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Panel on Financial Affairs
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Background Brief on the Work of the Financial Reporting Council

Purpose

This paper provides background information on the establishment of the Financial Reporting Council ("FRC") and its key functions and funding arrangements. The paper also provides a summary of the views and concerns expressed by members during discussions at the Panel on Financial Affairs ("FA Panel") on the work of FRC.

Background

Establishment of Financial Reporting Council

2. In the wake of the Asian financial crisis in late 1990s and various corporate scandals in the United States¹ in the early 2000s, 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") to examine ways to enhance the regulatory regime for the accountancy profession. HKICPA then put up 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

¹ Scandals involving large corporations such as Enron and Worldcom revealed in the early 2000s 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.

investigatory council to take charge of investigation of complaints that involved public interest and lodged against auditors. The Government conducted a public consultation on the proposals in September 2003. According to the Administration, there was overwhelming support from the respondents for the establishment of an independent investigatory council. The FA Panel was briefed on the proposals and the outcome of the public consultation on 13 June 2003 and 2 April 2004 respectively.

3. In early 2005, after consultation with HKICPA, the Stock Exchange of Hong Kong Limited ("SEHK") and the Securities and Futures Commission ("SFC"), the Government 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. Subsequently, the Government conducted a second round of public consultation. The FA Panel was briefed on the detailed proposals and the outcome of the public consultation on 7 March 2005 and 6 May 2005 respectively. At these meetings, a great majority of Panel members indicated support in principle for the proposal to establish FRC.

4. On 29 June 2005, the Administration introduced the FRC Bill into the Legislative Council ("LegCo"). Following scrutiny by a Bills Committee, the FRC Ordinance (Cap. 588) ("FRCO") was passed by LegCo and enacted on 13 July 2006. Four Notices² were made by the Secretary for Financial Services and the Treasury under section 1(2) of FRCO to implement the Ordinance in phases. FRC became fully operational on 16 July 2007.

Functions of Financial Reporting Council

5. 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.

6. FRC may initiate investigations or enquiries upon receipt of complaints or on its own initiative. Two subsidiary organs, the Audit

² 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).

Investigation Board³ and the Financial Reporting Review Panel ("FRRP")⁴ have been set up to assist FRC in discharging its key functions. When FRC decides to initiate an investigation into auditing or reporting irregularities, it may direct the Audit Investigation Board to conduct the investigation. An Advisory Panel consisting of three highly experienced certified public accountants has been set up to provide advice to FRC and the Audit Investigation Board on investigation cases. When FRC decides to conduct an enquiry into a non-compliance with financial reporting requirement on the part of a listed entity, it may appoint a Financial Reporting Review Committee consisting of a Panel Convenor as the Chairman and at least four other members of the FRRP to conduct the enquiry.

7. To avoid overlapping the work of other regulatory bodies, FRC has signed Memoranda of Understanding ("MoU") with HKICPA and other regulators including SFC, 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 non-compliances relevant to the Listing Rules will be referred to SFC or SHEK for necessary action. Cases involving criminal offences will be referred to the Police or the Independent Commission Against Corruption (ICAC) for necessary actions. FRC is not empowered to discipline or prosecute listed entities.

Organization structure of Financial Reporting Council

8. According to section 7 of the FRCO, the Council of FRC is to consist of nine to 11 members including two ex-officio members (viz. the Registrar of Companies or his representative 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 and a majority of FRC members must be lay persons, i.e. non-accountants. Four committees, namely, the Operations Oversight Committee, the Corporate Communications Committee, the Tender Committee and the Remuneration Committee have been established to advise FRC on relevant areas of its work. A Process Review Panel was established on 1 November 2008 to review cases handled by FRC and consider whether the actions taken by FRC are fair and consistent with its internal procedures.⁵ An organization chart of FRC is given in the **Appendix**.

³ 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.

⁴ 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).

⁵ The Process Review Panel comprises five members appointed by the Chief Executive including the FRC

Funding arrangements for Financial Reporting Council

9. FRC is funded by four parties, namely, the Companies Registry Trading Fund, SFC, Hong Kong Exchanges and Clearing Limited and HKICPA. The four parties contributed an annual amount of \$10 million (\$2.5 million from each party) as recurrent funding for the first three years (i.e. 2007 to 2009) of operation and a further \$20 million (\$5 million from each party) to establish a Reserve Fund for meeting any unexpected inadequacies of the recurrent funding and other exigencies of circumstances. The combined annual contribution from the four funding parties has increased to HK\$16 million in 2010, with a 5% upward adjustment annually from 2011 to 2014.

10. In accordance with the FRCO, FRC is required to submit its estimates of income and expenditure to the Secretary for Financial Services and the Treasury for approval. The accounts of FRC are to be audited by the Director of Audit. The FRCO also provides that the annual report, annual accounts and auditor's report of FRC are to be laid before LegCo after the end of each financial year.

Deliberations of the Panel on Financial Affairs

11. The Administration and FRC briefed the FA Panel on 8 April 2008, 6 April 2009, 8 April 2010, and 4 April 2011 on the work of FRC. The major concerns and views expressed by Panel members and the discussions are summarized in the following paragraphs.

Investigation and enquiry work of FRC

Follow-up to completed enquiries/investigations

12. At the meeting on 6 April 2009, members expressed concern about the disclosure of investment risks and the timely issuance of profit warnings by listed entities as some listed entities might have sustained hefty losses from their investment in derivatives amid the global financial tsunami. In this connection, members sought information on the cooperation arrangements between FRC and other regulatory bodies.

13. FRC advised that there should be sufficient disclosure of investment risks if the accounting requirements had been fully complied with. The auditors of listed entities were responsible for ensuring compliance with the requirements in the preparation of the auditor's reports. The MOU signed between FRC and other regulatory bodies set out in clear terms the agreed mode of cooperation and protocols for referring cases/complaints to FRC for investigation and enquiry. In its day-to-day work, FRC maintained close liaison with other regulatory bodies, such as liaison with SFC for information sharing on cases of profit warnings related to investments in derivatives.

14. At the meeting on 8 April 2010, members sought information on the follow-up actions taken by the relevant regulators after FRC had referred the investigation/enquiry reports to them. A member enquired how FRC would handle complaints regarding fraud/deception.

15. FRC advised that upon completion of an investigation/enquiry, FRC would issue the report to the concerned parties and the relevant regulator, place it on FRC's website for general information and issue a press release. In enquiry cases, the listed entities concerned would be required to rectify their financial statements if non-compliance was identified. For investigation cases, the report would be forwarded to the relevant regulator(s) for follow-up action. The first case of investigation completed was referred to HKICPA, which in turn issued a disapproval letter to both the auditor and the engagement director concerned with regard to the need to exercise due care and to act with proper regard to their legal and professional obligations. If complaints regarding fraud/deception were received, the cases would be referred to the law enforcement agencies, e.g. the Independent Commission Against Corruption and the Commercial Crime Bureau of the Hong Kong Police Force, for investigation.

Taking a more proactive approach

16. The Panel noted that since July 2008, FRC had adopted a proactive approach by making reference to modified auditors' reports on financial statements of all listed entities to identify potential non-compliance with accounting requirements and following up by reviewing the relevant financial statements. Besides, FRC would monitor news and discussions relating to listed entities in the public domain to see if there were any possible auditing irregularities or non-compliance with accounting requirements which warranted FRC's follow-up.

17. At the meeting on 6 April 2009, some members enquired whether FRC would consider conducting random review of auditor's reports which did not contain modifications. FRC responded that as there were about 1 300 listed

entities each issuing two financial statements annually, FRC did not have the resources to review the auditor's reports which did not contain modifications. Another member suggested that FRC conduct random checking of accounting firms to facilitate timely detection of auditing irregularities. FRC advised that it was not empowered to conduct random checking on accounting firms, which was the responsibility of HKICPA. However, HKICPA would refer cases of auditing irregularities and/or non-compliance of accounting requirements to FRC for investigation or enquiry.

Risk-based review programme

18. The Panel noted that FRC had widened its scope of review by implementing a new risk-based financial statement review programme since January 2011. As a result, in addition to reviewing issues identified in modified auditors' reports, FRC also performed comprehensive reviews of entire sets of financial statements selected from various categories. For the 2011 operational year, FRC expected to review the financial statements of approximately 5% of the listed companies, i.e. about 70 companies.

19. At the meeting on 4 April 2011, some members expressed concern that the reported profit of some listed companies was at great variance with the profit forecast made by the companies before listing, and opined that the risk-based review programme should cover review of financial statements of such listed companies, with a view to enhancing the protection for the investing public. FRC heeded the members' suggestion. FRC also undertook to consider a member's suggestion of making public the criteria for selection of financial statements for review under the risk-based review programme.

20. A member enquired whether FRC would initiate an investigation if a listed company frequently changed its asset assessor which resulted in significant changes to the value of its assets. FRC responded that under the risk-based review programme, FRC would review cases where the change in valuation of the assets of a listed company was not in line with the change in valuation on similar assets of other listed companies. The FRC's review would include a review of the assumptions for the valuations.

Cross-border cooperation

21. At the meetings on 6 April 2009 and 8 April 2010, some members expressed concern about the difficulties FRC might face in conducting investigations involving listed entities incorporated or with business operations in the Mainland. FRC advised that it had been handling many such complaint cases. FRC maintained close liaison with the Ministry of

Finance in the Mainland, and had signed a Memorandum of Understanding (“MOU”) with the MoF in 2009 to establish an investigation cooperation framework. Under the framework, the FRC could investigate, through the Ministry of Finance, potential auditing irregularities in relation to Mainland auditors of Hong Kong listed companies.

22. At the meeting on 4 April 2011, a member enquired whether FRC had access to the original accounting and audit documents in the Mainland during the investigation of complaints relating to listed Mainland companies using approved Mainland audit firms. Another member expressed concern that the accounting and auditing standards used in Hong Kong and the Mainland might not be consistent, and opined that given that there would be more Mainland companies listed in Hong Kong, the arrangement to solely rely on the Ministry of Finance to investigate complaints relating to listed Mainland companies using Mainland auditors should be reviewed.

23. FRC responded that the MOU signed with the Ministry of Finance was in line with international practice, where the relevant regulator of the economy in which the company was incorporated would be responsible for investigation of complaints against the company and make a report to the regulator of the place where the company was listed. Based on the MOU, the Ministry of Finance would work as the agent of FRC in the Mainland to investigate the cases. The Ministry of Finance and FRC would closely liaise with each other regarding the detailed requirements and arrangements for investigation of the cases. The FRC would request an investigation report from the Ministry of Finance, and FRC would publish the full or part of the report as appropriate. The Ministry of Finance had shortlisted 12 approved Mainland audit firms to undertake the auditing work for Mainland companies listed in Hong Kong, and had indicated that it would continue to closely monitor the work of these audit firms. FRC would also try to arrange a meeting with the representatives of the 12 audit firms to brief them on the regulatory concerns and expectations of FRC. Under the risk-based review programme, reviews on the financial statements of the Mainland companies listed in Hong Kong using Mainland audit firms would be conducted.

24. Another member suggested that FRC make reference to the reciprocal investigatory arrangements of ICAC for its investigation work in the Mainland. Under the arrangements, ICAC might send officers to the Mainland to interview witnesses and check documents, in the presence of the relevant Mainland authority. FRC responded that it would study ICAC's investigation arrangements in the Mainland for reference, but pointed out that the MOU with the Ministry of Finance was signed on a reciprocal basis; if FRC was allowed to investigate complaints in the Mainland, the implications

of allowing Mainland authorities to investigate complaints against Hong Kong companies listed in Mainland stock markets had to be considered.

25. At the meeting on 6 April 2009, a member expressed the view that it was of paramount importance that a mechanism could be put in place for cooperation between FRC and relevant authorities overseas, in order that there would be effective regulation of overseas accounting firms providing services to listed entities in Hong Kong. At the meeting on 4 April 2011, the member enquired whether FRC had signed MOUs with the overseas regulators concerned, similar to the arrangement with the Mainland Ministry of Finance.

26. FRC advised that given that the number of overseas companies listed in Hong Kong had increased to 15 companies as of April 2011, FRC would closely monitor the situation. So far FRC had not received any complaint relating to overseas companies listed in Hong Kong. If such a complaint was received, FRC would follow the same investigation procedures for all listed companies, and where appropriate, would seek assistance from the overseas regulator concerned. Where necessary, FRC would also seek assistance from the Stock Exchange of Hong Kong if problems were encountered in the investigation of the overseas auditors.

Transparency of work

27. At the meeting on 8 April 2008, some members expressed concern about the disclosure of information by FRC on concluded cases, and suggested that without prejudice to the rights and privacy of the parties concerned and having regard to public interest, FRC should consider making public the reports or part thereof upon conclusion of an investigation or enquiry. At the meeting on 6 April 2009, FRC informed members that it had decided to publish on its website a summary of completed complaints since July 2008. The summary would contain information on the allegations in the complaints and findings of the Council. FRC would also continue to publish statistics of its operation on a monthly basis.

28. At the meeting on 8 April 2010, a member expressed concern about the transparency of FRC meetings and investigation process. FRC advised that in view of the sensitivity of the information involved and as stipulated in the FRCO, the meetings and investigation process of FRC would not be made public.

Corporate governance

29. At the meeting on 8 April 2008, some Panel members called on FRC to review the arrangement where staff members of FRC were only required to report their investment in listed securities once a year, with a view to strengthening safeguards against any real, potential or perceived conflict of interests in their investigation or enquiry work. FRC informed members at the meeting on 6 April 2009 that staff members of FRC were now required to report transactions in securities listed in Hong Kong within 14 days of the day of transaction. In addition, staff members were required to report their securities holdings upon reporting duty and at the end of each calendar year thereafter.

30. At the meeting on 8 April 2010, a member expressed concern about FRC's measures to prevent conflict of interests as the majority of FRC staff were accountants, and had worked in accounting firms. FRC advised that members of FRC were required to declare interests and would not be involved in discussion of any cases in which he had an interest. Similarly, a mechanism was in place to require FRC staff to make declaration of interests, and staff members who had previously worked in the accounting firm under investigation or enquiry would not be allowed to handle the relevant case.

Resource provision for FRC

31. At the meetings on 6 April 2009, 8 April 2010, and 4 April 2011, members expressed concern whether FRC had sufficient capacity to effectively perform its statutory functions, and to take proactive actions to follow-up possible non-compliance cases. A member asked whether the Administration was prepared to provide additional funds to FRC if the Council needed extra resources to perform its statutory functions.

32. FRC advised that the Council deployed its staff in such a way that both its investigation work and other functions could be carried out as scheduled. In 2010, two full-time positions were added. As of April 2011, all the 15 full-time positions in the Secretariat had been filled. For any short-term increase in workload, FRC would adopt flexible short-term measures, such as the hiring of staff on short-term contracts. If necessary, FRC would consider outsourcing its work, in which case FRC would be mindful of the need to safeguard information confidentiality.

33. As regards funding for FRC, the Administration advised at the meeting on 8 April 2010 that the annual funding for FRC had been increased from \$10 million in 2009 to \$16 million for 2010, with a 5% upward adjustment annually from 2011 to 2014. The provisions should be sufficient to enable

FRC to perform its statutory functions. Where necessary, FRC could seek additional funds to meet extraordinary expenses from the contingency fund which had a balance of some \$20 million.

Appointment of members to FRC

34. Some Panel members expressed the view at the meeting on 8 April 2008 that to boost public confidence in FRC's impartiality and credibility, only competent individuals of the right caliber with no vested interests should be appointed to the Council of FRC, its committees, boards and panels. Besides, the appointed persons should be prepared 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 the appointments.

Public awareness of the work of FRC

35. Panel members noted that the numbers of complaints received by FRC in 2007, 2008, 2009 and 2010 were 17, 12, 13 and 9 respectively. Some members raised concern that the community might not be aware of the role and functions of FRC, and considered that publicity on the work of FRC should be stepped up.

36. FRC advised that the small number of complaints received by FRC reflected, to a certain extent, the high standard of financial reporting of Hong Kong listed companies and the high standard of services provided by Hong Kong's audit firms. Since people who did not possess professional knowledge in accounting would unlikely be able to identify non-compliance with accounting requirements and lodge complaints to FRC, most of the complaint cases came from persons associated with the companies concerned. Some of the other cases were referrals from other regulators. To enhance public awareness of FRC, FRC had launched a publicity programme which included advertisements to publicize the work of FRC during popular financial programmes on radio.

Recent development

37. FRC will brief the FA Panel on its work in the past year on 2 April 2011.

References

38. The relevant papers are available at the following hyperlink -

Meeting of the Panel on Financial Affairs on 5 July 2007	Financial Reporting Council's paper Minutes (paragraphs 5-22)
Meeting of the Panel on Financial Affairs on 8 April 2008	Financial Reporting Council's paper Minutes (paragraphs 6-21)
Meeting of the Panel on Financial Affairs on 6 April 2009	Financial Reporting Council's paper Powerpoint presentation materials at the meeting (Chinese version only) Minutes (paragraphs 21-42)
Meeting of the Panel on Financial Affairs on 8 April 2010	Financial Reporting Council's paper Powerpoint presentation materials at the meeting (Chinese version only) 2009 Annual Report of the Process Review Panel for the Financial Reporting Council Minutes (paragraphs 7-25)
Meeting of the Panel on Financial Affairs on 4 April 2011	Financial Reporting Council's paper Powerpoint presentation materials at the meeting (Chinese version only) 2010 Annual Report of the Process Review Panel for the Financial Reporting Council Minutes (paragraphs 60-76)

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