

立法會
Legislative Council

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**Bills Committee on
Financial Reporting Council Bill**

Background Brief

Purpose

This paper sets out the background of the Financial Reporting Council Bill, and summarizes the major concerns expressed by Members when the relevant proposal was deliberated at the meetings of the Panel on Financial Affairs (FA Panel) on 7 March and 6 May 2005.

Background

2. Quality and reliable financial reporting is of paramount importance for upgrading market quality and maintaining investors' confidence. The auditing profession is the first line of defence against defective financial reporting and in upholding corporate governance. Since 1973, the auditing profession has been subject to a self-regulatory regime under the Professional Accountants Ordinance (PAO) (Cap. 50). However, the corporate scandals in the United States (US) and suspected cases involving false financial reports of listed companies in Hong Kong in recent years have aroused considerable public concern about the integrity of the auditing profession and accuracy of financial reporting. In this connection, two parallel proposals for reform were raised, the first by the Hong Kong Institute of Certified Public Accountants (HKICPA) for the establishment of an Independent Investigation Board (IIB) and the second by the Standing Committee on Company Law Reform (SCCLR) for the establishment of a Financial Reporting Review Panel (FRRP).

Proposal of establishing an IIB

3. In January 2003, the then Hong Kong Society of Accountants (HKSA)^{Note 1} put forward four major reform proposals to open up its governance structure and improve the regulatory regime, including the proposal to establish an IIB to deal with alleged accounting, auditing and/or ethics irregularities related to listed companies. While the Administration agreed that the proposal to establish an IIB was a move in the right direction, it considered appropriate to examine the proposal in detail and conduct public consultation. As regards the remaining three proposals, the Administration encouraged HKSA to pursue the proposals in the form of a Member's Bill^{Note 2}.

4. In September 2003, the Administration issued a consultation paper to seek public views on the proposal to establish an IIB. Of the 20 submissions received, 16 supported the establishment of the IIB and 14 agreed that the IIB's functions should be confined to undertaking investigations and not extended to disciplinary decisions. In the light of the outcome of the public consultation, the Administration proposed that an IIB be set up to undertake investigations on irregularities of the auditing profession in cases involving public interest (i.e. those relating to listed companies) while investigation of accounting anomalies relating to non-listed companies would continue to be undertaken by HKSA, as would decision on discipline. As a start, the Administration proposed that the IIB should act only on referrals from other regulators and on complaints. It would undertake investigations and prepare investigation reports. Upon completion of an investigation, the IIB would refer the case to the relevant law enforcement agency if it appeared to involve criminal offences. If the case related only to a violation of the professional code of the auditors in question, the IIB would report the outcome of the investigation to HKSA.

Note 1

The title of HKSA was changed to the "Hong Kong Institute of Certified Public Accountants" under the Professional Accountants (Amendment) Bill 2004 passed by the Legislative Council (LegCo) in July 2004.

Note 2

The three proposals were:

- (a) Increasing the lay members of HKSA's Council;
- (b) Expanding the membership of any Investigation Committee (IC) instigated by HKSA's Council, and altering the composition of the IC with the majority of members (including the chairman) being lay persons; and
- (c) Altering the composition of the Disciplinary Committee with the majority of members (including the chairman) being lay persons.

The three proposals were subsequently incorporated into the Professional Accountants (Amendment) Bill 2004 sponsored by Dr Hon Eric LI, and the Bill was passed by LegCo in July 2004.

Proposal of establishing a FRRP

5. At present, there is no mechanism in Hong Kong's regulatory regime to provide for the making of enquiries into compliance of companies' financial statements with the accounting requirements of the Companies Ordinance (CO) (Cap. 32), nor there any requirement for directors to revise and re-issue financial statements. The SCCLR, in its Consultation Paper on Phase I of the Corporate Governance Review issued in July 2001, proposed the setting up of a body with authority to investigate financial statements and enforce any necessary changes to companies' financial statements. The submissions received by SCCLR indicated support for the establishment of a FRRP.

6. To take the proposal forward, the Administration issued in September 2003 a consultation paper to seek public views. Of the 20 submissions received, 16 supported the establishment of the FRRP, and 13 agreed that it should adopt a reactive approach, at least initially. The Administration then proposed that the FRRP's ambit should be to enquire into apparent departures from the law, accounting standards and listing rules in the annual accounts of companies, as well as to seek remedial action. FRRP's work should cover the financial statements of all listed companies initially.

Subsequent developments

7. When the FA Panel was briefed on 2 April 2004 on the outcome of the public consultation on the two reform proposals, members noted the Administration's proposal to establish an independent governing board to oversee both the IIB and FRRP so that there would be one independent entity overseeing auditors and financial statements preparers. The Administration indicated that it would continue the discussion with the parties concerned on the details of the proposals and funding arrangements, and prepare the legislative amendments for implementing the proposals.

8. In early 2005, the Administration, in consultation with HKICPA, the Hong Kong Exchanges and Clearing Limited (HKEx), and the Securities and Futures Commission (SFC), proposed to establish a new statutory body to be named as the Financial Reporting Council (FRC). The FRC would oversee both the Audit Investigation Board (AIB) (i.e. IIB in HKICPA's original proposal) and the Financial Reporting Review Committee(s) (FRRC) (i.e. FRRP in SCCLR's original proposal). In February 2005, the Administration conducted a second round of

public consultation on the detailed proposals about the FRC. The FA Panel was briefed on the detailed proposals and the outcome of the second round of public consultation at its meetings on 7 March and 6 May 2005 respectively. Members' views and concerns raised at the two meetings are summarized in paragraph 20 below.

9. On 29 June 2005, the Administration introduced the Financial Reporting Council Bill (the Bill) into the Legislative Council (LegCo). On 8 July 2005, the House Committee decided that a bills committee be formed to study the Bill.

Objects of the Bill

10. The principal objects of the Bill are to provide for—

- (a) the establishment of a FRC:
 - (i) to investigate irregularities committed by auditors of listed entities in the auditing of accounts; and irregularities committed by reporting accountants of listed entities in the preparation of financial reports for prospectuses or other listing documents; and
 - (ii) to enquire into non-compliance with legal, accounting or regulatory requirements in the financial reports of listed entities;
- (b) the establishment of an AIB to conduct such investigations; and
- (c) the appointment by the FRC of a FRRC to conduct such enquiries.

Salient features of the FRC proposal

Composition of the FRC

11. It is proposed under the Bill that the FRC should comprise not more than 11 members, namely:

- (a) One ex-officio member from Government, i.e. the Registrar of Companies or his representative;

- (b) Three members, each nominated by HKEx, HKICPA and SFC separately and appointed on an ad personam basis;
 - (c) At least four and not more than six other appointed members; and
 - (d) The Chief Executive Officer of the FRC.
12. Save for the ex-officio member, all members of the FRC should be appointed by the Chief Executive (CE). The majority of FRC members must be lay persons, i.e. non-accountants. The non-executive Chairman of the FRC would be appointed by the CE from among the lay members.

AIB

13. AIB would be responsible for investigating suspected irregularities of auditors of listed entities in relation to the audit of published accounts or financial statements of such entities and the preparation of financial reports for inclusion in prospectuses or other listing documents. Investigation of irregularities of auditors and accountants outside this scope would continue to be undertaken by HKICPA under the PAO, as would decisions on discipline on HKICPA members.

14. Where it appears to the FRC that there are circumstances suggesting the occurrence of auditors' irregularities, the FRC (or AIB if so directed by the FRC) may require the auditor of a listed entity or other persons (e.g. the relevant listed entity and its officers and employees) to produce relevant records and to give explanation for any entry in the records or an omission of an entry. Furthermore, when the FRC has reasonable cause to believe that an auditor of a listed entity may have engaged in irregularities, the FRC would be able to exercise more extensive investigatory powers, such as requiring a person to attend before the FRC to answer questions or to give the FRC all reasonable assistance in connection with the investigation. To ensure compliance, the FRC would be empowered to require the person giving an explanation to verify the explanation by statutory declaration, or to seek assistance from the court in case of unreasonable refusal or failure to comply with the FRC's request. With a warrant granted by the magistrate, officers of the FRC may also enter and search premises and seize relevant documents.

FRRC and FRRP

15. FRRC would be responsible for enquiring into suspected non-compliance of the financial reports of a listed entity with relevant accounting requirements under the CO (Cap. 32), the relevant SFC Codes, Listing Rules, and Financial Reporting Standards. If it appears to the FRC that there may be a question on whether or not there is a relevant non-compliance in relation to a listed entity, the FRC would enquire into the questionable financial reports, or constitute a FRRC by drawing at least five members from a FRRP to conduct the enquiry. The FRRP would comprise not less than 20 members to be appointed by the CE in consultation with the FRC. The members are expected to come from a wide range of financial reporting, auditing, banking, financial services and commercial expertise. In the course of enquiry, the FRC (or FRRC if so constituted) may require the relevant persons to produce records or information relating to the financial reports concerned. If the enquiry shows that the relevant financial reports do not comply with the relevant requirements or standards, the FRC would be empowered to request a voluntary rectification of financial reports or seek a court order to mandate such a rectification.

Referral and publication of investigation/enquiry reports

16. It is proposed under the Bill that upon the completion of an investigation/enquiry, the AIB or a FRRC would submit a report to the FRC for consideration of any necessary follow-up actions, such as referring the relevant report to a “specified body” for disciplinary action, further investigation or any other actions. A “specified body” includes a regulatory authority or a professional accountancy body in Hong Kong or elsewhere. To illustrate, the FRC would be empowered to refer a case of auditors’ irregularities to HKICPA for disciplinary proceedings; to SFC and HKEx for enforcement of the relevant SFC Codes and Listing Rules; or to the Police for follow-up investigation of suspected criminal offences.

Funding arrangement

17. According to the Administration, the Government, HKEx, HKICPA and SFC have agreed to contribute to the funding of the FRC on an equal share basis. The Administration’s contribution would be funded by the Companies Registry Trading Fund (CRTF). CRTF would also provide free office accommodation for the FRC.

For the first three years, each party would contribute \$2.5 million per annum, plus a one-off contribution of up to \$2.5 million as a Reserve Fund. The detailed funding agreement would be effected through a Memorandum of Understanding among the four parties and is not incorporated in the Bill.

Accountability measures

18. To enable the FRC to function independently and with due propriety, the Administration proposes the following accountability measures under the Bill:

- (a) The approval of the FRC's budget by the Secretary for Financial Services and the Treasury;
- (b) The audit of the FRC's accounts by the Director of Audit;
- (c) The laying of the FRC's annual reports and accounts together with the auditor's report before LegCo; and
- (d) Provisions in respect of the avoidance of conflict of interests of FRC members/staff and other related persons.

19. Since the role of the FRC is investigatory/enquiry only and the FRC would not have the power to impose sanctions, the Administration does not propose to set up a separate body to hear appeals against the decisions of the FRC. Instead, actions of the FRC may be subject to judicial review by the court and complaints against actions or staff of the FRC may be lodged with the Ombudsman.

Major views and concerns expressed by Members' at Panel meetings

20. At the FA Panel meetings on 7 March and 6 May 2005, a great majority of members indicated support for the proposal of establishing the FRC in principle for enhancing the oversight of the public interest activities of auditors and the transparency of the self-regulatory regime of the accounting profession, and speeding up the investigation of suspected cases of accounting irregularities. Some members however expressed concerns about the proposal, as follows:

- (a) The FRC might change the self-regulatory regime of the accounting profession and have negative impact on self-regulatory regimes of

other professions, resulting in professionals being regulated by non-professionals;

- (b) As the proposal of establishing the FRC was not modelled on any accounting regulatory bodies in overseas jurisdictions, concern was raised on whether there were any unique circumstances in Hong Kong that justified the establishment of the FRC;
- (c) Given that HKICPA were empowered under the PAO to investigate into cases of misconduct and irregularities of the accounting profession and that SFC was empowered under the Securities and Futures Ordinance (Cap. 571) to investigate accounting irregularities of listed entities, the functions of the FRC would overlap with the investigation duties of these two bodies;
- (d) The proposal that the function of the FRC should be purely investigatory had given rise to a number of concerns. First, there would be lack of connection between the investigatory work of the FRC and the subsequent prosecution work of HKICPA or the law enforcement bodies. As a result, these bodies might have to conduct their own investigation to collect the required evidence and use the investigation reports of the FRC as a reference only. This would result in duplication of efforts, wastage of resources and delay in taking disciplinary/enforcement actions against the parties involved in accounting irregularities. Moreover, the FRC would become a toothless tiger;
- (e) In connection with item (d) above, it was suggested that the FRC should be empowered to undertake prosecution after investigation or make recommendations to HKICPA or law enforcement agencies on the necessary follow-up actions to be taken on the cases;
- (f) Given that publication of investigation/enquiry reports was important for enhancing the transparency and accountability of the FRC, concern was raised on the proposal of providing the FRC with the discretion to decide whether the reports should be published. If such proposal was adopted, it was necessary to set out clearly the circumstances under which the FRC should not publish an investigation/enquiry report;

- (g) As the Administration did not propose to set up a separate tribunal to hear appeals against the decisions of the FRC, there was concern about the lack of a review mechanism on the actions of the FRC;
 - (h) The establishment of the FRC might impose more obligations on auditors of listed companies and might therefore have cost implications on listed corporations because their auditors might charge higher fees for providing better services; and
 - (i) The annual total contribution of \$10 million from the CRTF, HKEx, HKICPA, and SFC might not be sufficient to meet the FRC's expenses, in particular when the FRC had to handle large and complex cases involving accounting irregularities of listed entities.
21. Extracts from the minutes of the FA Panel meetings on 2 April 2004, 7 March 2005 and 6 May 2005 are in **Appendices I, II and III** respectively. To address the concern in item (d) above about the lack of connection between the investigatory work of the FRC and the subsequent prosecution work of HKICPA or the law enforcement bodies, the Administration was requested to explore, in consultation with HKICPA, on how the concern could be addressed and consider the suggestions made in item (e) above. The Administration's response is in **Appendix IV**.

References

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

Council Business Division 1
Legislative Council Secretariat
18 July 2005

Appendix I

Extract from the minutes of meeting of the Panel on Financial Affairs on 2 April 2004

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V. Regulation of the accounting profession

(LC Paper No. CB(1)1393/03-04(05) — Paper provided by the Administration

LC Paper No. CB(1)2487/02-03 — Consultation Paper on the proposals to enhance the oversight of the public interest activities of auditors and to establish a Financial Reporting Review Panel

LC Paper No. CB(1)1393/03-04(06) — Extract of the minutes (Item I) of the special meeting of the Panel on 13 June 2003)

Briefing by the Administration

23. The Chairman pointed out that when the Panel was consulted on 13 June 2003 on a proposed Member's Bill sponsored by Dr Eric LI to enhance the self-regulatory regime of the accounting profession, members were informed that the Administration would consult the public on a related proposal of the Hong Kong Society of Accountants (HKSA), i.e. the proposal to set up an Independent Investigation Board (IIB) to consider complaints of alleged accounting, auditing and/or ethics irregularities committed by professional auditors involving listed companies. The Administration then issued a consultation paper on 19 September 2003. The public consultation also included a proposal to establish a Financial Reporting Review Panel (FRRP), which was initiated in the Standing Committee on Company Law Reform's Phase I Corporate Governance Review in 2001. The FRRP's ambit was to enquire into apparent departures from the law and accounting standards in the annual accounts of companies. The public consultation exercise ended on 31 October 2003.

24. At the Chairman's invitation, SFST briefed members on the results of the public consultation and sought members' views on the preliminary proposals on the way forward. He highlighted the following points:

- (a) The results of the public consultation indicated that there was overwhelming support for the establishment of IIB to deal with investigation of irregularities of the auditing profession relating to listed companies. Investigation of accounting anomalies relating to non-listed companies would continue to be undertaken by HKSA, as would decisions on discipline.
- (b) Most respondents agreed with the proposal to establish FRRP to enquire into apparent departures from the law, accounting standards and listing rules in the annual accounts of companies and to seek remedial action. FRRP's work should cover the financial statements of all listed companies.
- (c) On the institutional arrangements of IIB and FRRP, the Administration proposed to establish an independent governing board to oversee both bodies so that there would be one independent entity overseeing auditors and financial statements preparers. The new governing board should comprise not more than ten members. They would be from the Financial Services and the Treasury Bureau and the Companies Registry (CR), persons nominated by SFC and HKEx, and persons appointed by the Government to represent public interest.
- (d) As regards funding for the new governing board, the Administration proposed that the cost be shared among SFC, HKEx, the accounting profession and the Government. The Government's contribution would be borne by the Companies Registry Trading Fund (CRTF).
- (e) The Administration would continue discussion with the relevant parties on the details regarding the structure, functions and funding of the new governing board and the preparatory work on the legislative amendments for implementing the proposal. The Administration planned to submit the legislative proposals to LegCo in the next session.

Discussion

Functions and powers of IIB

25. Responding to Mr Kenneth TING's enquiry about the functions and powers of IIB, SFST advised that as IIB aimed at enhancing oversight of the public interest activities of the auditing profession, it would concentrate on investigation of alleged accounting, auditing and/or ethics irregularities related to listed companies. As a start, IIB would act only on referrals from other regulators and on complaints. As regards investigations into alleged misconduct in respect of non-listed companies, they would continue to be carried out by the Investigation Committees of HKSA. SFST stressed that IIB would not be given disciplinary powers, which remained vested with HKSA. Upon completion of an investigation, IIB would refer the case to the relevant law enforcement agency if it appeared to involve criminal offence. If the case related only to a violation of the professional code of the auditors concerned,

IIB would report the outcome of the investigation to HKSA for taking disciplinary actions as appropriate.

26. Mr Albert HO enquired about the mechanism for instigating an investigation under IIB, and the differences between such an investigation and the investigation instigated by FS under section 143 of the Companies Ordinance (CO) (Cap. 32). He also opined that the relevant legislative proposal should prescribe the regime for instigating investigations under IIB.

27. In reply, SFST said that it would be the responsibility of the new governing board to decide whether there were justifications for IIB to undertake an investigation having regard to the case concerned. Since members of the governing board would comprise professionals, prominent figures representing public interest and possibly people nominated by SFC and HKEEx, the Administration had confidence in the professionalism and capability of the board in making the decision. As regards investigations under section 143 of CO, SFST explained that the investigations were instigated by FS and covered a wide range of activities of a company that had given rise to serious public concerns and affected public interests. On the mechanism for instigating investigations under IIB, DS/FST(FS) supplemented that reference would be made to the existing system adopted by HKSA for investigating its members.

28. Given that the new governing board would have a lean structure and a small budget, Mr Albert HO expressed concern that it would be difficult for the board to handle a large corporate scandal. In response, PS/FST(FS) said that the governing board might consider hiring external expertise to assist in its investigation of a large corporate scandal.

29. While expressing support for the establishment of IIB, Mr NG Leung-sing considered that the relevant legislative proposals should cover the mechanisms for ensuring transparency of investigations and accountability of members of the new governing board as well as for avoiding prolonged investigation on cases.

Funding for IIB and FRRP

30. While expressing support for the establishment of IIB and FRRP, Mr Kenneth TING considered that as the accounting profession and the listed companies would be the major parties to be benefited from the proposal, they should be responsible for the costs involved. Moreover, he had reservation over the proposal of funding the Government's share from CRTF. Given that both listed and non-listed companies had contributed to CRTF but IIB only dealt with cases relating to listed companies, Mr TING considered it unfair to require non-listed companies to share the costs. He also enquired about the funding arrangements of similar oversight bodies in overseas jurisdictions.

31. In response, SFST stressed that the enhancement of market quality would ultimately benefit the accounting profession, market participants and reinforce Hong Kong's position as an international financial centre. As such, it would be

appropriate for the accounting profession, SFC, HKEx and the Government to share the costs of IIB and FRRP. Moreover, by adopting the cost-sharing approach, the Administration believed that it would facilitate the discussion and the reaching of consensus among the relevant parties so as to expedite the formation of IIB and FRRP. SFST also re-iterated that in order to minimize cost, the new governing board would consist of not more than ten members and its executive arm would employ about ten staff. With such a structure, the estimated annual operating cost would be about \$8 million to \$10 million. The initial proposal was that the cost would be shared equally among the four parties concerned. It was unlikely that the small amount would impose a financial burden on any parties.

32. As regards Government's contribution to the costs, SFST pointed out that to be in line with the "users pay" principle, the Administration considered it inappropriate to fund its share from the general revenue. As the income of CRTF came from the business sector, it was appropriate to utilize the fund for financing the operation of IIB and FRRP. DS/FST(FS) supplemented that the major source of income of CRTF was fees paid by both listed and non-listed companies incorporated in Hong Kong. She added that among the total of 17 investigations on accounting irregularities conducted by HKSA in the past six years, 14 cases were related to listed companies while the remaining three were related to non-listed companies. The Registrar of Companies also supplemented that while there was no policy governing the utilization of CRTF for regulating listed and non-listed companies, as listed companies involved more public interest concerns, the CR had to pay more attention to listed companies when enforcing the provisions of CO. To this extent, it was true that the non-listed companies were already subsidizing the listed companies.

33. On the funding arrangements of oversight bodies for the accounting profession in overseas jurisdictions, DS/FST(FS) said that while detailed arrangements varied among jurisdictions, the costs were generally shared by several parties including the accounting profession, business sector and government. For instance, in the UK, while the annual running costs of the Financial Reporting Council were equally shared among the accounting profession, business sector and the government, the costs of investigating and prosecuting public interest disciplinary cases were borne by the professional accounting bodies. In the United States, the issuers and the accounting profession paid for the costs of the Public Company Accounting Oversight Board. In Canada, the funding for the oversight body was paid by public accounting firms, while in Australia, the funding was in practice predominantly provided by the government.

34. Mr James TIEN expressed the views of the LegCo Members of the Liberal Party that IIB and FRRP should be funded by SFC, HKEx, listed companies and the accounting profession. Noting that the vast majority of cases investigated by HKSA had involved listed companies rather than non-listed companies, and that enhancement of market quality would ultimately benefit listed companies, Mr TIEN considered it appropriate to require listed companies to share the costs of IIB and FRRP. If the Government was required to share the costs, its contribution should be borne by fees collected from listed companies in CRTF.

35. Mr Jasper TSANG asked whether SFC and HKEx would consider imposing levies on listed companies to recover their contributions to the costs. In response, SFST said that it was a matter for SFC and HKEx to decide. While SFC would consider paying its share from its income, HKEx had not yet made a decision on the matter. Given the small amount to be contributed by each party, it was not envisaged that HKEx would recover the costs from a special levy on listed companies.

36. Mr Kenneth TING opined that the costs for IIB and FRRP should be paid by accountants or listed companies who had been found responsible for the accounting irregularities. Mr NG Leung-sing shared the view and suggested that the Administration should explore the feasibility of imposing fines on the parties involved to recover the investigation costs. Mr Albert HO however considered that since the establishment of IIB and FRRP would enhance investors' confidence and market stability, it might not be appropriate to apply the "users pay" principle in recovering the costs.

37. PS/FST(FS) said that the "abusers pay" principle applied in theory in the recovery of investigation costs, as ultimately the costs would be recoverable from the parties who were found responsible for the irregularities.

38. Mr SIN Chung-kai expressed support for the establishment of IIB and FRRP and agreed that the operating costs be shared among the four parties proposed by the Administration. He also urged that the Administration should expedite discussion with the relevant parties for reaching a consensus so that Hong Kong could keep pace with international developments as early as possible.

39. SFST took note of members' views on the institutional and funding arrangements of IIB and FRRP. He assured members that there would be opportunity for them to discuss the details when the relevant legislative proposals were introduced into LegCo.

Proposal of expanding the membership of HKSA's Council

40. Mr Albert HO noted from Annex A to the paper provided by the Administration that there was a proposal under the Professional Accountants (Amendment) Bill 2004 (the Bill) that the Government might appoint four lay members to HKSA's Council. Pointing out that currently there was no appointment of lay members to the governing councils of self-regulatory professional bodies, such as the Law Society of Hong Kong and the Hong Kong Medical Association, Mr HO was concerned that the proposal would depart from the general principle of self-regulation of professional bodies and might have impact on the structure of other professional bodies.

41. In reply, SFST advised that under the existing Professional Accountants Ordinance (Cap. 50), the Chief Executive (CE) might appoint two members from the academia (i.e. non-accountants) to HKSA's Council. To open up the Council, it was proposed under the Bill that CE might appoint four non-accountant members to the

Council. In this connection, SFST pointed out that public confidence in the accounting profession had been affected by the corporate scandals in the United States in recent years. Given the public concern about the credibility of financial reporting and accounting practices of corporations, a number of jurisdictions had introduced reforms in their regulatory framework governing the accounting profession. In line with international developments, HKSA had put forward a series of proposals to reform its regulatory regime under the Bill. The Administration recognized that given the significant impact of the work of the accounting profession on the financial services market and the general public as a whole, there was a need to enhance the public oversight of the profession and the transparency of HKSA's Council. The proposal of increasing the number of lay members of HKSA's Council would serve these purposes and hence was supported by the Administration.



**Extract from the minutes of meeting
of the Panel on Financial Affairs on 7 March 2005**

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V. Proposals to enhance the oversight of public interest activities of auditors and establish a Financial Reporting Council

(LC Paper No. CB(1)1020/04-05(04) — Paper provided by the Administration (with consultation paper on the legislative proposals to establish the Financial Reporting Council)

LC Paper No. CB(1)1020/04-05(05) — Background brief prepared by the Legislative Council Secretariat)

Briefing by the Administration

32. Upon the Chairman's invitation, the Secretary for Financial Services and the Treasury (SFST) gave a brief account of the background of the Administration's proposal to establish the Financial Reporting Council. SFST highlighted the following points:

- (a) In December 2002, the Administration requested the Hong Kong Society of Accountants (HKSA) (subsequently renamed as the Hong Kong Institute of Certified Public Accountants (HKICPA)) to put forward proposals to strengthen the regulatory regime for the accounting profession. In January 2003, HKSA put forward four major reform proposals. Three of the reform proposals relating to opening up HKSA's governance structure were incorporated into the Professional Accountants (Amendment) Bill 2004 sponsored by Dr Hon Eric LI and passed by LegCo in July 2004. The remaining proposal was to set up an independent investigation board (IIB) to investigate irregularities of auditors of listed corporations. Moreover, the Standing Committee on Company Law Reform had recommended in its consultation paper on Phase I of the Corporate Governance Review the establishment of a Financial Reporting Review Panel (FRRP) to check the compliance of financial reporting of listed corporations with relevant legal and accounting requirements.

- (b) In September 2003, the Administration issued a consultation paper to seek public views on the proposals on IIB and FRRP. Most respondents generally supported the proposals. Building on the public support received, the Administration, in consultation with the Hong Kong Exchanges and Clearing Limited (HKEx), HKICPA and SFC, proposed to establish a new statutory body to be named as the Financial Reporting Council (FRC). The FRC would oversee both the independent investigation board (to be named as the Audit Investigation Board (AIB)) and the Financial Reporting Review Committee(s) (FRRC).
- (c) On 28 February 2005, the Administration issued the “Consultation Paper on the Legislative Proposals to Establish the Financial Reporting Council” (Consultation Paper) to consult the relevant stakeholders and the public on the detailed proposals. The proposals contained in the Consultation Paper aimed to underpin a draft bill being formulated by the Administration. The Administration welcomed members’ views on the Consultation Paper. Subject to the outcome of the consultation exercise, the Administration planned to introduce the relevant bill into LegCo within the 2004-05 session.

33. The Deputy Secretary for Financial Services and the Treasury (Financial Service) (DS/FST(FS)) took members through the detailed proposals contained in the Consultation Paper which were summarized as follows:

- (a) Composition of the FRC
It was proposed that the FRC would comprise not more than eleven members with the majority being lay persons. i.e. non-accountants. The non-executive Chairman would be appointed by the Chief Executive (CE) from among the lay persons appointed, and supported by the Chief Executive Officer, who would also be a member of the FRC.
- (b) Functions of the AIB
The AIB would be responsible for investigating suspected irregularities of auditors of listed corporations in relation to the audit of published accounts or financial statements of such corporations and the preparation of any auditors’ reports for inclusion in prospectuses. Investigations would mainly be carried out by staff of the FRC. The proposed investigatory framework of the AIB was modelled on SFC’s powers of investigation under sections 179 and 183 of the SFO. In short, where it appeared to the AIB that there were circumstances suggesting the occurrence of auditors’ irregularities, the AIB might require the auditor of a listed corporation or other persons (e.g. the corporation itself and its officers and employees) to produce records

or documents relating to the affairs of the corporation. It would also be empowered to ask for an explanation on the information. Moreover, if the AIB had reasonable cause to believe that an auditor of a listed corporation had engaged in irregularities, it might require the person under investigation to attend before it to answer any relevant questions and give all reasonable assistance in connection with the investigation. The proposed design would be an enhancement over the relatively limited powers vested in the Investigation Committees of HKICPA under the Professional Accountants Ordinance (PAO) (Cap. 50) in respect of investigation into suspected irregularities of the Institute's members.

(c) **Functions of the FRRC**

The FRRC would be responsible for enquiring into suspected non-compliance of the financial reports of listed corporations with relevant accounting requirements under the Companies Ordinance (Cap. 32), the relevant SFC Codes, Listing Rules, and Financial Reporting Standards. It was proposed that a FRRC would be constituted to enquire into a case of questionable financial reports by at least five members drawn from a FRRP. The FRRP would comprise not less than 20 members who would be appointed by the CE in consultation with the FRC. They would be from a wide range of financial reporting, auditing, banking, financial services and commercial expertise. It was proposed that, with reference to the similar set-up in UK, a FRRC would be empowered to require information from relevant persons; request for a voluntary rectification of accounts and financial statements; seek a court order to mandate such a rectification; and consult other professional and regulatory bodies in the course of the enquiries.

(d) **Referral and publication of investigation/enquiry reports**

The majority views reviewed in the public consultation were that the function of the FRC should remain purely investigatory. It was proposed that upon completion of the investigation/enquiry, the AIB or a FRRC should submit an investigation/enquiry report to the FRC for consideration and deciding on the follow-up actions.

(e) **Accountability and independence of the FRC**

To enable the FRC to function independently, fairly, properly, efficiently and with due propriety, it was proposed that accountability measures be put in place. These measures included the approval of the FRC's budget by the Secretary for Financial Services and the Treasury; the audit of the FRC's accounts by the Director of Audit; and the laying of the annual report and accounts together with the auditor's report before LegCo. In addition, actions of the FRC might be subject to judicial review by the court, and complaints against

actions and staff members of the FRC might be lodged with the Ombudsman. The relevant bill would also contain provisions in respect of the avoidance of conflict of interests to uphold the independence and credibility of the FRC.

(f) **Funding arrangement for the FRC**

The Administration, HKEx, HKICPA and SFC had agreed to contribute to the funding of the FRC on an equal share basis. The Administration's contribution would be funded by the Companies Registry Trading Fund (CRTF). For the first three years, each party would contribute \$2.5 million per annum, plus a one-off contribution of up to \$2.5 million as Reserve. The amount of contributions from the fourth year onwards would be reviewed in the third year in the light of the actual experience. The agreement would be effected through a Memorandum of Understanding (MOU) among the four parties. In addition, the CR would provide office accommodation for the FRC.

Discussion

Proposal to establish the FRC

34. Mr WONG Ting-kwong expressed the support of the Democratic Alliance for Betterment and Progress of Hong Kong (DAB) for the proposal of establishing the FRC for enhancing the oversight of the public interest activities of auditors and speeding up the investigation of suspected cases of accounting irregularities. Mr Andrew LEUNG conveyed the support of the Liberal Party for the proposal which would help maintain Hong Kong's position as a leading international financial centre, and enhance the public oversight and transparency of the self-regulatory regime of the accounting profession. Mr SIN Chung-kai said that the Democratic Party supported the proposal in principle. Miss Mandy TAM expressed support for the proposal in principle for inspiring public confidence in the integrity of the accounting profession. Ms Emily LAU said that she supported the proposal in principle.

35. While noting that members indicated support for the proposal at the Panel meetings held in June 2003 and April 2004, Mr Ronny TONG said that he inclined to object to the proposal. He expressed concern that the proposal might change the self-regulatory regime of the accounting profession and have negative impact on self-regulatory regimes of other professions, resulting in professionals being regulated by non-professionals. As the Professional Accountants (Amendment) Ordinance 2004 had enhanced the effectiveness and accountability of the regulatory regime of the accounting profession, Mr TONG questioned the need to set up the FRC. Moreover, given that HKICPA was empowered under the PAO to investigate into cases of misconduct and irregularities of the accounting profession and that SFC was empowered under the SFO to investigate accounting irregularities of listed

corporations, the proposed FRC would overlap with the investigation duties of these two bodies. If necessary, the Administration should strengthen the investigatory powers of HKICPA and SFC instead of establishing the FRC. As the majority of members of the FRC were lay persons, Mr TONG expressed concern about its capability of handling complex cases of accounting irregularities efficiently. In his view, the establishment of the FRC would complicate the regulatory regime of the accounting profession and was inconsistent with the Administration's objective of streamlining the structure of the public sector. He therefore urged the Administration to re-examine the proposal and extend the period of the current consultation exercise.

36. Mr Albert HO also expressed concerns about the impact of the proposal on the self-regulatory regimes of the accounting profession and other professions, and possible overlap in the investigation duties of SFC, HKICPA and FRC. The Chairman expressed concern about possible overlap in the investigation duties of the three bodies.

37. SFST stressed that the objective of establishing the FRC was to enhance the effectiveness, transparency and accountability of the self-regulatory regime of the accounting profession with a view to enhancing investor confidence, upgrading corporate governance and market quality. The objective was in line with the Administration's policy of maintaining Hong Kong's position as a leading international financial centre. SFST re-iterated that the proposal was put forward by HKICPA in December 2002 and had the support from the public, SFC and HKEEx during the consultation conducted in September 2003. The Administration therefore took forward the proposal. It was believed that the proposal would not have negative impact on the self-regulatory regime of the accounting profession.

38. As regards the concern about possible overlap of functions of the FRC with those of HKICPA and SFC, SFST pointed out that the three bodies had different terms of reference. While the AIB would be responsible for investigating suspected irregularities of auditors of listed corporations in relation to the audit of published accounts or financial statements of such corporations and the preparation of any auditors' reports for inclusion in prospectuses, investigation of misconduct of the accounting profession outside this scope would continue to be undertaken by HKICPA. As regards SFC, its investigatory powers applied not only to auditors but also other persons involved in market misconducts. SFST re-iterated that HKICPA, SFC, HKEEx and the Administration had all expressed support for the proposal and agreed to share the funding for the setting up and running of the FRC.

39. In response to Mr Andrew LEUNG's enquiry about the timetable for the setting up of the FRC, SFST said that the Administration planned to introduce the relevant bill into LegCo within the 2004-05 session. He envisaged that it would take about six months to prepare for the setting up of the FRC after passage of the Bill.

Funding arrangement for the FRC

40. Mr WONG Ting-kwong said that during the previous public consultation exercise, the DAB had expressed concern that the proposal might impose cost burden on the accounting profession and listed corporations. The DAB was pleased to note that the proposed funding arrangements contained in the Consultation Paper had addressed the concern.

41. Mr SIN Chung-kai expressed concern that the proposed annual contribution of \$10 million by CRTF, HKEx, HKICPA and SFC might not be sufficient to meet the expenses of the FRC, in particular when the FRC had to handle large and complex cases. He enquired about the details of the financial arrangements for the FRC and how the four parties concerned would share the funding requirements should the FRC face operating deficits.

42. Mr Andrew LEUNG expressed concern about insufficient funding to support the work of the FRC and to meet the substantial litigation expenses when the actions of the FRC were subject to judicial review.

43. In response, SFST advised that the proposed financial arrangements for the FRC were agreed by the four parties concerned after thorough discussion and would be effected through a MOU. It was agreed that besides the annual contributions, each party would contribute \$2.5 million to set up a Reserve for the FRC. Moreover, the FRC would have a lean structure to ensure its cost-effectiveness and that the CR would provide office accommodation for the FRC. SFST assured members that the FRC would keep in view its funding requirements and the four parties concerned would discuss further on their contributions should the FRC require further resources.

44. The Chairman enquired about the bases for working out the FRC's estimated annual operating cost and its staffing requirements. In reply, SFST said that the estimates were based on past experience of HKICPA in undertaking its investigation work. As regards staffing requirements, SFST stressed that the objective was to put in place a lean structure for the FRC so as to ensure its cost-effectiveness. The FRC might review its staffing requirements after it had come into operation for a period of time.

Powers and functions of the FRC

45. Miss Mandy TAM enquired about the details of the proposal for the FRC to follow up investigation/enquiry reports submitted by the AIB and a FRRC, the FRC's power in disclosing such reports, and the checks on such power to ensure protection of the parties involved in suspected accounting irregularities.

46. DS/FST(FS) advised that the FRC would consider the reports submitted by

the AIB and a FRRC upon completion of their investigation/enquiry work. It would be for the FRC to decide on the necessary follow-up actions. The FRC might decide, after taking account of the evidence found during the investigation/enquiry, to close the case without further action, or refer the case or disclose the relevant information obtained during the investigation/enquiry to an authority, regulatory organization or a professional accountancy body in Hong Kong or elsewhere for disciplinary action, or undertake further investigation (including criminal investigation) or any other necessary actions. DS/FST(FS) also advised that having regard to the public interest and the need to maintain the transparency of the FRC, there might be circumstances justifying the publication of investigation/enquiry reports by the FRC. Hence, there would be provisions in the relevant bill stipulating that the FRC might cause the investigation/enquiry reports or any part thereof to be published. This would provide the FRC with the discretion to publish the reports as and when it saw fit. In deciding whether the reports should be published, the FRC should exercise care to ensure that such publication would not prematurely jeopardize the interests of any parties involved in the case, and would not prejudice any proceedings subsequent to the referral by the FRC to a relevant authority/body.

47. Mr Albert HO pointed out that publication of investigation/enquiry reports was important for enhancing the transparency and accountability of the FRC. He was therefore concerned about the proposal of providing the FRC with the discretion to decide whether the reports should be published. He considered that if such proposal was adopted, it was necessary to set out clearly the circumstances under which the FRC should not publish an investigation/enquiry report.

48. In response, SFST said that as the integrity of the accounting profession was of considerable concern of the public, it was believed that the FRC would seek to publish the investigation/enquiry reports wherever possible. Given that majority of the members of the FRC would be lay persons, SFST expected that they would represent public interests and exercise the discretionary power in an appropriate manner.

49. Mr Albert HO noted from paragraphs 4.5 to 4.8 of the Consultation Paper that the Administration had not proposed to set up a separate appeal tribunal to hear appeals against actions of the FRC. Pointing out that the Securities and Futures Appeal Tribunal was set up for reviewing a wide range of SFC's decisions affecting persons' rights and interests, Mr HO enquired about the reasons for the Administration's current proposal.

50. SFST advised that considerable thoughts had been given to the need and desirability of setting up a separate tribunal to handle and hear appeals against the decisions of the FRC. He pointed out that the functions and powers of the FRC would be different from those of SFC. The FRC's functions would be mainly confined to investigatory and enquiry work. If the FRC considered that there was sufficient evidence to substantiate a case or complaint, it would refer the case to the

relevant authorities for follow-up actions. Unlike SFC, the FRC would not be vested with regulatory, enforcement or disciplinary powers. Given the nature of the functions and powers of the FRC, the Administration did not consider it necessary and justified to establish a separate appeal tribunal. DS/FST(FS) supplemented that the measures proposed in paragraphs 4.3, 4.4, 5.18 and 6.15 of the Consultation Paper would provide sufficient checks and balances on the powers of the FRC. It should be noted that any parties aggrieved by the action of the FRC could apply to the court for a judicial review of the action concerned.

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51. In this connection, Mr Albert HO re-iterated his concern about the lack of a review mechanism on the actions of the FRC and urged the Administration to consider his views.

52. Mr Albert HO noted from paragraph 5.18 of the Consultation Paper that it was proposed that the FRC should consult the Hong Kong Monetary Authority, the Insurance Authority, SFC, or the Mandatory Provident Fund Schemes Authority as appropriate before issuing a direction to a person which was itself an authorized financial institutions, an insurer, a licensed person of SFC or an approved trustee of MPF schemes. He enquired about the reason for the proposal and whether the FRC was obliged to follow the results of the consultation.

53. In response, SFST explained that the proposed consultation arrangement was a further measure for providing checks and balances on the investigatory powers of the FRC. As auditors' irregularities and accounting malpractices of listed corporations often involved a number of parties, the consultation arrangement was necessary to enhance communication among the relevant regulators and the FRC.

54. Mr WONG Ting-kwong expressed concern that the FRC would not be given any sanctioning powers. He was also concerned about the possible delay in taking enforcement/disciplinary actions against the parties involved in accounting irregularities in the event that upon receiving a referral by the FRC, the relevant body might have different views and undertake other actions it saw fit.

55. In response, SFST re-iterated that the majority views revealed in the consultation in September 2003 were that the function of the FRC should remain purely investigatory. The proposal of referring cases to the relevant law enforcement agency and /or professional bodies for legal and/or disciplinary actions would provide proper checks and balances on the powers of the FRC and inspire public confidence in its work.

Experiences in other jurisdictions

56. Noting that the proposal of establishing the FRC was not modelled on any accounting regulatory bodies of overseas jurisdictions, Mr Albert HO enquired whether the Administration had made reference to overseas experiences in formulating the current proposal.

57. SFST advised that the Administration had conducted research on the regulatory regimes for the accounting profession in overseas jurisdictions. The proposed FRC would suit the unique circumstances and practical situations in Hong Kong which was characterized by the self-regulatory regime for the accounting profession.

58. Mr Albert HO requested the Administration to provide an information paper on the unique circumstances in Hong Kong that justified the establishment of a FRC, and the experience of overseas jurisdictions in the regulation of accounting profession. The paper should cover the details of the regulatory regimes in overseas jurisdictions, whether the accounting profession was subject to a self-regulatory regime, the functions of the regulatory bodies involved and whether the functions were comparable to those proposed to be undertaken by the AIB and a FRRC, and the funding arrangements for performing these functions. SFST agreed to provide the paper.

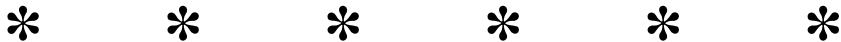
Institutional arrangement of the FRC

59. Miss Mandy TAM enquired whether the Administration would consider providing the Financial Secretary with the authority to appoint members of the FRC. SFST advised that given that the FRC was to be set up as an independent statutory body, it would be appropriate for the CE to appoint its members. This arrangement was in line with that for other statutory bodies.

60. In reply to Mr Andrew LEUNG's enquiry, SFST advised that the current intention was that the FRC would not initiate investigation/enquiry relating to auditors' irregularities or non-compliance of financial reports of listed corporations happened prior to its establishment.

Way forward

61. Ms Emily LAU requested the Administration to report to the Panel on the outcome of the current public consultation exercise and the proposed way forward before introducing the relevant bill into LegCo. SFST undertook to do so.



Appendix III

Extract from the minutes of meeting of the Panel on Financial Affairs on 6 May 2005

* * * * *

V. Consultation conclusions on legislative proposals to establish Financial Reporting Council

(LC Paper No. CB(1)1312/04-05(07) — Paper provided by the Administration

LC Paper No. CB(1)1020/04-05(04) — Paper provided by the Administration (with consultation paper on the legislative proposals to establish the Financial Reporting Council)

LC Paper No. CB(1)1020/04-05(05) — Background brief prepared by the Legislative Council Secretariat

LC Paper No. CB(1)1311/04-05 — Minutes of meeting on 7 March 2005 (Agenda Item V))

Briefing by the Administration

38. At the Chairman's invitation, the Secretary for Financial Services and the Treasury (SFST) briefed members on the outcome of the public consultation on the legislative proposals to establish the Financial Reporting Council (FRC) and the Administration's proposed way forward. He highlighted the following points:

- (a) As the Administration briefed members on 7 March 2005, it had launched a public consultation on the FRC proposal on 28 February 2005 through a "Consultation Paper on the Legislative Proposals to Establish the Financial Reporting Council" (the Consultation Paper) which set out the detailed proposals in respect of the composition and funding of the FRC, its powers and functions, checks and balances, as well as miscellaneous matters.
- (b) The consultation closed on 15 April 2005. As at 5 May 2005, the Administration received a total of 28 submissions. The

overwhelming majority of the respondents indicated support for the establishment of the FRC. They considered that the proposal was in the right direction and would help strengthen the oversight of auditors and enhance the quality of financial reporting of listed entities in Hong Kong.

- (c) At the Panel meeting on 7 March 2005, members sought further information on three matters namely, the circumstances in Hong Kong that justified the establishment of the FRC; the question of possible “regulatory overlap” (i.e. division of roles and responsibilities among the relevant bodies); and a comparison of the FRC proposal with similar set-up in other jurisdictions. The Administration’s responses were set out in paragraphs 8 to 16 of its paper (LC Paper No. CB(1)1312/04-05(07)).
- (d) Regarding regulatory regimes for the accounting profession in other jurisdictions, a comparison table covering Hong Kong, Australia, the United Kingdom (UK) and the United States (US) was provided in Annex C to the Administration’s paper. There was a general trend in all jurisdictions towards greater independence from the accounting profession in the oversight of auditors and listed companies’ financial reporting. As far as the FRC proposal was concerned, the part of the proposal related to the Financial Reporting Review Committee (FRRC) was generally modelled on the similar set-up in the UK, in terms of its functions, powers and composition. As for the proposed Audit Investigation Board (AIB), the Administration’s proposals were similar to Australia, UK and US in areas such as investigatory work being conducted by bodies other than the professional associations, but different in one aspect, i.e. AIB’s role and functions being confined to investigation only rather than encompassing disciplinary proceedings against an auditor.
- (e) The FRC proposal recognized the importance of reassuring the market and the investing public that Hong Kong’s financial reporting and corporate governance frameworks were and would continue to be robust. The proposal had the full support of the Hong Kong Institute of Certified Public Accountants (HKICPA), Securities and Futures Commission (SFC), and Hong Kong Exchanges and Clearing Limited (HKEx). The Administration and these parties had agreed to contribute to the funding of the FRC on an equal share basis. In the light of the overwhelming support received during the recent public consultation, the Administration aimed at introducing a bill into LegCo within the 2004-05 session to take forward the FRC proposal.

39. Upon the Chairman’s invitation, the Deputy Secretary for Financial Services and the Treasury (Financial Services) (DS/FST(FS)) took members through the summary of written submissions and the Administration’s responses in Annex B to

the paper. She said that the Administration took note of the views and suggestions in the submissions and where appropriate would incorporate them in the bill.

Discussion

Proposal to establish the FRC

40. Mr Ronny TONG re-iterated his concern expressed at the Panel meeting on 7 March 2005 that given that HKICPA was empowered under the Professional Accountants Ordinance (PAO) (Cap.50) to investigate into cases of misconduct and irregularities of the accounting profession, the proposed FRC would overlap with the investigation duties of HKICPA.

41. In response, SFST advised that on any suspected breaches of the professional ethics and standards specified by HKICPA, the Council of HKICPA (HKICPA Council) might constitute an Investigation Committee to undertake investigation of the case where it reasonably suspected or believed that there were justifications for doing so. An Investigation Committee was required by law to report the outcome of its investigation to the HKICPA Council. On the basis of the Investigation Committee's findings, the HKICPA Council might constitute a Disciplinary Committee to determine whether disciplinary action should be taken and if it should, the appropriate disciplinary action. For suspected criminal offences committed by auditors, the HKICPA Council would refer them to the law enforcement agency for appropriate action. SFST added that the Professional Accountants (Amendment) Ordinance 2004 enacted in July 2004 had expanded the membership and composition of Investigation Committee and the Disciplinary Committee to include more lay persons.

42. On the concern about possible overlap of investigatory functions of the FRC and HKICPA, SFST pointed out that upon its establishment, AIB under the FRC would investigate auditors' irregularities involving listed entities, whereas HKICPA would continue to deal with cases in the non-listed sector. In a nutshell, the FRC would simply take over from HKICPA the responsibility for investigating the irregularities of auditors concerning listed corporations and listed collective investment schemes. Moreover, as a transitional arrangement, the FRC would not deal with those cases which took place before its establishment and had been received by HKICPA. Hence, there would not be any overlap of the investigatory functions of the FRC and HKICPA. SFST also pointed out that the set-up and investigatory power of AIB would address the need to enhance the independence of investigation of the audits of listed corporations and the concern about the lack of adequate power under PAO to require non-HKICPA members to produce documents or provide information, thus enhancing the effectiveness and efficiency of the investigation of auditors' irregularities. Furthermore, the proposed FRRC would fill the existing gap of the lack of statutory powers of HKICPA and HKEx to enquire into non-compliance of financial reports of listed companies and request companies to take necessary rectifications.

43. Given the existing transparent self-regulatory regime of the accounting profession and the fact that HKICPA was empowered under PAO to investigate into cases of misconduct and irregularities of the accounting profession, Mr Ronny TONG queried the role to be played by the proposed FRC. Moreover, as the function of the FRC was purely investigatory and that it might, upon completion of the investigation, refer a case of auditors' irregularities to HKICPA for disciplinary action or to the law enforcement bodies for criminal investigation, Mr TONG was concerned that the investigation reports of FRC were not connected with the subsequent "prosecution" work of HKICPA or the law enforcement bodies. As a result, HKICPA or the law enforcement bodies might have to conduct its own investigation to collect the required evidence and use the investigation reports of FRC as a reference only. This would result in duplication of efforts and wastage of resources. As such, the FRC would not expedite the investigation and handling of auditors' irregularities. Mr TONG urged the Administration to address this concern and consider the following two possible options:

- (a) To empower the FRC to undertake "prosecution" after investigation; or
- (b) To put in place a mechanism for HKICPA or the law enforcement body to set out the suspected irregularities, including stating all possible offences of an auditor, for the FRC to undertake investigation to collect the relevant evidence.

44. SFST advised that during the first consultation conducted in late 2003, the vast majority of the respondents supported that the function of the FRC should remain purely investigatory. SFST stressed that the FRC would not be a regulatory body per se. The power to impose disciplinary and criminal sanctions on the auditors who had committed irregularities should continue to be vested with HKICPA and the relevant law enforcement bodies respectively. Given that the accounting profession was subject to a self-regulatory regime, HKICPA rather than the Government was responsible for regulating the profession.

45. DS/FST(FS) supplemented that the proposal of establishing the FRC was put forward by HKICPA and had the support from the public, SFC and HKE. She further explained that under the present proposal, AIB would initiate investigation on suspected auditor's irregularities of listed corporations where justified on receiving complaints or referrals from relevant bodies. AIB would carry out investigation with its statutory powers. The investigation report would be submitted to the FRC which would then decide on the necessary follow-up actions, including referring the case or disclosing the relevant information to HKICPA for consideration of disciplinary actions if the case was related to auditors' professional standards or ethics; or to law enforcement bodies, such as the Police, for consideration of prosecution if the case was related to criminal offences. For a case referred to HKICPA, its Council would decide whether further investigation would be needed and whether disciplinary action should be taken under PAO. In order to facilitate the disciplinary proceedings of HKICPA, AIB would provide the necessary assistance to HKICPA, such as disclosing the evidence obtained during

the investigation to HKICPA and giving evidence during the proceedings. As for a case referred to law enforcement bodies, AIB would also provide assistance in the prosecution process or follow-up investigation where appropriate.

46. Mr CHAN Kam-lam echoed Mr Ronny TONG's concern that if the function of the FRC was purely investigatory, it would become a toothless tiger. It was highly likely that HKICPA or the law enforcement bodies would have to conduct its own investigation to collect the required evidence and use the investigation reports of the FRC as a reference only. To address this concern, Mr CHAN suggested that, in addition to referring its investigation reports to HKICPA or the law enforcement bodies, the FRC should be empowered to make recommendations on the necessary follow-up actions to be taken on the cases. This arrangement would enhance the credibility of the FRC's work and avoid the complication of involving AIB in the disciplinary proceedings of HKICPA or the prosecution process of the law enforcement bodies.

47. In response, SFST pointed out that Mr CHAN Kam-lam's suggestion would have the implication of subjecting the accounting profession to the regulation of the Government, and would also have wide implications on the self-regulatory regimes of other professions. In fact, the self-regulatory regime of the accounting profession had been enhanced by the enactment of the Professional Accountants (Amendment) Ordinance 2004 in July 2004 and would be further enhanced by the present proposal of establishing the FRC. SFST stressed the importance of making improvements to the regime step by step and reviewing it from time to time.

48. Mr Ronny TONG expressed support for maintaining the self-regulatory regime for the accounting profession. However, he re-iterated his concern about the lack of connection between the investigatory work of the FRC and the disciplinary work of HKICPA and prosecution work of the law enforcement bodies.

49. Ms Emily LAU and Miss Mandy TAM expressed support for the proposal of establishing the FRC in principle and maintaining the self-regulatory regime for the accounting profession. Ms LAU also urged the Administration to refine the details of the proposal and examine how the concerns expressed by Mr Ronny TONG could be addressed.

50. SFST took note of Mr Ronny TONG's concerns and suggestions expressed in paragraph 43 above and undertook to explore, in consultation with HKICPA, how the concerns could be addressed.

(*Post-meeting note:* The Administration's responses were circulated to members and non-Panel Members vide LC Paper No. CB(1)1805/04-05(02) on 16 June 2005.)

51. Mr SIN Chung-kai said that the LegCo Members of the Democratic Party supported the proposal of establishing the FRC in principle. He considered that the Administration should further refine the details of the proposal and consider how the

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concerns expressed at this meeting could be addressed. In this connection, Mr SIN pointed out that the proposal was introduced to address the public concern about the integrity of the auditing profession and accuracy of financial reporting given the corporate scandals in the US and suspected cases involving false financial reports of listed companies in Hong Kong in recent years. He considered that apart from putting forward the present proposal, the Administration should also enhance the disclosure requirements on listed corporations by making reference to the disclosure regime adopted in the US.

52. Mr CHIM Pui-chung was concerned that the proposal of establishing the FRC might impose more obligations on auditors of listed corporations and might therefore have cost implications on listed corporations because their auditors might charge higher fees for providing better services. He also requested the Administration to consider whether it was fair for the proposal to aim at enhancing the regulation of the accounting profession only but not the regulation of HKEx.

53. In response, SFST pointed out that at present, professional accountants were required to comply with the relevant professional standards and statutory requirements. The proposal of establishing the FRC would not impose additional obligations on auditors in their work for listed corporations. He further pointed out that SFC, as the regulator, had the duty to monitor the work of HKEx, and both parties had their own duties over listing under the dual filing system.

Summary of written submissions on the legislative proposals of establishing the FRC

54. Ms Emily LAU noted from Annex A to the Administration's paper that one of the respondents to the consultation had requested its name not to be disclosed. She enquired whether the respondent's views had been incorporated in the summary provided in Annex B to the Administration's paper.

55. In response, DS/FST(FS) explained that in general, if the respondents to a public consultation exercise did not request for not disclosing their views, the Administration would consolidate and present their views in the summary of submissions. For the present case, DS/FST(FS) undertook to check and confirm whether the views expressed by the respondent referred to by Ms Emily LAU had been incorporated in the summary provided in Annex B to the Administration's paper.

(*Post-meeting note:* The Administration confirmed that the views expressed by the respondent had been incorporated in the summary (LC Paper No. CB(1)1805/04-05(02) issued on 16 June 2005).)

56. In this connection, Ms Emily LAU expressed concern that in the event that some respondents to a public consultation exercise requested their names and views not to be disclosed, the public would not have a full picture of the views collected during consultation and would not know whether the Administration had taken on

Admin board their views. She opined that the Administration should consider how such a situation should be handled.

57. Ms Emily LAU enquired about the Administration's responses to the comments on the modus operandi of the FRC in paragraphs 17 and 18 of Annex B to the Administration's paper about the implication of the publication of FRC's investigation/enquiry reports and the need to provide auditors with statutory immunity in reporting to the FRC on any suspected fraud or irregularities in audits. DS/FST(FS) said that the Administration had noted the comments. It was envisaged that the FRC would consider the need to work out appropriate guidelines governing the publication of FRC's investigation/enquiry reports and would incorporate in the relevant bill the provisions to provide statutory immunity to auditors where appropriate.

Conclusion

58. The Chairman concluded that a great majority of the members present supported the Administration's proposal of establishing the FRC. He urged the Administration to discuss with HKICPA in order to address Mr Ronny TONG's concerns.

59. Responding to the Chairman' enquiry about the legislative timetable for the relevant bill, SFST said that subject to the outcome of further consultation with HKICPA, the Administration would introduce the bill into LegCo within the 2004-05 session.



2528 9016
2527 0292
L/M to (5) in G9/8/5(04) Pt.3

15 June 2005

Clerk to Panel on Financial Affairs, Legislative Council
(Attn: Ms. Connie Szeto)
Legislative Council Building
8 Jackson Road
Central
Hong Kong

Dear Ms. Szeto,

**LegCo Panel on Financial Affairs
Follow-up to Meeting on 6 May 2005**

**Consultation Conclusions on Legislative Proposals
to Establish the Financial Reporting Council**

I refer to your letter of 12 May 2005. Having consulted the Hong Kong Institute of Certified Public Accountants (HKICPA) and the Department of Justice (D of J), we set out our responses in the ensuing paragraphs.

The “Investigatory” Role of the Financial Reporting Council (FRC)

2. We note that a Member was concerned that the referral of cases to the HKICPA and law enforcement agencies might result in “duplication of investigatory efforts” and “wastage of resources”. Suggestions had been made for the Administration to explore whether to -

- (a) empower the FRC to undertake “prosecution” after investigation; or
- (b) put in place a mechanism for the HKICPA or the law enforcement agencies to identify the suspected irregularities, including stating any possible offences of an auditor, for the FRC to undertake investigation.

3. In response, we would like to make reference to the **existing** modus operandi under which the HKICPA deals with a complaint. At present, under the Professional Accountants Ordinance (PAO, Cap. 50), there is generally a “two-stage” approach in dealing with a complaint against HKICPA’s members, registered firms and corporate practices. Where the Council of the HKICPA reasonably suspects or believes that an irregularity has occurred, the Council of the HKICPA may constitute an Investigation Committee (constituted by drawing members from the Investigation Panels) to investigate the complaint¹. Subsequent to the completion of the investigation, the Council of the HKICPA will consider the Investigation Committee’s findings and may refer the case to a Disciplinary Committee (constituted by drawing members from the Disciplinary Panels) to take disciplinary actions².

4. Upon the establishment of the FRC, the FRC will investigate auditors’ irregularities involving listed entities, whereas the HKICPA will continue to deal with other cases including those in the non-listed sector. In this light, the FRC will take the place of the HKICPA’s Investigation Committees in respect of the investigation of auditors’ irregularities concerning listed entities. After the completion of the FRC’s investigation, the FRC may refer the case to the Council of the HKICPA which may constitute a Disciplinary Committee to take disciplinary actions. The proposed arrangement reflects the majority view in the public consultation conducted by the Administration in late 2003, namely that the FRC’s role should be investigatory only and disciplinary proceedings should continue to be vested with the relevant professional bodies such as the HKICPA.

¹ Section 42C(2)(a) of the PAO.

² Section 34(1) of the PAO.

5. We do not consider that there will be practical difficulties in relation to the referral of cases from the FRC to the HKICPA. At present, the Disciplinary Committees of the HKICPA also rely on the findings of the Institute's Investigation Committees, each of which comprises a majority of lay persons, to consider whether a complaint is proven. Furthermore, with a view to enabling a smooth interface between the FRC and the HKICPA (or law enforcement agencies), the FRC Bill will contain provisions to -

- (a) empower the FRC to provide assistance to the HKICPA and other bodies and enter into memoranda of understanding to settle the detailed arrangement therefor. Such assistance may include disclosing the evidence obtained during the investigation to the HKICPA for the preparation of the proceedings and giving evidence during such proceedings; and
- (b) enable a copy of the FRC's investigation report to be admissible in any proceedings before a court or magistrate or the Market Misconduct Tribunal, or any investigation and disciplinary proceedings of the HKICPA under the PAO, as evidence of the facts stated in the report.

Second Public Consultation

6. We would also like to reply that, during the public consultation earlier this year, a respondent had requested that his name should not be disclosed, and that his views have been covered in the summary of submissions attached to the Administration's paper for the Panel meeting on 6 May 2005.

Yours sincerely,

(Alan Lo)
for Secretary for Financial Services and the Treasury

c.c.

Hong Kong Institute of Certified Public Accountants

(Attn: Mr. Edward Chow, President)

(Attn: Ms. Winnie Cheung, Chief Executive and Registrar)

Department of Justice

(Attn: Ms. Beverly Yan, Civil Division)

(Attn: Mr. Lawrence Peng, Law Drafting Division)

(Attn: Miss Selina Lau, Law Drafting Division)

Registrar of Companies

(Attn: Mr. Gordon Jones)

Appendix V

Financial Reporting Council Bill

List of relevant papers (Position as at 18 July 2005)

Paper	LC Paper No.
Consultation paper on the proposals to: (a) Enhance the oversight of the public interest activities of auditors; and (b) Establish a Financial Reporting Review Panel	CB(1)2487/02-03 <i>(discussed at the FA Panel meeting on 2 April 2004)</i>
Administration's paper on "Regulation of the auditing profession and preparers of financial statements"	CB(1)1393/03-04(05) <i>(discussed at the FA Panel meeting on 2 April 2004)</i>
Administration's paper on "The legislative proposals to establish the Financial Reporting Council" (with the consultation paper)	CB(1)1020/04-05(04) <i>(discussed at the FA Panel meeting on 7 March 2005)</i>
Background brief on "Proposals to enhance the oversight of public interest activities of auditors and establish a Financial Reporting Council"	CB(1)1020/04-05(05) <i>(discussed at the FA Panel meeting on 7 March 2005)</i>
Administration's paper on "The legislative proposals to establish the Financial Reporting Council"	CB(1)1312/04-05(07) <i>(discussed at the FA Panel meeting on 6 May 2005)</i>
Legislative Council Brief on Financial Reporting Council Bill	File Ref: C15/3(05) Pt. 9 <i>(issued by the Financial Services and the Treasury Bureau on 15 June 2005)</i>
Legal Service Division Report on Financial Reporting Council Bill	LS86/04-05 <i>(issued on 7 July 2005)</i>

Council Business Division 1
Legislative Council Secretariat
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