papers/Minutes of meeting
30 January 2019	The Legislative Council ("LegCo") passed the Financial Reporting Council (Amendment) Bill 2018	<a href="#">Report of the Bills Committee on Financial Reporting Council (Amendment) Bill 2018</a> (LC Paper No. CB(1)505/18-19)  <a href="#">Legislative Council Brief</a> (File Ref: ACCT/2/1/2C)  <a href="#">Legal Service Division Report</a> (LC Paper No. LS25/17-18)
6 May 2019	FA Panel discussed the work of FRC since April 2018	<a href="#">Powerpoint presentation materials at the meeting</a> (LC Paper No. CB(1)1019/18-19(02))  <a href="#">Administration's paper</a> (LC Paper No. CB(1)954/18-19(04))  <a href="#">Minutes</a> (LC Paper No. CB(1)1315/18-19)
22 May 2019	The Financial Reporting Council (Amendment) Ordinance 2019 (Commencement) Notice was tabled before LegCo	<a href="#">The Notice</a>  <a href="#">Report of the Subcommittee</a> (LC Paper No. CB(1)1209/18-19)
4 May 2020	FA Panel discussed the work of FRC since April 2019	<a href="#">Powerpoint presentation materials at the meeting</a> (LC Paper No. CB(1)582/19-20(02))  <a href="#">Administration's paper</a> (LC Paper No. CB(1)564/19-20 (04))  <a href="#">Information paper</a> (LC Paper No. CB(1)576/19-20 (01))  <a href="#">Minutes</a> (LC Paper No. CB(1)899/19-20)

Date	Event	Papers/Minutes of meeting
21 October 2020	Registration of Determinations and Orders of Public Interest Entities Auditors Review Tribunal Rules were tabled before LegCo	<a href="#">Registration of Determinations and Orders of Public Interest Entities Auditors Review Tribunal Rules</a>  <a href="#">Report of the Subcommittee</a> (LC Paper No. CB(1)266/20-21)
1 March 2021	FA Panel was consulted on FRC's budget for the financial year 2021-22	<a href="#">Administration's paper</a> (LC Paper No. CB(1)604/20-21(06))  <a href="#">Minutes</a> (LC Paper No. CB(1)883/20-21)
21 April 2021	Hon LAU Kwok-fan raised a written question on "Strengthening the regulation of the capital markets"	<a href="#">Hansard</a> (pages 4942- 4944)
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	<a href="#">SFST's blog</a>