

# 立法會 *Legislative Council*

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## **Panel on Financial Affairs Meeting on 6 April 2009**

### **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' views and concerns expressed 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 States<sup>1</sup>, 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)<sup>2</sup> 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

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<sup>1</sup> 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.

<sup>2</sup> 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 Notices<sup>3</sup> 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)<sup>4</sup> and the Financial Reporting Review Panel (FRRP)<sup>5</sup> 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.<sup>6</sup>

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<sup>3</sup> 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).

<sup>4</sup> Section 22(2) of the FRCO provides that AIB is to consist of the Chief Executive Officer (as an ex officio member and chairman of the AIB) and other members appointed by the FRC.

<sup>5</sup> 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).

<sup>6</sup> 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). FRC is not empowered to discipline or prosecute listed entities.

#### Structure of FRC

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 Chief Executive Officer of FRC). To uphold FRC's status as an independent investigator for the accountancy profession, section 7(2) and (4) of the FRCO require that the Chairman<sup>7</sup> 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 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.

#### Funding arrangements for FRC

8. 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. As for the funding model beyond 2009, FRC will liaise with the Government and the four funding parties having regard to the actual operational experience.

9. Under section 17 of the FRCO, FRC is required to submit its estimates of income and expenditure to SFST for approval. 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.

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<sup>7</sup> The incumbent chairman is Ms Sophia KAO, JP.

## **Views and concerns expressed by Members**

10. At the FA Panel meetings on 5 July 2007 and 8 April 2008, members were briefed by the Administration and FRC on the preparatory work for the commencement of operation of FRC and the work progress of FRC since its full operation in July 2007. Members' views and concerns on the work of FRC are summarized in the following paragraphs.

### Investigation and enquiry work of FRC

11. 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. They urged FRC to consider taking a more proactive approach in handling investigations or enquiries, i.e. carrying out investigations or enquiries on its own initiative instead of acting on complaints only. 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.

12. Members also raised concern 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.

### Corporate governance of FRC

13. The Panel noted that a Process Review Panel (PRP) would be established in the latter half of 2008 (and to begin work in 2009) to review the operating procedures of FRC to ensure that they were fair and reasonable, and to determine whether FRC had followed its internal procedures in handling cases. In this connection, some members urged the Administration/FRC to consider strengthening the role of PRP by making reference to the work of the Operations Review Committee of ICAC.

14. Some members expressed concern about the disclosure of information by FRC on concluded cases and 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. In this connection, some members urged that without prejudice to the rights and privacy of the parties concerned and having regard to public interest, FRC should consider making public the report or any part thereof upon conclusion of an investigation or enquiry. This would enhance transparency and increase the awareness of the accountancy profession of the auditing and financial reporting requirements.

15. Noting that the staff of the FRC Secretariat were only required to report their investment in listed securities once a year, some Panel members called on FRC to

review the existing mechanism for declaration of interests by staff of the FRC Secretariat with a view to strengthening safeguards against any real, potential or perceived conflict of interests in their investigation or enquiry work.

#### Appointment of members to FRC

16. 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 the Council of FRC, its committees, boards and panels. The Administration was requested to review the criteria for appointment of members to FRC, having regard to their caliber and preparedness to actively participate in the work of FRC. The Administration should also observe strictly the "six-board rule" and the "six-year rule" in making appointments.

#### Funding for FRC

17. Noting FRC's modest budget of \$10 million for 2008, members were concerned about the adequacy of the financial provision for FRC to discharge its functions effectively. Some members were of the view that to meet public expectations on FRC's role in maintaining the integrity of auditing and financial reporting, it was essential that FRC must not be under resource constraints in the performance of its functions.

#### **Latest position**

18. FRC is following up the issues of concern raised by Panel members at the last briefing on 8 April 2008. These issues include: the appointment of members to FRC, information disclosure on completed cases, safeguard for procedures in handling complaints and mechanism for declaration of interest by FRC staff. FRC will update the Panel on its work at the meeting to be held on 6 April 2009.

#### **References**

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

## Appendix

### List of relevant papers

Committee	Paper	LC Paper No.
<p>Council Meetings on 12 and 13 July 2006</p>	<p>✧ Report of the Bills Committee on Financial Reporting Council Bill</p> <p><a href="http://www.legco.gov.hk/yr04-05/english/bc/bc13/reports/bc13cb1-1944-e.pdf">http://www.legco.gov.hk/yr04-05/english/bc/bc13/reports/bc13cb1-1944-e.pdf</a></p> <p>✧ Hansard of Council Meeting on 12 July 2006</p> <p><a href="http://www.legco.gov.hk/yr05-06/english/counmtg/hansard/cm0712-translate-e.pdf">http://www.legco.gov.hk/yr05-06/english/counmtg/hansard/cm0712-translate-e.pdf</a> (Page 276 to 317)</p> <p>Hansard of Council Meeting on 13 July 2006</p> <p><a href="http://www.legco.gov.hk/yr05-06/english/counmtg/hansard/cm0713-translate-e.pdf">http://www.legco.gov.hk/yr05-06/english/counmtg/hansard/cm0713-translate-e.pdf</a> (Page 5 to 105)</p>	<p>CB(1)1944/05-06</p>
<p>Meeting of Panel on Financial Affairs (FA Panel) on 5 July 2007</p>	<p>✧ Administration's paper on "Establishment of the Financial Reporting Council"</p> <p><a href="http://www.legco.gov.hk/yr06-07/english/panels/fa/papers/fa0705cb1-2008-1-e.pdf">http://www.legco.gov.hk/yr06-07/english/panels/fa/papers/fa0705cb1-2008-1-e.pdf</a></p> <p>✧ Powerpoint presentation material on "Progress of the work of the Financial Reporting Council" (Chinese version only)</p> <p><a href="http://www.legco.gov.hk/yr06-07/chinese/panels/fa/papers/fa0705cb1-2066-1-c.pdf">http://www.legco.gov.hk/yr06-07/chinese/panels/fa/papers/fa0705cb1-2066-1-c.pdf</a></p> <p>✧ Minutes of the FA Panel meeting on 5 July 2007</p> <p><a href="http://www.legco.gov.hk/yr06-07/english/panels/fa/minutes/fa070705.pdf">http://www.legco.gov.hk/yr06-07/english/panels/fa/minutes/fa070705.pdf</a></p>	<p>CB(1)2008/06-07(01)</p> <p>CB(1)2066/06-07(01)</p> <p>CB(1)2364/06-07</p>

Committee	Paper	LC Paper No.
Meeting of FA Panel on 8 April 2008	✧ FRC's paper "progress Report on the Work of the Financial Reporting Council"  <a href="http://www.legco.gov.hk/yr07-08/english/panels/fa/papers/fa0408cb1-1163-3-e.pdf">http://www.legco.gov.hk/yr07-08/english/panels/fa/papers/fa0408cb1-1163-3-e.pdf</a>	CB(1)1163/07-08(03)
	✧ Updated background brief on the Work of the Financial Reporting Council  <a href="http://www.legco.gov.hk/yr07-08/english/panels/fa/papers/fa0408cb1-1164-e.pdf">http://www.legco.gov.hk/yr07-08/english/panels/fa/papers/fa0408cb1-1164-e.pdf</a>	CB(1)1164/07-08
	✧ Minutes of meeting  <a href="http://www.legco.gov.hk/yr07-08/english/panels/fa/minutes/fa080408.pdf">http://www.legco.gov.hk/yr07-08/english/panels/fa/minutes/fa080408.pdf</a>	CB(1)1381/07-08