

**立法會**  
**Legislative Council**

LC Paper No. LS86/04-05

**Paper for the House Committee Meeting  
on 8 July 2005**

**Legal Service Division Report on  
Financial Reporting Council Bill**

**I. SUMMARY**

1. **Objects of the Bill** (a) To establish a Financial Reporting Council (FRC) to investigate irregularities committed by auditors or reporting accountants of listed entities in auditing accounts and in preparing financial reports for prospectuses or other listing documents, and to enquire into non-compliance with legal, accounting or regulatory requirements in the financial reports of such entities;  
(b) To establish an Audit Investigation Board (AIB) and a Financial Reporting Review Committee (FRRC) to carry out such investigations and enquiries respectively.
2. **Comments** (a) No qualifications for appointment by CE as a lay member of FRC, or as a member of the Financial Reporting Review Panel, have been specified.  
(b) No reasonable opportunity of being heard seems to have been given to a person under investigation but reports of AIB and FRRC are admissible as evidence of facts contained in them.  
(c) There is no right to review or appeal against a report of AIB or FRRC.
3. **Public Consultation** Two rounds of public consultation have been conducted by the Administration: first in 2003 on the broad proposals, and then on detailed proposals from 28 February to 15 April 2005. According to the Administration, the overwhelming majority of respondents support the establishment of FRC.
4. **Consultation with LegCo Panel** The Panel on Financial Affairs was briefed on the broad proposals on 13 June 2003 and 2 April 2004 and on the detailed proposals on 7 March and 6 May 2005. A great majority of members indicated their support for the proposal in principle.
5. **Conclusion** The legislative proposal is a significant development in the supervisory regime of auditors and reporting accountants and could have long term effects on the accounting profession. It is recommended that a Bills Committee be set up to study the Bill in detail.

## **II. REPORT**

### **Objects of the Bill**

- (a) To establish a Financial Reporting Council (FRC) to -
  - (i) investigate irregularities committed by auditors of listed entities (i.e. listed companies and listed collective investment schemes) in the auditing of accounts and irregularities committed by reporting accountants of such entities in the preparation of financial reports for prospectuses or other listing documents, and
  - (ii) enquire into non-compliance with legal, accounting or regulatory requirements in the financial reports of such entities;
- (b) To establish an Audit Investigation Board (AIB) to conduct investigations described in (a)(i) above;
- (c) To establish a Financial Reporting Review Panel, whose members would be appointed to form a Financial Reporting Review Committee (FRRC) to make enquiries described in (a)(ii) above; and
- (d) To provide for related matters.

### **LegCo Brief Reference**

- 2. C15/3(05) Pt.9 issued by the Financial Services and the Treasury Bureau on 15 June 2005.

### **Date of First Reading**

- 3. 29 June 2005.

### **Comments**

- 4. The legislative proposals form part of the measures to strengthen the supervisory regime of the accounting profession in response to the overseas corporate scandals occurred in 2002, of which the most well-known is perhaps the Enron scandal in the United States of America. The Administration has worked out the details in consultation with the Hong Kong Exchanges and Clearing Limited (HKEx), the Hong Kong Institute of Certified Public Accountants (HKICPA) and the Securities and Futures Commission (SFC).

#### *Financial Reporting Council*

- 5. FRC would be a statutory body corporate with perpetual succession but independent of the Government (clause 6). It would comprise of not less than 9 and

not more than 11 members. The Registrar of Companies or his representative and the Chief Executive Officer (CEO) of FRC would be ex-officio members. SFC, HKEx and HKICPA would each nominate a person for appointment as member by the Chief Executive (CE), who would also be empowered to appoint 4 to 6 members of his own choice (clause 7(1)) and to determine the terms and conditions of their appointment. Apart from the express exclusion of public officers (clause 7(3)), no qualifications for appointment by CE as members of FRC have been specified. The number of members who are lay persons (i.e. non-accountants) should exceed the number of those who are not (clause 7(2)). The Chairman and CEO would be appointed by CE but the former only from amongst the members who are lay persons (clause 7 (4)).

6. The functions of FRC are mainly the investigation and enquiry into irregularities and non-compliances in relation to listed entities in respect of auditing and financial reporting (clause 9). It is, however, not entirely clear whether FRC could only respond to complaints or could act on its own initiative. It is also not clear whether FRC would have the right to investigate such irregularities or to enquire into such non-compliances to the exclusion of HKICPA.

7. CE could, after consultation with the Chairman and upon being satisfied that it is in the public interest to do so, give FRC such directions as he thinks fit with respect to the performance of any of FRC's functions (clause 14). The FRC's statement of accounts would be audited by the Director of Audit (clause 19). FRC would have to lay before the Legislative Council after the end of each financial year a report on its activities, the statement of accounts and the auditor's report (clause 20).

#### *Funding of FRC*

8. According to the Administration, the Administration, SFC, HKEx and HKICPA have agreed to fund FRC in equal shares. Each would contribute HK\$2.5 million annually for the first three years as FRC's recurring funding and an additional sum up to HK\$2.5 million upfront as a one-off contribution to a reserve fund. The Administration's share would be borne by the Companies Registry Trading Fund (CRTF), which would also provide free accommodation for FRC. This arrangement would be effected through a Memorandum of Understanding to be signed by the parties and is not reflected in the Bill. It is observed that the resolution under the Trading Funds Ordinance (Cap. 430) establishing CRTF would need to be amended to enable it to lawfully discharge the Administration's obligations under the funding agreement.

#### *Audit Investigation Board*

9. There would be established an AIB comprising the CEO and at least a member appointed by FRC (clause 22). It seems that the AIB would alone investigate all the cases required to be investigated. It remains to be seen whether practically it could effectively handle all the required investigations by itself.

10. An investigation would be initiated when FRC has certified that there

are circumstances suggesting, or that it has reasonable cause to believe, that there is an auditing or a reporting irregularity in relation to a listed entity, and has in writing directed the AIB to investigate (clause 23). The relevant irregularities are specified in clause 4. They include the falsification of documents, making of material false statements, negligence, professional misconduct and any act or omission that would reasonably be regarded as bringing discredit to the auditor or reporting accountant, HKICPA or the accounting profession.

11. When the relevant irregularities concern an authorized institution (AI) or a controller of AI; or an insurer authorized under the Insurance Companies Ordinance (Cap. 41); or a licensed person authorized under, or a collective investment scheme authorized under, the Securities and Futures Ordinance (Cap. 571); or an approved trustee under the Mandatory Provident fund Schemes Ordinance (Cap. 486), FRC shall notify in writing the Monetary Authority (MA), the Insurance Authority (IA), SFC or the Monetary Provident Fund Schemes Authority (MPFSA) respectively (clause 24).

12. AIB has power to require the production of records and documents (including audit working papers) relating to the relevant irregularities from the auditor or reporting accountant of a listed entity in possession of them and explanation in relation to them (clauses 25, 26 and 27). It also has power to require such persons to answer questions and render such other assistance as they may be reasonably able to give (clause 28). Self incrimination would not be an excuse for refusing compliance with any of AIB's requirements. FRC shall consult MA, IA, SFC or MPFSA respectively before imposing any requirement on persons under the supervision of each of the regulatory authorities (clause 29). It is not clear why such prior consultation, which may cast doubt on the independence of AIB, is necessary.

13. AIB shall submit a report to FRC as soon as practicable after the completion of its investigation (clause 35(1)). The report would be admissible as evidence of the facts stated in it in any proceedings before a court or magistrate or the Market Misconduct Tribunal or any proceedings under Part V or VA of the Professional Accountants Ordinance (Cap. 50). This provision seems to be in conflict with clause 30 that purports to exclude the use of incriminating evidence in criminal proceedings. Moreover, there is no provision for a reasonable opportunity of being heard being afforded to any person who may be adversely affected by the report. FRC could decide whether or not to publish the whole or any part of a report (clause 35(3) and (4)). Neither AIB nor FRC has any power to impose any sanction in consequence of any findings in the report. There would be no appeal or review mechanism provided for any person aggrieved by a report, although it would be open to judicial review.

14. If a person is convicted in criminal proceedings instituted as a result of an investigation made under the provisions of Part III of the Bill, the court or magistrate may order the convicted to pay FRC a sum the court or magistrate considers appropriate for the costs and expenses in relation or incidental to the

investigation reasonably incurred by FRC (Clause 37).

#### *Financial Reporting Review Panel and Committee*

15. A Financial Reporting Review Panel comprising at least 20 persons, of whom 3 would be Panel Convenors, would be appointed by CE (clause 39). No qualifications for appointment have been specified. From this Panel, FRC may appoint a FRRC to enquire into relevant non-compliances. Each FRRC would comprise 5 Panel members, of whom one must be a Panel Convenor who would be the chairman. The relevant non-compliances are specified in clause 5 and Schedule 1. They are concerned with the balance sheet, and accounts of a corporation which are required to be filed or sent under the Companies Ordinance (Cap. 32) or the listing rules of HKEx. The powers exercisable by FRRC (clause 43) and other provisions applicable to FRRC are similar to those governing AIB.

16. FRC would have power to give notice to a listed entity to remove a relevant non-compliance (clause 49). When such notice has not been complied with, FRC could apply by originating summons to the Court of First Instance for a declaration that there is a relevant non-compliance and an order to revise the relevant financial report or to take such remedial action as the Court considers necessary (clause 50). However, it is not clear whether a report by FRRC is necessary before FRC could give such a notice under clause 49.

#### **Public Consultation**

17. Two rounds of public consultation have been conducted by the Administration: first in September 2003 on the “Proposals to (a) Enhance the Oversight of the Public Interest Activities of Auditors; and (b) Establish the Financial Reporting Review Panel”, and then on detailed proposals from 28 February to 15 April 2005. According to the Administration, the overwhelming majority of respondents support the establishment of FRC.

#### **Consultation with LegCo Panel**

18. The Panel on Financial Affairs was briefed on the broad proposals on 13 June 2003 and 2 April 2004, on the detailed proposals on 7 March 2005, and on the outcome of the public consultation conducted on the proposals on 6 May 2005. A great majority of members indicated their support for the proposal 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 proposals. They include the following:-

- (a) The functions of the FRC would overlap with the investigation duties of SFC and HKICPA;

- (b) 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;
- (c) 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 services; and
- (d) 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.

### **Conclusion**

19. The legislative proposal is a significant development in the supervisory regime of auditors and reporting accountants and could have long term effects on the accounting profession. It is recommended that a Bills Committee be set up to study the Bill in detail.

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