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Panel on Financial Affairs

Meeting on 4 April 2022

Background brief on the Financial Reporting Council and the new regulatory regime for the accounting profession

Purpose

This paper provides background information on the Financial Reporting Council ("FRC") including its establishment and key roles, as well as the new regulatory regime for the accounting profession introduced under the Financial Reporting Council (Amendment) Ordinance 2021 ("the Amendment Ordinance 2021"), which seeks to reform FRC to become a full-fledged independent regulatory and oversight body for the local accounting profession ("the reform"). The paper also provides a summary of the relevant discussions at the Panel on Financial Affairs ("FA Panel") and the Bills Committee on Financial Reporting Council (Amendment) Bill 2021 ("the Bills Committee") on the reform.

Background

Establishment and role evolvement of the Financial Reporting Council

2. The Financial Reporting Council Ordinance (Cap. 588) ("FRCO") which was enacted in 2006 provides for the establishment of Financial Reporting Council ("FRC") to take charge of investigation of possible auditing and reporting irregularities in relation to listed entities, and conduct enquiries into possible non-compliance with accounting requirements by listed entities. FRC became fully operational in July 2007. At its inception, while FRC could initiate investigations and conduct enquiries, it was not empowered to discipline. All other regulatory powers with respect to the audit profession were vested with the Hong Kong Institute of Certified Public Accountants ("HKICPA"), which is a statutory professional body established under the Professional Accountants Ordinance (Cap. 50) ("PAO"). FRC would refer

relevant cases to other parties for follow-up as necessary after performing its investigation/enquiry function.[1]

3. The Financial Reporting Council (Amendment) Ordinance 2019 ("the Amendment Ordinance 2019") was enacted in 2019 to establish a new regulatory regime for auditors of public interest entities ("PIEs")[2] ("the regulatory regime for PIE auditors") by transferring HKICPA's regulatory powers in respect of PIE auditors to FRC. Under the regime, FRC is responsible for the inspection, investigation and discipline of PIE auditors and registered responsible persons of the PIE auditors, as well as recognition of PIE auditors from overseas. Practice units[3] and certified public accountants ("CPAs") in general continue to be regulated under PAO except for their engagements under the PIE auditor regulatory regime as specified in FRCO. FRC also has powers to 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,[4] an appeal

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1 Any auditing or reporting irregularities identified by the Financial Reporting Council ("FRC") would be referred to the Hong Kong Institute of Certified Public Accountants ("HKICPA"), while any non-compliances relevant to the Listing Rules will be referred to the Securities and Futures Commission or the Hong Kong Exchanges and Clearing Limited for necessary action.

2 Public interest entities ("PIEs"), as defined in section 3 of the Financial Reporting Council Ordinance ("FRCO"), are listed corporations (equities) or listed collective investment schemes.

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

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 PIE engagements.

mechanism regarding decisions made in relation to PIE auditors, and levies payable to FRC.[5]

Further enhancement of the accounting profession regulatory regime under the Financial Reporting Council (Amendment) Ordinance 2021

4. According to the Administration, the international trend on accounting profession regulation is to vest the regulatory powers with a regulatory body independent from the trade to ensure impartiality. To take forward the reform, the Administration introduced the Financial Reporting Council (Amendment) Bill 2021 ("the Bill") in 2021. In gist, the Bill sought to amend FRCO, PAO and the Professional Accountants By-laws (Cap. 50A) to implement the reform by:

(a) empowering FRC to issue practising certificates to CPAs and register CPA firms, corporate practices and local PIE auditors;[6]

(b) expanding FRC's current powers of inspection, investigation and discipline over PIE auditors to cover practice units and CPAs, and renaming FRC as the Accounting and Financial Reporting Council ("AFRC") in light of the expanded scope of regulation beyond PIE auditors; 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, and issuing or specifying standards on professional ethics, and accounting, auditing and assurance, for CPAs; and (v) providing training for qualifying as CPAs and for CPD of CPAs.

5. The Bill was passed by the Legislative Council at the meeting of 20 October 2021 and enacted as the Financial Reporting Council (Amendment) Ordinance 2021 ("Amendment Ordinance 2021") which will come into

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5 A new funding model is introduced under the 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. To facilitate FRC's transition to the PIE auditor regulatory regime, the Government provided a seed capital of $400 million to FRC in 2019 to help it migrate to the regime and exempt the levies for the first two years upon the implementation of the regime. FRC has started collecting levies since 1 January 2022.

6 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.

operation on a day to be appointed by Secretary for Financial Services and the Treasury by notice published in the Gazette.

Concerns and views expressed by Members

6. The Administration briefed FA Panel on the legislative proposals of the reform at the meeting on 5 July 2021. The major issues discussed by FA Panel and the Bills Committee on the reform are summarized in the ensuing paragraphs.

Benefits of the reform

7. In response to the Bills Committee's enquiry about the benefits of the reform, the Administration advised that besides making the Hong Kong regulatory regime of the accounting profession more in line with the relevant international standards and practices and reinforcing Hong Kong's status as an international financial centre and business hub, the reform would reduce the compliance burden of the accounting profession.

8. The Administration explained that as under the PIE auditor regulatory regime, practice units and CPAs in general continued to be regulated under PAO except for their PIE engagements, individual practice units and CPAs were subject to separate inspections by FRC and HKICPA in accordance with FRCO and PAO respectively for their quality control systems which were applicable for both PIE engagements and all other engagements. The arrangement had led to inefficient use of resources and unnecessary compliance burden. Moreover, while FRC had assumed regulatory functions over local PIE auditors, HKICPA was still responsible for the registration of such auditors which resulted in a fragmented approach in regulation. The reform could alleviate such problems.

Transitional arrangements and timetable for implementing the reform

9. The Bills Committee enquired about the timetable for commencing the new regime and transitional arrangements for the transfer of regulatory powers from HKICPA to FRC.

10. The Administration advised that it was preparing the subsidiary legislation to provide for the transitional arrangements (including those for handling ongoing cases) and other technical details of the new regime. The plan was to table the subsidiary legislation for negative vetting by LegCo in 2022 as soon as possible. Meanwhile, FRC would develop guidelines and other administrative documents in relation to its expanded powers over practice

units and CPAs, and develop a cooperation mechanism with HKICPA. The new regime would commence when all such preparatory work was satisfactorily completed.

11. For the new registration function to be taken up by AFRC, the proposed transitional arrangements were that all applications approved by HKICPA before the commencement of the new regime would remain valid. In case there were any outstanding applications the processing of which had not been completed on the commencement date, they would be transferred to AFRC for processing. For the practice review, investigation and disciplinary functions, any proceedings carried out under PAO which had not been completed on the commencement date of the new regime would continue to be conducted under the PAO mechanism and subsequently be referred to AFRC for follow-up action. Any new cases that came up after the commencement of the new regime, irrespective of whether the engagements which were the subjects of these cases were conducted before the commencement, would be handled by AFRC. In other words, AFRC would also take up new cases of the inspection and disciplinary work for PIE engagements completed before the commencement of the regulatory regime for PIE auditors on 1 October 2019.

Imposition of pecuniary penalties by the Accounting and Financial Reporting Council

12. The amended section 37H of FRCO provides, among others, that AFRC must not impose a pecuniary penalty for any CPA misconduct unless AFRC has had regard to the guideline(s) published in the Gazette (which are not subsidiary legislation) indicating the way in which AFRC exercises its power to impose the penalty. The Bills Committee enquired whether the matters that would be included in such guidelines were specified in the Bill, and how AFRC would formulate the guidelines. Some members suggested that the Bill should explicitly provide for the requirement of AFRC to consult relevant parties when formulating the guideline under section 37H.

13. The Administration responded that AFRC would start formulating guidelines for the exercise of its sanctioning power (including the imposition of pecuniary penalties) after the passage of the Bill, and would engage stakeholders including but not limited to accounting professionals and practices during the process. With reference to the similar guidelines on imposition of pecuniary penalties published for PIE auditors in 2019,[7] the guidelines to be promulgated by AFRC for practice units and CPAs were

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[7] The FRC Guidelines for Exercising the Power to Impose a Pecuniary Penalty, which are available on the web site of FRC at: https://www.frc.org.hk/en-us/Documents/discipline/Gazette%20Notice%20EN.pdf, have become effective on 1 October 2019.

expected to cover, inter alia, factors to be considered when determining whether a pecuniary penalty was appropriate, and factors to be considered when determining the amount of the penalty. In light of the experience of the formulation of the guidelines for PIE auditors in 2019 and the arrangement of other financial regulators including the Securities and Futures Commission and the Insurance Authority, the Administration considered it unnecessary to specify in the Bill the matters to be covered in the guidelines in order to provide flexibility for adjustment as appropriate.

Functions of the Accounting and Financial Reporting Council

14. At FA Panel's discussion and during the scrutiny of the Bill, some Members considered that besides taking over the regulation of practice units and CPAs, AFRC should be entrusted with the duty to promote the development of the accounting profession, and such duty should be explicitly stated in the proposed amended section 9 of FRCO regarding AFRC's functions.

15. The Administration stressed that AFRC would promote the development of the accounting profession through effective regulation and enhance its influence over the development of the accounting profession through expansion of its functions. Taking into account the Bills Committee's views, the Administration agreed to introduce amendments to the proposed amended section 9 of FRCO to clearly specify AFRC's function to promote and support the development of the accounting profession.[8]

16. The Bills Committee noted that the existing PAO prohibited an individual or a company from using certain descriptions in an attempt to mislead the public into believing that the individual or company was a CPA or a practice unit registered under PAO. Some members urged AFRC to step up work in prohibiting misleading descriptions to enhance protection for the interests of service users and assist the profession in combating the situation of bogus accountants.

17. The Administration responded that various stakeholders had expressed concerns about the prohibition provisions, in particular about the need to strike a balance between prohibiting the use of misleading descriptions and allowing room for development for general businesses such as book-keeping and tax services. As the matters involved were complicated and controversial, the Administration would discuss with the accounting regulatory and professional bodies to explore how public protection against misleading descriptions could be enhanced, and aimed to brief FA Panel on the progress of the work in 2022.

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[8] The Financial Reporting Council (Amendment) Bill 2021 was passed with the proposed amendments concerned.

Funding mechanism of the Accounting and Financial Reporting Council

18. During FA Panel's discussion and the scrutiny of the Bill, some Members expressed concern whether AFRC would use its levies from PIEs and securities transactions to fund its new regulatory duties relating to practice units and CPAs who did not conduct PIE engagements. There were also concerns from the accounting profession about a possible surge in AFRC's fees for issuing practising certificates for CPAs and registration of firms and corporate practices ("fees relating to AFRC's new functions"). Members considered that the Administration should provide undertakings that (a) such fees would be kept at HKICPA's current level for a certain period of time after implementation of the reform, and (b) the Administration would inject additional seed capital into FRC to help it migrate to the new regime.

19. The Administration stressed that the existing levies arrangement and rate would not be affected by the reform. The Administration was pursuing the exemption of the fees relating to AFRC's new functions in the first year of implementation of the reform. For fees to be collected thereafter, the Administration planned to freeze them for the first few years of implementation at a level no higher than that which was currently collected by HKICPA. In the initial stage of discharge of expanded functions by AFRC, the deficit resulted from the exemption and freeze on the relevant fees would be met by the unspent balance of the $400 million seed capital provided by the Government in 2019.[9] The Administration would, having regard to the prevailing circumstance, propose the commencement time and rate of AFRC's fees collection by way of subsidiary legislation for scrutiny by LegCo during the Seventh LegCo. It would also consider injecting additional funding into AFRC as necessary.

20. As regards the concern on possible cross-subsidization between AFRC's levy income and its expenditure for the regulation of non-PIE auditors, the Administration stressed that the income and expenditure for AFRC's regulatory work in respect of PIE auditors and other practice units and CPAs would be planned on the "user-pay" principle to avoid unreasonable cross-subsidization. This would be suitably reflected in AFRC's annual budgets which were required to be submitted to the Financial Secretary for approval in accordance with FRCO. AFRC and the Administration would also brief FA Panel on the key points of the budgets.

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9 FRC estimated in its proposed budget for the financial year 2022-2023 that the unspent Government Grant, upon funding FRC's relevant work (including expenditure relating to its non-PIE functions) in 2022-2023, would be about $122.52 million by 31 March 2023.

Latest development

21. The Administration will brief FA Panel at the meeting on 4 April 2022 on the subsidiary legislation on transitional arrangements of the new regime of the accounting profession as well as to report on the progress of other relevant preparation work for the new regime.

References

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

Council Business Division 1
Legislative Council Secretariat
30 March 2022

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	The Bill passed Legislative Council Brief Report of the Bills Committee (LC Paper No. . CB(1)505/18-19)
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)
21 October 2020	Registration of Determinations and Orders of Public Interest Entities Auditors Review Tribunal Rules were tabled before LegCo	Registration of Determinations and Orders of Public Interest Entities Auditors Review Tribunal Rules Report of the Subcommittee (LC Paper No. CB(1)266/20-21)
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	The Panel on Financial Affairs was consulted on further reform of the regulatory regime of accounting profession	Administration's paper (LC Paper No. CB(1)1051/20-21(03)) Minutes (LC Paper No. CB(1)1248/20-21) Background brief prepared by the Legislative Council Secretariat (LC Paper No. CB(1)1051/20-21(04))

Date	Event	Papers/Minutes of meeting
20 October 2021	LegCo passed the Financial Reporting Council (Amendment) Bill 2021	The Bill passed Legislative Council Brief Report of the Bills Committee (LC Paper No. CB(1)1417/20-21)
7 March 2022	The Administration provided an information paper on the proposed budget of the Financial Reporting Council for the financial year 2022-2023	Administration's paper (LC Paper No. CB(1)117/2022(04))