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Panel on Financial Affairs
Meeting on 3 May 2013

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 major views and concerns expressed by Members on the work of FRC since 2008.

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. The specific proposals put forward by HKICPA included 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 that

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.

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 Panel on Financial Affairs ("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 on 13 July 2006. The Ordinance was commenced in phases through four notices² made by the Secretary for Financial Services and the Treasury under section 1(2) of the FRCO in 2006 and 2007. 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.

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).

6. FRC may initiate investigations or enquiries upon receipt of complaints or on its own initiative. Two subsidiary organs, the Audit Investigation Board ("AIB")³ 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 AIB 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 AIB 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 SEHK 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 and funding arrangements for the 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

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).

and consistent with its internal procedures.⁵ An organization chart of FRC is given in the **Appendix I**.

9. FRC is funded by four parties, namely, the Companies Registry Trading Fund, SFC, Hong Kong Exchanges and Clearing Limited ("HKEx") 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 for approval by the Secretary for Financial Services and the Treasury on an annual basis. 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. Since its establishment in late 2006, the Administration and FRC has conducted briefing for the FA Panel on the work of FRC on an annual basis on 5 July 2007, 8 April 2008, 6 April 2009, 8 April 2010, 4 April 2011 and 2 April 2012. The major concerns and views expressed by Panel members at these meetings are summarized in the following paragraphs.

Investigation and enquiry work of FRC

Follow-up to completed enquiries/investigations

12. The Panel noted that the function of the FRC, in relation to auditing and reporting irregularities, was confined to investigation and reporting the findings of its investigations. The FRC is not empowered to carry out disciplinary action or prosecution. The FRC may refer its investigation reports to HKICPA for follow-up action. If the irregularities related to the Listing Rules, the reports may be referred to SEHK or SFC for follow-up

⁵ The Process Review Panel comprises five members appointed by the Chief Executive including the FRC Chairman as an ex-officio member. Since 2010, the Process Review Panel published its Annual Report in February or March each year. The fourth Annual Report of the Process Review Panel was published in March 2013.

action. The reports may also be referred to other regulatory bodies and law enforcement agencies for necessary follow-up action as appropriate.

13. In response to members' views raised at the meeting on 2 April 2012, FRC undertook to consider providing information on complaints relating to fraud and false accounting in the annual report of FRC, paying attention to the accounting firms in analyzing complaints so that enforcement work could be targeted at the firms, and carefully review the financial reports of the listed companies with incident(s) of resignation of independent non-executive director(s).

Taking a more proactive approach

14. 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.

15. 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 should 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.

16. At the meeting on 2 April 2012, FRC pointed out that it had reviewed all modified auditor's reports of listed companies, and had screened 434 modified auditors' reports since the proactive review approach was adopted in July 2008. Out of the 131 modified auditor's reports reviewed in 2011, only 71 reports revealed potential non-compliance with accounting requirements, including auditors not being able to obtain sufficient information to substantiate the results of the operations of subsidiaries.

Risk-based review programme

17. 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 auditor's reports, FRC also performed comprehensive reviews of entire sets of financial statements selected from various categories.

18. 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 took note of the members' views. It 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.

19. At the meeting on 4 April 2011, 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.

20. As regards how FRC would select the themes for its risk-based financial statements review programme, FRC advised that it selected the themes for the review programme each year after consultation with other relevant regulatory bodies, which reflected the concerns of market participants over the listed companies in the relevant period. It should be noted that out of the 70 financial statements reviewed in 2011 under the review programme, only 20 financial statements were selected based on the accounting and industry themes.

21. In response to a member's view that the financial statements review programme should cover overseas corporations listed in Hong Kong, FRC responded that the risk-based financial statements review programme already covered the 24 overseas corporations listed in Hong Kong, and so far irregularities had not been found in the relevant financial statements. The number of reviews under the risk-based financial statements review programme would be increased from 70 to 75 in 2012 as a result of the increase in the number of listed companies in Hong Kong. On whether FRC would review the Initial Public Offer documents of listed companies, FRC

remarked that the review of the financial statements of newly listed companies was an integral part of the review programme, and FRC would continue to keep a close watch on the relevant financial statements. FRC would also take into consideration the member's suggestion regarding "fair value" in drawing up the accounting theme in the future risk-based financial statements review programme.

Cross-border cooperation

22. The Panel noted that FRC had been handling many complaint cases involving listed entities incorporated or with business operations in the Mainland and that FRC maintained close liaison with the Ministry of Finance in the Mainland, and had signed a MoU with the Ministry of Finance ("MoF") in 2009 to establish an investigation cooperation framework. Under the framework, FRC could investigate, through MoF, potential auditing irregularities in relation to Mainland auditors of Hong Kong listed companies.

23. 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 MoF to investigate complaints relating to listed Mainland companies using Mainland auditors should be reviewed.

24. FRC responded that the MoU signed with MoF 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, MoF would work as the agent of FRC in the Mainland to investigate the cases. MoF and FRC would closely liaise with each other regarding the detailed requirements and arrangements for investigation of the cases. FRC would request an investigation report from MoF, and FRC would publish the full or part of the report as appropriate. 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.

25. At the meeting on 2 April 2012, members enquired about the steps FRC had taken to enhance the checking of the financial statements of Mainland companies listed in Hong Kong given that irregularities had been reported by

the media or found in the audit reports of certain Hong Kong-listed Mainland private enterprises, and the increasing number of Mainland companies listed in Hong Kong in the past years.

26. FRC remarked that in view of the relevant media reports on the irregularities of some of the Hong Kong-listed Mainland private enterprises, it had maintained a list of these companies for the purpose of continuous monitoring. FRC had discussed with other relevant regulatory bodies on the issues concerned and the appropriate actions required. FRC would review the financial reports of these companies to check against possible auditing or reporting irregularities, and/or possible non-compliance with accounting requirements once they had issued their financial reports. FRC further pointed out that FRC, HKICPA and HKEx had shared the review of all four Hong Kong-listed Mainland companies which opted to appoint Mainland auditors and prepare their 2010 financial statements in accordance with "China Accounting Standards for Business Enterprises". Based on the findings in the reviews, FRC had discussed with MoF regarding the areas of concern, and MoF would in turn discuss the relevant issues with the companies concerned. FRC pointed out that the number of such cases increased to 27 for the 2011 financial year and that such practice would be continued.

27. There was also a suggestion that FRC should 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 MoF 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.

Transparency of work

28. Members stressed the importance for FRC to step up transparency in its work and the disclosure of information. 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. FRC also advised at the meeting on 8 April 2010 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.

Appointment of members to FRC

29. 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.

Corporate governance

30. 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.

31. 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

32. 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, and asked whether the Administration was prepared to provide additional funds to FRC if the Council needed extra resources to perform its statutory functions.

33. 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. 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.

34. 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.

Question raised at the Council meeting

35. At the Council meeting on 27 February 2013, Hon Kenneth LEUNG raised a written question regarding the regulation of accounting firms. Mr LEUNG conveyed the concern from some practising accountants that their audit work performed on listed and unlisted entities were under supervision by both FRC and HKICPA, and such dual regulatory regime had sharply escalated the time and administrative costs of many accounting firms. He enquired about the Administration's measures to rationalize the dual regulatory regime in order to alleviate the burden on accounting firms. The Administration responded that under the existing statutory regulatory regime, FRC would conduct investigation on auditing and reporting irregularities in relation to listed entities while HKICPA would conduct investigation on auditing and reporting irregularities in relation to non-listed entities. There was no duplication between the statutory roles of FRC and HKICPA with regard to the regulation of accounting professionals. FRC would also maintain regular dialogues with HKICPA to ensure that there would not be any overlap of efforts in reviewing financial reports of listed entities under their respective financial report review programmes.

Recent development

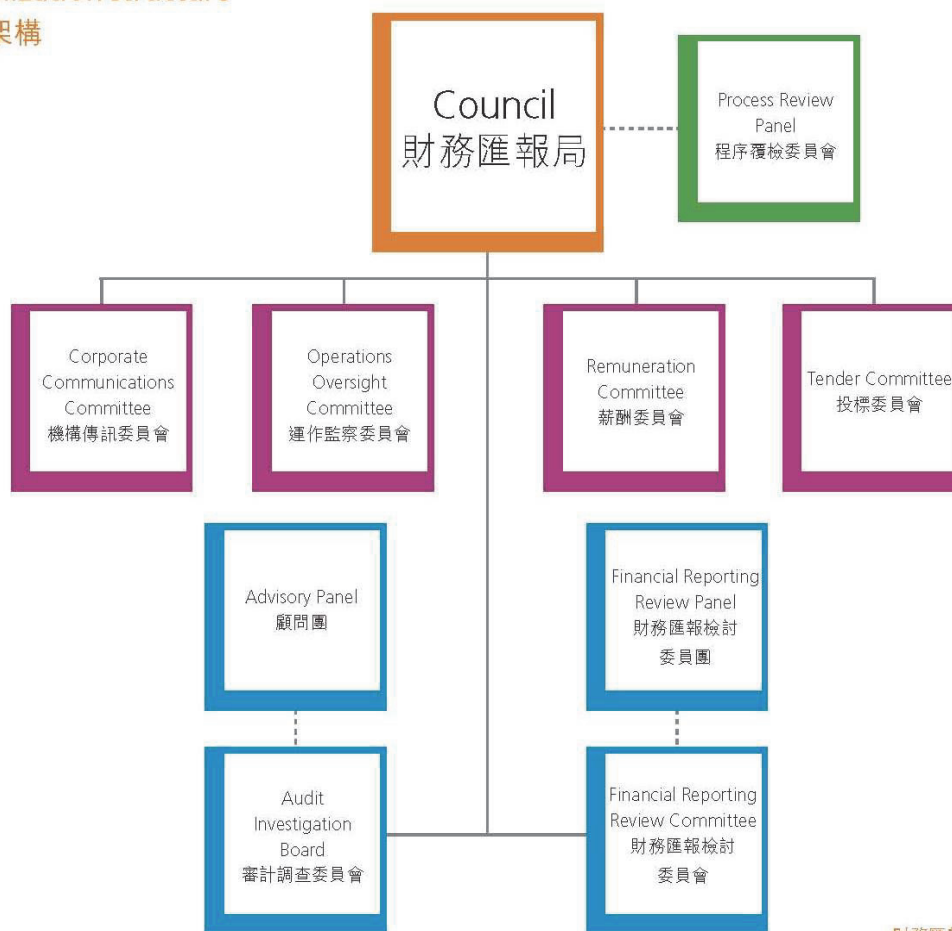
36. FRC will brief the FA Panel on its work in the past year on 3 May 2013.

References

37. A list of relevant papers is at **Appendix II.**

Council Business Division 1
Legislative Council Secretariat
30 April 2013

Organization structure
組織架構



Appendix II

List of relevant papers

Date	Event	Papers/Minutes of meeting
5 July 2007	The Panel on Financial Affairs ("FA Panel") discussed the establishment of the Financial Reporting Council ("FRC")	Financial Reporting Council's paper Minutes
8 April 2008	FA Panel discussed the work of FRC since July 2007	Financial Reporting Council's paper Minutes
6 April 2009	FA Panel discussed the work of FRC since April 2008	Financial Reporting Council's paper Powerpoint presentation materials at the meeting (Chinese version only) Minutes
8 April 2010	FA Panel discussed the work of FRC since April 2009	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
4 April 2011	FA Panel discussed the work of FRC since April 2010	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
2 April 2012	FA Panel discussed the work of FRC since April 2011	Financial Reporting Council's paper Powerpoint presentation materials at the meeting (Chinese version only)

Date	Event	Papers/Minutes of meeting
		<u>2011 Annual Report of the Process Review Panel for the Financial Reporting Council</u> <u>Minutes</u>
27 February 2013	Hon Kenneth LEUNG raised a written question regarding regulation of accounting firms	<u>Hansard</u>