

**For information
on 5 July 2007**

**Legislative Council
Panel on Financial Affairs**

Establishment of the Financial Reporting Council

PURPOSE

The Financial Reporting Council Ordinance (“FRCO”, Chapter 588), enacted on 13 July 2006, provides the legal framework for the establishment of the Financial Reporting Council (“FRC”) to investigate audit irregularities and enquire into accounting non-compliances concerning corporations and collective investment schemes listed in Hong Kong (i.e. “listed entities”).

2. This paper seeks to brief Members on the establishment of the FRC in accordance with the FRCO.

SUBSEQUENT LEGISLATIVE MATTERS

3. Since the enactment of the FRCO, the Secretary for Financial Services and the Treasury has, in exercise of his power under section 1(2) of the FRCO, made the following three Notices to implement the Ordinance in phases –

- (a) **FRCO (Commencement) Notice 2006** (L.N. 204 of 2006): This Notice specified 1 December 2006 as the commencement date for certain provisions of the FRCO necessary to accord the established FRC a legal status, enable the relevant appointments to the FRC, and permit the FRC to proceed with preparatory incorporation work;

- (b) **FRCO (Commencement) Notice 2007** (L.N. 27 of 2007): This Notice specified 20 April 2007 as the commencement date for certain consequential amendments to the Companies Ordinance (Chapter 32) to empower companies to make voluntary revisions to accounts. This commencement date tied in with the commencement of the Companies (Revision of Accounts and Reports) Regulation¹ (Chapter 32N); and
- (c) **FRCO (Commencement) (No. 2) Notice 2007** (L.N. 104 of 2007): This Notice specified **16 July 2007** as the commencement date for the provisions of the FRCO prescribing the investigation and enquiry powers of the Council to receive complaints and undertake investigation and enquiry work. From 16 July 2007 onwards, the FRC will be fully operational.

APPOINTMENTS

The Council

4. Under section 7 of the FRCO, the Council is to consist of nine to eleven members responsible for governing and overseeing the affairs of the FRC. This governing board (hereinafter the "FRC Board") comprises two ex-officio members (viz. Registrar of Companies or his representative, and the Chief Executive Officer ("CEO") of the FRC) and seven to nine members appointed by the Chief Executive ("CE").

5. To uphold the FRC's status as an independent investigator for the accountancy profession, sections 7(2) and (4) of the Ordinance require that the Chairman and the majority of the FRC Board members must be lay persons (i.e. non-accountants). In this connection, the Chief

¹ The Companies (Revision of Accounts and Reports) Regulation (Chapter 32N) was made by the Chief Executive in Council under section 359A of the Companies Ordinance, which was amended vide section 65 of the FRCO. The Regulation seeks to implement sections 141E and 336A of the Companies Ordinance which empower companies to make voluntary revisions to accounts when it appears to the directors that such accounts did not comply with the relevant reporting requirements. Gazetted on 16 February 2007 for negative vetting by the Legislative Council, the Regulation (except Part 4 thereof) came into operation on 20 April 2007.

Executive has appointed eight members, whose appointments took effect on 1 December 2006 for three years. A membership list of the FRC Board is at Annex.

6. The CEO is the FRC secretariat's administrative head. He was appointed by the CE under section 8 of the FRCO, pursuant to a worldwide open recruitment exercise conducted by a selection panel. Upon assuming office on 1 February 2007, the CEO immediately started preparatory work for commencement of FRC's operations under the direction of the FRC Board and in accordance with the FRCO, including building the executive secretariat of the FRC, drafting operational procedures, and formulating working arrangements with other regulatory bodies.

Audit Investigation Board and Financial Reporting Review Panel

7. The Audit Investigation Board ("AIB") and the Financial Reporting Review Panel ("FRRP") are the two subsidiary organs of the FRC to assist the FRC Board in discharging its two principal functions, i.e. to investigate audit irregularities in relation to listed entities, and to enquire into non-compliances of listed entities' financial reports with relevant accounting requirements. Section 22(2) of the FRCO provides that the AIB is to consist of the CEO (as an ex officio member and chairman of the AIB) and other members appointed by the FRC Board. Section 39 provides that the CE shall, in consultation with the FRC, appoint an FRRP of at least 20 suitable persons (including at least 3 Panel convenors). The appointments to the AIB and FRRP will be announced shortly.

BUILDING AN EFFECTIVE SETUP FOR THE FRC

Meetings of the FRC Board

8. Section 6(1) of Schedule 2 to the FRCO provides that meetings are to be held as often as necessary to enable the FRC Board to perform its functions. As at end-May 2007, the Chairman had convened two meetings to enable members to deliberate and approve issues and

decisions pertinent to the establishment of, and the performance of functions by, the FRC. Apart from the Board meetings, the Chairman and other non-executive members of the FRC Board maintain frequent contact with the CEO and other staff in the executive secretariat to give advice and steer on the relevant policy and administrative matters concerning the operation of the FRC. For the sake of efficiency, the FRC Board has also handled matters by written resolution in accordance with Section 7 of Schedule 2, as well as delegating certain administrative powers to individual members of the Board and the CEO.

Financial Arrangement

9. The Companies Registry Trading Fund, Securities and Futures Commission ("SFC"), Hong Kong Exchanges and Clearing Limited ("HKEx") and Hong Kong Institute of Certified Public Accountants ("HKICPA") have signed a memorandum of understanding in January 2007 regarding the funding contributions to the FRC. Under the agreed arrangement, the FRC will be provided a total of \$10 million per annum for first three financial years. Separately, an amount of \$20 million will be set aside as a Reserve Fund upon inauguration. The FRC duly received the contributions by the four parties in February 2007 under section 10(2)(g) of the FRCO.

10. The Secretary for Financial Services and the Treasury has approved the Council's proposal of fixing the period from 1 December 2006 to 31 December 2007 as its first financial year and thereafter following the calendar year as the period for each subsequent financial year, as well as the Council's proposed estimates of income and expenditure for its first financial year, pursuant to section 17 of the FRCO. The estimated expenditure of the FRC in the first financial year amounts to about \$9.3 million, of which around 60% is earmarked for salaries and staff expenses².

² Section 19 of the FRCO provides that the accounts of the FRC are to be audited by the Director of Audit. Section 20(2) provides that the Secretary for Financial Services and the Treasury shall cause the annual report, annual accounts and auditor's report of the FRC to be laid on the table of the Legislative Council, after the end of each financial year of the FRC.

Human Resources Structure

11. Section 10(2)(a) of the FRCO empowers the FRC to employ persons to assist the Council, the AIB and the FRRP in the performance of its functions. The FRC is determined to maintain a lean and efficient human resources structure. For the first financial year, the executive secretariat headcount is eleven, including the CEO. The team includes a number of investigators at different ranks who possess rich experience in and market exposure to the relevant financial reporting standards and listing requirements. They are currently tasked to assist the CEO in building an effective investigation team to prepare for the full operation of the FRC with effect from 16 July 2007. Where situations warrant in future, the FRC may also appoint consultants or legal advisers pursuant to section 10(2)(b) of the FRCO.

Office Accommodation

12. Schedule 1 to the Companies Registry Trading Fund (Chapter 430B) provides that one of the services to be provided by the Companies Registry Trading Fund is to support the FRC by making contributions, whether in cash or in kind, to sponsor the FRC's performance of its functions. The Companies Registry has agreed to permit the FRC to use part of the premises allocated to the Trading Fund on the 29th Floor of the Queensway Government Offices as the current office accommodation of the FRC.

Formulation of Investigation and Enquiry Procedures

13. In order to perform the functions under the FRCO, the FRC will investigate cases impartially, consistently, and in a reasonable and accountable manner, giving effect to natural justice and procedural fairness, and in accordance with the FRCO. Therefore, during 2007, internal procedures and guidelines are being developed with due reference to the same adopted by other local and overseas regulators and enforcement agencies. To enhance public understanding on how the FRC exercises its investigatory power, the FRC will soon publish its investigatory procedures, including how to lodge a complaint and the handling procedures for complaints.

Protocols with Relevant Authorities

14. The FRC is keenly aware of the need to ensure that its investigation and enquiry findings can assist the conduct of disciplinary proceedings by the Disciplinary Committees of the HKICPA under the Professional Accountants Ordinance (Chapter 50). There may also be occasions for the FRC to refer cases or findings to other enforcement bodies for necessary action. At the same time, the FRC itself may be on the receiving end of referrals of complaints from HKICPA and other bodies. Thus, it is necessary for the FRC to formulate working protocols with the HKICPA and concerned bodies.

15. In this regard, the FRC has been in dialogue, or will initiate discussion, with relevant enforcement bodies (including the HKICPA, SFC, Stock Exchange of Hong Kong Limited, Hong Kong Monetary Authority, Office of the Commissioner of Insurance, Mandatory Provident Fund Schemes Authority, Companies Registry, Hong Kong Police Force, Independent Commission Against Corruption) with a view to establishing close working relationships with them. Where situations warrant, the FRC may enter memoranda of understanding with these bodies, pursuant to section 10(2)(d) of the FRCO, to set out the cooperation frameworks.

Community Relations

16. As a new statutory body, the FRC is aware of the need for and importance of building its image and promoting better public understanding of its statutory functions. In this regard, the Chairman and the CEO will meet regularly with the press and members of the accountancy profession, and speak at and attend conferences and seminars organised by various professional bodies and institutes, to introduce the establishment of the FRC and its role in upgrading the integrity of financial reporting in Hong Kong. Upon its formal launch shortly before 16 July, the FRC website will also provide a valuable up-to-date source of information about the ongoing FRC's activities for practitioners, investors and other members of the public.

WAY FORWARD

17. The first half of 2007 has been a challenging and productive time for the FRC as it was tasked to build an effective organisational structure for the inauguration of the FRC within a short period of time. Despite the Council's short history, members and employees of the FRC are firmly committed to safeguarding the integrity of the accountancy profession and financial markets, and protecting the interest of the investing and general public.

18. Looking ahead, the FRC shall always endeavour with best effort to handle each and every case impartially, consistently, and in a reasonable and accountable manner, giving effect to natural justice and procedural fairness, and in accordance with the FRCO.

Financial Reporting Council
June 2007

Membership list of the FRC Board

Chairman

Ms. Sophia Kao, JP

Council Members

Mr. Moses Cheng, GBS, JP

Mr. Mark Dickens, JP

Mr. Martin Hadaway

Mr. Kam Pok-man

Hon. Mrs. Sophie Leung, SBS, JP

Mr. Vernon Moore

Prof. Judy Tsui

Mr. Gordon Jones, JP

Mr. Shum Man-to, SBS