



Hong Kong Law

August 2014

## FSTB CONSULTS ON INCREASING INDEPENDENCE OF REGULATORY REGIME FOR LISTED ENTITY AUDITORS

### Introduction

The Financial Services and the Treasury Bureau (the **FSTB**) has published a consultation paper (**Consultation Paper**) setting out proposals to enhance the independence of the regulatory regime governing auditors of listed entities. Noting that the existing regime lags behind international standards and practices under which require regulatory oversight of listed entity auditors to be independent of the profession itself, and International Monetary Fund recommendations for improvement, the Consultation Paper's proposals aim to benchmark the Hong Kong regime against international standards while ensuring that it remains appropriate in the local context.

The FSTB therefore proposes that the professional body, the Hong Kong Institute of Certified Public Accountants (**HKICPA**), will perform the statutory functions of registration, setting of continuing professional development (**CPD**) requirements, and setting of standards on professional ethics, auditing, and assurance with respect to listed entity auditors, subject to oversight by the independent auditor oversight body – the Financial Reporting Council (**FRC**), which was established following the enactment of the Financial Reporting Council Ordinance (Cap. 588) (**FRCO**). FSTB further proposes to vest in FRC disciplinary and inspection powers with regard to listed entity auditors, in addition to its existing investigatory functions. The FRC will in turn be funded by levies from three sources: listed entities, securities transactions, and listed entity auditors equally to ensure the FRC's independence from the Government.

Responses to the Consultation Paper should be returned to the FSTB on or before 19 September 2014.

### The Main Aims

#### *Ensuring independence of regulator of listed entity auditors from auditor profession*

Under the existing regime, all suspected auditing and reporting irregularities in relation to listed entities, including those identified by HKICPA and other financial regulators, are referred to the FRC for independent investigation. All other regulatory powers relating to auditors are vested with HKICPA, the professional body, under the Professional Accountants Ordinance (Cap. 50) (**PAO**). As a result, Hong Kong's auditor regulatory regime falls short of the admission requirements of the International Forum of Independent Audit Regulators (**IFIAR**), a multinational organisation for independent regulators of auditors which was established in 2006. Admission to IFIAR is restricted to regulators that are independent of the audit profession and professional bodies and engaged in regulatory functions in the public interest, including being ultimately responsible for the system of recurring inspection of audit firms and undertaking audits of public interest entities. IFIAR's membership currently comprises independent audit regulators from 49 jurisdictions. The Consultation Paper notes that non-membership of IFIAR is detrimental to Hong Kong since it lacks a voice in IFIAR discussions and its regulators' ability to cooperate with foreign regulators is compromised.

In its May 2014 report on Hong Kong's regulatory framework for listed entity auditors, the IMF noted that the current framework fails to ensure the independence of HKICPA and does not provide a strong enforcement framework. It therefore recommended that Hong Kong establish a fully independent authority with responsibility for the oversight of the audit profession with strong enforcement powers.

### ***Reference to international standards and practices***

One of IFIAR's membership criteria is that audit regulators are required to engage in auditor regulatory functions in the public interest in relation to auditors undertaking audits of "public interest entities". To facilitate Hong Kong's eligibility for IFIAR membership, FSTB proposes to define "public interest entities" as listed entities in Hong Kong in the legislation implementing the reforms.

The policy objective is to cover auditors of listed entities only and there are no plans to expand the definition of public interest entities. To alleviate possible concern from the audit profession, the definition of public interest entities will be set out in the main legislation so that any future changes could only be made by way of an amendment bill.

Some in the audit profession have also noted that many comparable overseas jurisdictions have already achieved regulatory equivalence with the EU system. Both the FRC and HKICPA have indicated support for Hong Kong to achieve regulatory equivalence with the EU system, with the HKICPA stating that its support is conditional upon the new regime not causing unnecessary disturbance to existing systems.

### ***FRC as the independent auditor oversight body***

Since FRC meets all relevant international standards in terms of independence from the auditing profession, FSTB proposes that FRC should become the independent auditor oversight body with respect to listed entities in Hong Kong under the proposed new regulatory regime by enlarging its regulatory remit as appropriate. This arrangement could synergise the expertise and knowledge gained by FRC in financial reporting regulation and minimise regulatory duplication.

### **Proposal Summary**

The Consultation Paper's proposals cover the following areas:

- Registration
- Setting of continuing professional development requirements
- Setting of standards on professional ethics, auditing and assurance
- Inspection
- Investigation and disciplinary proceedings
- Appeal mechanisms
- Funding mechanisms





**Summary of the respective statutory roles and functions of FRC and HKICPA under the proposed regulatory regime for listed entity auditors**

|                                    | HKICPA   | FRC  |
|------------------------------------|--|--|
| <b>Registration</b>                | <p><u>Mechanism for registering listed entity auditors</u></p> <p>(1) Maintaining a register of listed entity auditors and making it available for public inspection.</p> <p>(2) Receiving applications for registration/renewing registration as a listed entity auditor, and approving/rejecting such applications in accordance with the statutory registration criteria.</p> <p>(3) Removing a listed entity auditor from the register under specified circumstances (e.g. if the auditor is subject to a registration removal order under FRC's disciplinary proceedings (see (18)).</p> <p>(4) Submitting periodic reports to FRC on the exercise/performance of the above powers/functions (see (5)(a)) and complying with FRC's written directions in relation to the exercise/performance of any of the above powers and functions (see (5)(c)).</p> <p>(Note: Appeals to HKICPA's registration decisions will be heard by an independent appeal mechanism.)</p> <p><u>Mechanism for recognising overseas auditors of specific overseas entities listed in Hong Kong</u></p> <p>(6) Maintaining a list of overseas auditors recognised by FRC for entering into audit engagements with specific overseas entities listed in Hong Kong under (8), and updating the list having regard to recognition decisions made by FRC.</p> <p>(7) Making available for public inspection the list of overseas auditors who are recognized by FRC under (8).</p> | <p>(5) Exercising oversight powers over HKICPA in relation to the registration of listed entity auditors through the following arrangements –</p> <p>a) receiving periodic reports from HKICPA on the exercise/performance of its powers/functions;</p> <p>b) conducting quality review on HKICPA in respect of its exercise/performance of such powers/functions; and</p> <p>c) upon being satisfied that it is in the public interest to do so, giving HKICPA written directions in relation to its exercise/performance of such powers/functions.</p> <p>(8) Receiving applications for recognising/renewing the recognition of an overseas auditor of a specific overseas entity listed in Hong Kong, and approving/rejecting such applications in accordance with statutory requirements.</p> |
| <b>Setting of CPD requirements</b> | <p>(9) Setting CPD requirements for the purpose of renewal of registration of listed entity auditors.</p> <p>(10) Subjecting to FRC's oversight powers as in (5) when exercising/performing the power/function in (9).</p>   | <p>(11) Exercising oversight powers over the HKICPA in relation to the setting of CPD requirements through the arrangements as set out in (5).</p>   |

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|--|--|---|
| <b>Setting of standards on professional ethics, auditing and assurance</b> | <p>(12) Issuing or specifying statements of professional ethics required to be observed, maintained or applied by any registered listed entity auditors.</p> <p>(13) Issuing or specifying standards of auditing and assurance required to be observed, maintained or applied by any registered listed entity auditors.</p> <p>(14) Subjecting to FRC's oversight powers as in (5) when exercising/performing the powers/functions in (12) and (13).</p> | <p>(15) Exercising oversight powers over HKICPA in relation to the setting of standards on professional ethics, auditing and assurance through the arrangements as set out in (5).</p>  |
| <b>Inspection</b>  | <p>N/A</p>   | <p>(16) Performing/exercising the functions and powers (i.e. specifying/determining particular professional standards, practice and procedures) in relation to the inspection of listed entity auditors in respect of their listed entity audit engagements.</p>  |
| <b>Investigation</b>   | <p>N/A</p> <p><i>NB: At present, all suspected auditing and reporting irregularities in relation to listed entities identified by HKICPA are referred to FRC for independent investigation.</i></p>  | <p>(17) Conducting an investigation into an auditing/reporting irregularity in relation to a listed entity and carrying out follow-up action as it thinks fit.</p>  |
| <b>Disciplinary</b>  | <p>N/A</p>   | <p>(18) Making decisions on disciplinary cases and exercising disciplinary powers in respect of auditing/reporting irregularities of listed entity auditors subject to fair hearing and due process.</p> <p>(Note: Appeals to FRC's disciplinary decisions will be heard by an independent appeal mechanism.)</p> |

### Further Details: Registration

#### Registration of listed entity auditors

There will be no material change to the criteria for eligibility to audit listed entities. The proposed eligibility criteria for a "listed entity auditor" are that:

a) the auditor must be a practice unit as defined under the PAO (i.e. a **CPA (practising)** practising on his own, a firm or a corporate practice registered with HKICPA). He must also be a fit and proper person to be registered as a listed entity auditor which will be determined using the existing fit and proper test for becoming a **CPA**.<sup>1</sup> No changes are proposed

<sup>1</sup> The existing criteria stipulated by the HKICPA for considering an applicant's fitness and properness can be found at: [http://www.hkicpa.org.hk/file/media/section3\\_registration/Register%20as%20a%20CPA/pdf-file/info/membership-fit-proper.pdf](http://www.hkicpa.org.hk/file/media/section3_registration/Register%20as%20a%20CPA/pdf-file/info/membership-fit-proper.pdf)

to the existing qualification and experience requirements for meeting the existing fit and proper test for becoming a CPA, subject to regular reviews in future.

b) individuals who are authorised by the auditor to perform the following three specific roles must be fit and proper persons to perform such roles –

- audit engagement authorised persons (i.e. "engagement partners" that are responsible for the engagement and its performance, and for the report that is issued on behalf of the practice unit) – they are individuals who are authorised by the auditor to issue opinions in respect of its audit engagements with listed entities (if the auditor is a firm or a corporate practice);

- engagement quality control reviewers – they are individuals responsible for engagement quality control reviews in respect of the auditor’s audit engagements with listed entities under prevailing Hong Kong auditing standards; and
- quality control system responsible persons – they are individuals who assume ultimate responsibility for the auditor’s system of quality control.

FSTB proposes no change to the existing qualification and experience requirements for individuals to take up these roles with respect to a registered listed entity auditor when considering whether they are fit and proper to assume these positions. These three categories of individuals, together with all registered listed entity auditors, will be the regulated persons under the new regulatory regime for listed entity auditors.

### **Register of listed entity auditors**

- a) It is proposed that an individual, partnership or body corporate that wishes to enter into an audit engagement<sup>2</sup> with a listed entity in Hong Kong will be required to register with a Registrar of Listed Entity Auditors. An unregistered auditor which enters an audit engagement with a listed entity will commit a criminal offence. A new register of listed entity auditors will be established.
- b) HKICPA will be assigned the role of the Registrar of Listed Entity Auditors, with its registration functions discharged through the HKICPA Registrar (please refer to summary chart in 3.2).
- c) FRC, as Hong Kong’s independent auditor oversight body under the proposed new regulatory regime, will be responsible for independent oversight of the registration of listed entity auditors (please refer to summary chart in 3.2). It will also publish on its website periodic reports received from the HKICPA Registrar on the performance of its functions and exercise of its powers in relation to the registration of listed entity auditors. FRC will additionally conduct quality reviews on the HKICPA Registrar and may give written directions to it regarding its functions and powers. The FRC will provide information on the results of its quality reviews and written directions given in its annual reports.

<sup>2</sup> “Audit engagements” will be deemed to cover all assurance engagements required to be undertaken by auditors under the Listing Rules (c.f. Rules 4.03 and 19.20).

### **Appeal mechanism**

Any person subject to a registration decision by the HKICPA Registrar may appeal against the decision, and any such appeal will be handled by an appeal mechanism that is independent of both the HKICPA Registrar and FRC. A registration decision will not come into effect until the appeal is determined. For further details, please see “Appeals” at section 7 below.

### **Other registration provisions**

- a) Registration will remain in force until 1 January in the year following that in which the auditor was registered. Registration will be subject to annual renewal.
- b) The register of listed entity auditors will contain the following information about each registered listed entity auditor –
  - the full name of the registered listed entity auditor;
  - the start and expiry date of each registration;
  - any conditions placed on the registered listed entity auditor;
  - the name of individuals authorised by the registered listed entity auditor to perform the roles of: the audit engagement authorised person(s), the engagement quality control reviewer(s) and the quality control system responsible person(s), and their relevant particulars; and
  - any other prescribed information, including the business address of the listed entity auditor.

### **Recognition of overseas auditors of specific overseas entities listed in Hong Kong on an exceptional basis**

- a) The FSTB proposes to bring the mechanism for the acceptance of overseas auditors to audit overseas entities listed in Hong Kong under the new regulatory regime for listed entity auditors. Accordingly, the FRC will be vested with statutory powers to take over the Securities and Futures Commission (SFC)/Exchange’s existing roles in relation to receiving and making decisions on applications for recognising overseas auditors of specific overseas entities approved for listing in Hong Kong.

b) Overseas auditors wishing to enter into audit engagements with specific overseas entities approved for listing on the Exchange will be required to apply to FRC for recognition. The criteria for recognition as an overseas auditor of a Hong Kong listed entity will be that –

- the auditor must be a member of a body of accountants recognized by FRC;
- there must be an agreement of mutual or reciprocal cooperation arrangement in force between the overseas regulator of the auditor and FRC; and
- the auditor must demonstrate to the FRC's satisfaction that he has adequate resources and possesses the capability to perform the audit of the relevant overseas entity listed in Hong Kong.

The above criteria will not affect the eligibility of overseas auditors which have already been accepted by the SFC/ the Exchange<sup>3</sup> for continuing to be recognised as overseas auditors for auditing specific overseas listed entities under the new regime.

c) FRC's assessment as to whether an overseas auditor is able to meet the above criteria will be specific to the overseas entity listed in Hong Kong with respect to which the application is made. A fresh application must be made to the FRC for a recognised overseas auditor to be able to enter into an audit engagement with any other overseas entity listed in Hong Kong. Each application will be considered on a case-by-case basis.

d) Recognition of an overseas auditor of a Hong Kong listed overseas entity will remain in force until the earlier of:

- 1 January in the year following that in which the overseas auditor was recognised; or
- the time when the overseas auditor ceases to be the auditor of the relevant overseas entity.

e) The HKICPA will maintain and update a list of overseas auditors which have been recognised by FRC for entering into audit engagements with specific listed overseas entities. The HKICPA Registrar will publish this list on its website.

### **Further Details: Inspection Powers**

The FSTB is proposing to transfer from HKICPA to FRC the statutory functions for conducting recurring inspections of listed entity auditors in respect of their listed entity audit engagements. It proposes to give FRC the following statutory powers, which are similar to the HKICPA's existing powers –

a) to enter any business premises of the listed entity auditor at any reasonable time;

b) to inspect, and make copies or otherwise record details of, any records or documents of the listed entity auditor in relation to his audit engagement with a listed entity;

c) to make enquiries of the listed entity auditor (or a person whom the reviewer has reasonable cause to believe has information relating to, or is in possession of, the record or document of the listed entity auditor) concerning –

- a record or document of the listed entity auditor in relation to his audit engagement with a listed entity; or
- an activity that was undertaken in the course of, or may affect, the audit engagement entered into by the listed entity auditor with a listed entity;

d) to require the listed entity auditor (or a person whom the reviewer has reasonable cause to believe has information relating to, or is in possession of, the record or document) to –

- give the reviewer access to a record or document of the listed entity auditor in relation to his audit engagements with listed entities;
- produce to the reviewer, within the time and at the place specified in the requirement, a record or document of the listed entity auditor in relation to his audit engagements with listed entities; or
- answer any question regarding a record or document of the listed entity auditor in relation to his audit engagements with listed entities, or

<sup>3</sup> As at 31 March 2014, the Exchange had accepted 18 overseas auditors for auditing the annual accounts of 24 overseas-incorporated listed companies pursuant to Rule 19.20 of the Listing Rules and 11 Mainland auditors for auditing the annual accounts of 41 Mainland-incorporated listed companies pursuant to Rule 19A.31 of the Listing Rules.

concerning any activities that were undertaken in the course of, or may affect, the audit engagement entered into by the listed entity auditor with a listed entity;

- e) if a person gives an answer in compliance with a requirement imposed under (c) or (d) above, to require, in writing, the person to verify the answer by a statutory declaration within a required time; and
- f) if, for the reason that the information concerned is not within the person's knowledge or possession, a person does not give any answers in compliance with a requirement imposed under (c) or (d) above, to require, in writing, the person to verify, within the time specified in the requirement, that reason and fact by a statutory declaration.

The Consultation Paper also invites views on whether FRC should be allowed to delegate to HKICPA its functions and powers on the inspection of listed entity auditors in respect of their listed entity audit engagements; and if so, what checks-and-balances measures should be introduced to ensure proper delegation and accountability for the quality of delegated work.

The FSTB refers to the example of the United Kingdom, where the independent oversight body focuses on inspecting large audit firms with a significant number of listed clients while delegating its inspection function to the professional accounting body for inspecting smaller audit firms.

It is proposed that non-compliance with the above inspection requirements will be a criminal offence modelled on existing provisions in the Financial Reporting Council Ordinance (**FRCO**) concerning failure to comply with requirements in relation to an investigation into auditing/reporting irregularities.

To facilitate inspection activities, FSTB proposes that the secrecy provisions in PAO and FRCO should be suitably amended to provide that both organisations could share their inspection results in respect of listed entity auditors with each other to enhance regulatory efficiency.

## Further Details: Disciplinary actions

FSTB proposes continuing the existing arrangements under the FRCO for FRC to be responsible for conducting independent investigations into relevant irregularities by listed entity auditors.

It is also proposed that the existing definition of "irregularity" under the FRCO (as set out in Annex C to the Consultation Paper) should be modified to include irregularities in respect of other assurance engagements required to be undertaken by auditors under the Listing Rules<sup>4</sup> since the opinions issued under such engagements may also affect the interests of investors.

The FSTB is inviting views on whether the new regime should specifically provide that individual(s) who assume(s) ultimate responsibility for the system of quality control within a practice unit should be held accountable for the absence/systemic failure of that system. The relevant provision would be drafted in such a way to ensure that listed entity auditors could not designate junior staff as such individual(s), but are expected to be the practice unit's chief executive officer (or equivalent) or its managing board of partners (or equivalent).<sup>5</sup>

To ensure fairness and due process, the FSTB proposes -

- a) requiring the FRC to inform the person concerned in writing of its intention and give the person a reasonable opportunity of being heard before exercising such disciplinary power. The notice would have to include the reasons for the disciplinary decision; the time when the decision is to take effect; and, in so far as applicable, the terms of the disciplinary order to be imposed under the decision. This is in line with the procedural requirements for disciplinary sanctioning powers exercised by other financial regulators in Hong Kong.<sup>6</sup>
- b) empowering the FRC to establish an expert panel with members having audit expertise to provide advice on the application of audit standards, related practices of the audit profession or experiences in previous cases of similar nature.
- c) that any person who is aggrieved by a disciplinary decision made by FRC in respect of him may appeal against the decision through an independent appeal mechanism by giving notice within 21 days after the decision is served.

<sup>4</sup> cf. Main Board Listing Rules 4.03 and 19.20.

<sup>5</sup> Paragraph 18 of Hong Kong Standard on Quality Control 1.

<sup>6</sup> The regulatory regimes as set out in the Securities and Futures Ordinance (Cap. 571), the Mandatory Provident Fund Schemes Ordinance (Cap. 485) and the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615).



d) that FRC would be required to put in place appropriate arrangements to ensure that its investigative staff will not be involved in the disciplinary process and the determination of disciplinary sanctions to ensure an independent disciplinary decision.

The FSTB proposes the FRC be empowered to exercise any one or more of the following disciplinary powers<sup>7</sup> -

- a) to reprimand him publicly or privately;
- b) to direct him to carry out remedial actions as specified by FRC;
- c) to order that his name be removed from the register of listed entity auditors, either permanently or for a period of time as specified by FRC;
- d) to prohibit him from applying to be registered/approved as a regulated person for such period or until the occurrence of such event as FRC may specify;
- e) to impose conditions on his registration/approval as a regulated person;
- f) to order him to pay to FRC the costs and expenses in relation or incidental to the investigation reasonably incurred by FRC; and
- g) to order him to pay a pecuniary penalty not exceeding the amount which is the greater of –
  - \$10,000,000; or
  - three times the amount of the profit gained or loss avoided by the listed entity auditor as a result of the irregularity.

To enhance transparency, the FSTB proposes that FRC would be required by law to issue guidelines to indicate the manner in which it exercises its power to order a regulated person to pay a pecuniary penalty, and to have regard to the guidelines when imposing such a penalty. The guidelines would include factors the FRC would consider in determining the level of pecuniary penalty, including, for example –

- a) the nature and seriousness of the irregularity;

<sup>7</sup> NB: Such power already exists under the present disciplinary regime administered by HKICPA and other comparable overseas jurisdictions.

b) the amount of profits accrued or loss avoided as a result of the irregularity;

c) the audit fees received by the listed entity auditor; and

d) other circumstances of the regulated person, which would include the size and financial resources of the firm or individual and that the penalty should not have the likely effect of putting a firm or individual in financial jeopardy.

An alternative route proposed for concluding a disciplinary matter is a resolution entered into by the FRC with the person subject to disciplinary action. However, FRC would have to consider it appropriate to do so in the interest of the investing public or in the public interest when exercising such power.

To ensure impartiality, any pecuniary penalty or other amount paid to or recovered by FRC are proposed to be paid into the Government general revenue.



## Appeals

It is proposed that a new independent appeals tribunal should be established to hear appeals in respect of HKICPA registration decisions and FRC disciplinary decisions. This would replace the current system of referring appeals to the Court of Appeal.

FSTB proposes that any person –

- a) who disagrees with a registration decision made by the HKICPA Registrar in respect of him, e.g. a decision to reject a registration application/renewal application or to remove his name from the register; or
- b) who is aggrieved by a disciplinary decision made in respect of him by FRC,



may apply to the proposed new independent appeals tribunal for a review of the decision within 21 days after a notice of the relevant decision has been served upon him.

The independent appeals tribunal may, upon application by the relevant person, extend the time within which an application for review of a decision can be made. However, an extension will only be granted after the applicant and FRC/the HKICPA Registrar have been given a reasonable opportunity to be heard on the proposed extension and if the independent appeals tribunal is satisfied that there is a good cause for granting the extension.

The independent appeals tribunal will comprise a chairman, who should be a person qualified for appointment as a judge of the High Court, and two members who are not public officers. All of them are to be appointed by the Chief Executive.

In reviewing proceedings, FSTB proposes that the independent appeals tribunal –

- a) may confirm, vary, reverse, set aside the relevant decisions or remit the matter to FRC/the HKICPA Registrar with any directions that it may consider appropriate;
- b) will determine any relevant questions or issues on the basis of the standard of proof applicable to civil proceedings in a court of law;
- c) will give both the applicant and FRC/the HKICPA Registrar an opportunity of being heard in reviewing a decision; and
- d) will be empowered to obtain evidence including ordering a person to attend before it to give evidence, and to prohibit the disclosure of evidence it receives at any sitting which is held in private.

FSTB proposes that a person will commit an offence if he, without reasonable excuse, fails to comply with an order or a requirement of the appeals tribunal (e.g. to answer truthfully any questions the independent appeals tribunal considers appropriate) for the purpose of a review. In addition, the independent appeals tribunal will have the same powers as the Court of First Instance to punish for contempt.

Proceedings of the tribunal will be held in public unless it determines that in the interests of justice a sitting or any part thereof should be held in private.

A party to the appeal who is dissatisfied with a determination of the independent appeals tribunal may further appeal to the Court of Appeal on a question of law, fact, or mixed law and fact. To avoid unnecessarily prolonging the case, the FSTB proposes that no appeal may be made unless leave to appeal has been granted by the Court of Appeal upon satisfaction that the appeal has a reasonable prospect of success or there is some other reason in the interests of justice exists why the appeal should be heard.

### Funding

A statutory levy on listed entities in Hong Kong is proposed to help finance FRC.

The proposed levy on listed entities would be based on the prevailing formula under which listed entities pay their annual listing fees to the Hong Kong Exchanges and Clearing Ltd (**HKEx**), and HKEx would collect the levy on behalf of FRC. Listed entities with small capitalisation would be expected to account for a smaller share of the financial contribution than those with larger capitalisation which is consistent with practices in overseas (e.g. UK and US) jurisdictions.

FSTB proposes that investors should also help finance FRC; therefore a new statutory levy on securities transactions is proposed. The levy would be based on the modus operandi for the existing levy charged by the SFC under the Securities and Futures Ordinance (Cap. 571). SFC would collect the levy on behalf of FRC.

A statutory levy requiring all listed entity auditors to help finance FRC is proposed. The levy would be proportional to the number of listed entity audit engagements entered into by the auditors. The HKICPA Registrar would collect the levy on behalf of FRC at the time of first registration or registration renewal of the listed entity auditors. After implementation of this new levy, the present “FRC levy” charged by HKICPA on listed company auditors will be abolished. Besides the proposed levy, there would also be user fees for specific services provided by FRC, e.g. notification in relation to changes of particulars of a registrant.

All three levies are proposed to be determined at levels that would sustain FRC operations without subsidy from general taxpayers. The three levies should each provide roughly equal contributions to FRC. The Chief Executive in Council will determine them by order published in the Gazette. FSTB proposes that the order would be subsidiary legislation subject to negative vetting by the Legislative Council.

FSTB also proposes that FRC should be required to review the levels of the three levies once its reserves have reached a level equivalent to 24 months of its operating expenses, after deducting depreciation and all provisions, and to consult the Secretary for Financial Services and the Treasury with a view to recommending to the Chief Executive in Council that the levies be reduced.

### Governance of the Financial Reporting Council

The current arrangements for HKICPA, HKEx and the SFC to nominate individuals to be appointed as FRC members and for the Registrar of Companies to be an ex-officio member of FRC stem from the present funding mechanism for FRC, which is supported by contributions from HKICPA, HKEx, the SFC and the Companies Registry Trading Funding. As a corollary to the proposal for a new funding mechanism, FSTB proposes to abolish the above arrangements for the nomination of FRC members and for the Registrar of Companies to be an ex-officio member, and to provide that FRC should in future comprise not less than seven members appointed by the Chief Executive, together with the Chief Executive Officer of FRC as an ex-officio member.

At least two persons to be appointed by the Chief Executive to become FRC members must possess knowledge of and experience in the auditing of Hong Kong listed entities. In appointing the remaining members, the Chief Executive will continue to consider candidates who are suitable for such appointment either because of their experience in: accounting, finance, banking, law, administration or management, or because of their professional or occupational experience.

FSTB proposes to maintain the requirement for FRC to have a chairman and a majority of members who are independent of the audit profession. However, the restriction on FRC membership will be by reference to “non-practitioner” instead of “lay person”, where “non-practitioner” will be defined as a person who –

- a) is not, or has not during the previous three years been, a CPA (practising); and
- b) is not, or has not during the previous three years been, a partner, director, agent or employee of a practice unit (i.e. a CPA (practising) practising on his own, a firm of CPAs (practising) or a corporate practice).

This is intended to ensure that FRC will continue to maintain a majority of members who are independent of the audit profession.

### Comments

The Government is inviting comments to the proposals as set out in the Consultation Paper. A list of questions for consultation is also available at the end of the Consultation Paper. Comments are to be submitted on or before **19 September 2014** by the following means –

By mail to: Division 4  
Financial Services Branch  
Financial Services and the Treasury Bureau  
15/F, Queensway Government Offices  
66 Queensway  
Hong Kong

By fax to: (852) 2869 4195

By email to: [rpirrlea@fstb.gov.hk](mailto:rpirrlea@fstb.gov.hk)

Subject to the outcome of the consultation, the Government plans to introduce a bill to amend the PAO and the FRCO into the Legislative Council in 2015.

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