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Panel on Financial Affairs Meeting on 8 April 2008

Updated Background Brief on the Work of the Financial Reporting Council

Purpose

This paper recaps the background on the establishment of the Financial Reporting Council (FRC), as well as its functions and funding arrangements. It also summarizes Members' major views and concerns on the subject.

Background

Establishment of FRC

2. In the wake of the Asian financial crisis in late 1990s and various corporate scandals in the United States¹, there was considerable public demand for enhanced regulation of the accountancy profession in Hong Kong. In December 2002, the Government requested the Hong Kong Institute of Certified Public Accountants (HKICPA)² to examine ways to enhance the regulatory regime for the accountancy profession. HKICPA then proposed a series of specific proposals, including enhancing the participation of independent lay members in the governing body of the accountancy profession and setting up an independent investigatory council to take charge of investigation of complaints involving public interest lodged against auditors. The Government subsequently conducted a public consultation on the proposals in September 2003. The consultation exercise ended in October 2003. According to the Administration, there was overwhelming support from the respondents for the establishment of an independent investigatory council. The

¹ In recent years, scandals involving large corporations such as Enron and Worldcom have aroused global concern for corporate governance and regulation of the accountancy profession. In order to rebuild public confidence in the information disclosed in company financial reports, various major international financial centres in the world, such as the United States and the United Kingdom have actively introduced reforms to strengthen their regulation of the accountancy profession.

² Formerly known as the Hong Kong Society of Accountants

Panel on Financial Affairs (FA Panel) was briefed on the proposals and the outcome of the public consultation at its meetings on 13 June 2003 and 2 April 2004 respectively.

3. In early 2005, the Government, in consultation with HKICPA, the Hong Kong Exchanges and Clearing Limited (HKEx), and the Securities and Futures Commission (SFC), proposed to set up a new and independent statutory body, namely FRC, to safeguard the integrity of financial reporting in Hong Kong and to protect the interest of the investing public. The Government then conducted a second round of public consultation and briefed the FA Panel on the detailed proposals and the outcome of the public consultation at its meetings on 7 March 2005 and 6 May 2005 respectively. A great majority of Panel members indicated support in principle for the proposal to establish FRC. On 29 June 2005, the Administration introduced the FRC Bill into the Legislative Council (LegCo). A Bills Committee was formed to scrutinize the Bill. The FRC Ordinance (Cap. 588) (FRCO) was enacted on 13 July 2006. Four Notices³ were made by the Secretary for Financial Services and the Treasury (SFST) under section 1(2) of FRCO to implement the Ordinance in phases. FRC became fully operational on 16 July 2007.

Functions of FRC

4. The key functions of FRC are to:

- (a) conduct independent investigations into possible auditing and reporting irregularities related to listed entities;
- (b) enquire into possible non-compliances with financial reporting requirements on the part of listed entities; and
- (c) require listed entities to remove any non-compliance identified.

5. FRC may initiate investigations or enquiries upon receipt of complaints or on its own initiative. Two subsidiary organs, the Audit Investigation Board (AIB)⁴ and the Financial Reporting Review Panel (FRRP)⁵ have been set up to assist the Council of FRC (FRC Council) in discharging its two principal functions, i.e. to investigate audit irregularities related to listed entities, and to enquire into possible non-compliances of listed entities' financial reports respectively.⁶

³ They are the Financial Reporting Council Ordinance (Commencement) Notice 2006 (L.N. 204 of 2006), the Financial Reporting Council Ordinance (Commencement) Notice 2007 (L.N. 27 of 2007), the Financial Reporting Council Ordinance (Commencement) (No.2) Notice 2007 (L.N. 104 of 2007) and the Financial Reporting Council Ordinance (Commencement) (No.3) Notice 2007 (L.N.188 of 2007).

⁴ Section 22(2) of the FRCO provides that AIB is to consist of the CEO (as an ex officio member and chairman of the AIB) and other members appointed by the FRC.

⁵ Section 39 of the FRCO provides that the Chief Executive shall, in consultation with FRC appoint a FRRP of at least 20 suitable persons (including at least 3 Panel Convenors).

⁶ Section 9 of the FRCO.

6. To avoid overlap of work with other regulatory bodies, FRC has reached agreements with HKICPA and other regulators including SFC, The Stock Exchange of Hong Kong Limited (SEHK), Hong Kong Monetary Authority and the Insurance Authority on the protocols for referring cases/complaints to FRC for investigation and enquiry. Any auditing or reporting irregularities identified by FRC will be referred to HKICPA for follow up action while any non-compliances relevant to the Listing Rules will be referred to the SFC or SHEK for necessary action. Any cases involving criminal offences will be referred to Hong Kong Police Force and the Independent Commission Against Corruption (ICAC). The FRC is not empowered to discipline or prosecute listed entities.

Structure of FRC

7. Nine members have been appointed to FRC which is responsible for governing and overseeing the affairs of FRC.⁷ To uphold FRC's status as an independent investigator for the accountancy profession, section 7(2) and (4) of the FRCO require that the Chairman⁸ and a majority of FRC members must be lay persons, i.e. non-accountants. Four committees, namely, the Operations Committee, the Corporate Communications Committee, the Tender Committee and the Remuneration Committee are established to underpin the FRC to formulate policies and oversee the activities of FRC. In addition, an Advisory Panel is set up to provide advice to FRC and AIB on investigation of cases.

8. Following a worldwide open recruitment exercise conducted by a selection panel, a Chief Executive Officer (CEO) has been appointed in February 2007 to head the FRC Secretariat. For the first financial year commencing on 1 December 2006 and ending on 31 December 2007⁹, the FRC Secretariat headcount is 11, including the CEO and a number of investigation staff experienced in financial reporting and listing requirements. According to FRCO, FRC may appoint consultants or legal advisers where circumstances so warranted.

Funding arrangements for FRC

9. FRC is funded by four parties, namely, the Companies Registry Trading Fund, SFC, HKEx and HKICPA. The four parties have signed a Memorandum of Understanding under which they have agreed to provide FRC a total of \$10 million (\$2.5 million from each party) per annum for its recurrent expenses for the first three years of operation, and a further \$20 million (\$5 million from each party) to establish a Reserve Fund. Contributions from the fourth year onwards will be reviewed and adjusted in the light of actual requirements.

⁷ According to section 7 of the FRCO, FRC Council is to consist of nine to eleven members including two ex-officio members (viz the Registrar of Companies or his representatives and the CEO of FRC).

⁸ The incumbent chairman is Ms Sophia KAO, JP.

⁹ According to the Administration, SFST has approved FRC'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.

10. Under section 17 of the FRCO, FRC is required to submit its estimates of income and expenditure to SFST for approval. For the first financial year of FRC, the approved estimated expenditure of FRC was about \$9.3 million, of which 60% was earmarked for salaries and staff expenses. Pursuant to section 19 of the FRCO, the accounts of FRC are to be audited by the Director of Audit. Section 20(2) of the FRCO provides that the annual report, annual accounts and auditor's report of FRC are to be laid by SFST before LegCo after the end of each financial year of FRC.

Major views and concerns expressed by Members

11. At the FA Panel meeting on 5 July 2007, members were briefed by the Administration and FRC on the preparatory work in the lead-up to the commencement of operation of FRC. Members' major views and concerns are summarized in the following paragraphs.

Investigatory functions of FRC

12. Some Panel members called on FRC to conduct investigation in a vigorous, fair, open and accountable manner to build up its credibility as an independent investigator for the accountancy profession. As a number of regulatory bodies might be involved in the investigation of irregularities, they cautioned that some cases might slip through the functional gaps between various bodies and escape investigation by FRC. Noting members' concerns, FRC advised that it would endeavour to handle cases impartially, consistently, and in a reasonable and accountable manner, having regard to procedural fairness and in accordance with the FRCO. FRC also assured members that due diligence would be exercised to avoid complaints or allegations being overlooked or missed.

13. As the statutory function of FRC was confined to investigation and reporting the findings of its investigation, some members expressed concern about follow-up action, if required, on irregularities or non-compliance. In this connection, they noted that irregularities and breaches identified by FRC would be referred to the relevant regulator or enforcement agency for further action. For instances, cases involving criminal offences would be referred to ICAC and the Police; auditing and reporting irregularities involving auditors or accountants who were members of HKICPA or other professional bodies would be referred to the respective professional body; and irregularities under the Listing Rules would be referred to SEHK and/or SFC. In the event of non-compliance with financial reporting requirements, FRC could require the listed entity concerned to remove the non-compliance identified. If the listed entity failed to do so, FRC might apply to the Court for an order to remove the non-compliance. Failure to rectify non-compliances might be referred to SEHK and/or SFC for follow-up.

Cross-border investigation on listed entities

14. Concern was raised about the difficulties in conducting investigation on locally listed companies incorporated in the Mainland and conducting most of their business activities in the Mainland. In this regard, members stressed the importance of putting in place an effective mechanism for cross-border investigation.

15. FRC noted members' concern and advised that for listed companies still in operation, FRC could carry out investigation and enquiries by requiring them to provide records, documents and information as they were bound by the Listing Rules of Hong Kong. Where such companies had ceased operation or were involved in criminal offences, they would be investigated by the Police. FRC also informed members that time was required to establish the necessary working relations, protocols and cooperation framework with the Mainland counterparts. To this end, contacts would be made with the Ministry of Finance, the regulatory authority of the accountancy profession and other relevant agencies in the Mainland.

Policy on disclosure of information

16. The Panel noted that once an investigation or enquiry was initiated, FRC would be bound by the secrecy provision under the FRCO to maintain confidentiality and no information concerning the investigation or enquiry could be disclosed. Nevertheless, where circumstances so warranted, disclosure of information would be considered on a case-by-case basis in accordance with the FRCO. In this connection, some members called on FRC to formulate and publish its policies and guidelines on disclosure of information, setting out the circumstances under which it would disclose information on individual cases so as to inspire public confidence in the credibility and impartiality of FRC. Considering that there was a lack of transparency in the enforcement and regulatory action taken by some other regulators, some members urged FRC to increase transparency as far as practicable.

17. In this regard, FRC advised that internal guidelines on disclosure policy had been developed and would be fine-tuned in the light of operational experience. Moreover, FRC would regularly publish statistical information such as the number of complaints received and the number of investigations or enquiries initiated. Upon conclusion of an investigation or enquiry, FRC would decide whether to make public the report or any part of it, having regard to public interest, and the implications, if any, on the parties concerned and the criminal or civil proceedings instituted by other regulatory bodies.

Appointment of membership to subsidiary committees

18. When the Panel was last briefed on the work of FRC, members noted that appointments to AIB and FRRP would be announced in July 2007. To boost public confidence in FRC's impartiality and credibility, there was a view that only

competent individuals of the right caliber with no vested interests should be appointed to AIB and FRRP. On concerns about the fundamental principle underlying the appointment of members to the FRC boards and committees, the Administration confirmed that the appointment was consistent with the "six-board rule", while the "six-year rule" would not arise until 2012, when incumbent members have served their six-year term of office.

Funding for FRC

19. Noting FRC's approved estimated expenditure of \$9.6 million for the 2007 financial year, concern was raised about the adequacy or otherwise of the approved financial provision for FRC to discharge its functions effectively, given the complexity of cases which would require in-depth investigation and the need for expertise in the auditing and reporting standards of different jurisdictions.

20. According to FRC, the annual provision of \$10 million for the first three financial years plus a reserve fund of \$20 million should be sufficient for the initial period of operation. Nevertheless, FRC assured members that it would not refrain from undertaking investigation work due to resource constraint and where necessary, would seek additional resources to ensure the proper discharge of its functions. Members noted that a more realistic estimate on the number of complaints and the need or otherwise to commission consultants would shed light on FRC's future resources requirement. In this connection, FRC was requested to conduct a review of the financial and human resources requirements in the light of operational experience.

Latest position

21. FRC will update the Panel on its work, including a review of its financial and human resources requirements, as well as its procedures and guidelines on complaint handling and information disclosure at the meeting to be held on 8 April 2008.

References

22. A list of relevant papers is in **Appendix**.

Appendix

List of relevant papers

Committee	Paper	LC Paper No.
Council Meetings on 12 and 13 July 2006	<ul style="list-style-type: none"> ✧ Report of the Bills Committee on Financial Reporting Council Bill http://www.legco.gov.hk/yr04-05/english/bc/bc13/reports/bc13cb1-1944-e.pdf ✧ Hansard of Council Meeting on 12 July 2006 http://www.legco.gov.hk/yr05-06/english/counmtg/hansard/cm0712-translate-e.pdf (Page 276 to 317) Hansard of Council Meeting on 13 July 2006 http://www.legco.gov.hk/yr05-06/english/counmtg/hansard/cm0713-translate-e.pdf (Page 5 to 105) 	CB(1)1944/05-06
Meeting of Panel on Financial Affairs (FA Panel) on 5 July 2007	<ul style="list-style-type: none"> ✧ Administration's paper on "Establishment of the Financial Reporting Council" http://www.legco.gov.hk/yr06-07/english/panels/fa/papers/fa0705cb1-2008-1-e.pdf ✧ Powerpoint presentation material on "Progress of the work of the Financial Reporting Council" (Chinese version only) http://www.legco.gov.hk/yr06-07/chinese/panels/fa/papers/fa0705cb1-2066-1-c.pdf ✧ Minutes of the FA Panel meeting on 5 July 2007 http://www.legco.gov.hk/yr06-07/english/panels/fa/minutes/fa070705.pdf 	CB(1)2008/06-07(01) CB(1)2066/06-07(01) CB(1)2364/06-07