

**立法會**  
***Legislative Council***

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**Panel on Financial Affairs**  
**Meeting on 5 May 2014**

**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 in recent years.

**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 States<sup>1</sup> 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

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<sup>1</sup> 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.

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 Financial Affairs ("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 notices<sup>2</sup> 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.

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<sup>2</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).

6. FRC may initiate investigations or enquiries upon receipt of complaints or on its own initiative. Two subsidiary organs, the Audit Investigation Board ("AIB")<sup>3</sup> and the Financial Reporting Review Panel ("FRRP")<sup>4</sup> 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.

#### 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. The Council of FRC has established five committees, namely, Operations Oversight Committee, Corporate Communications Committee, Finance Committee, Remuneration Committee, and Independent Audit Oversight Reform Committee to advise on relevant areas of its work. A Process Review Panel was established on 1 November 2008 to review cases handled

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<sup>3</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>4</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).

by FRC and consider whether the actions taken by FRC are fair and consistent with its internal procedures.<sup>5</sup> 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\$17.6 million in 2012, with a 5% annual upward adjustment according to an agreed arrangement among FRC and the four funding parties.

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 FRC's work on an annual basis on 5 July 2007, 8 April 2008, 6 April 2009, 8 April 2010, 4 April 2011, 2 April 2012 and 3 May 2013. 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 FA Panel noted that the function of FRC, in relation to auditing and reporting irregularities, was confined to investigation and reporting the findings of its investigations. FRC is not empowered to carry out disciplinary action or prosecution and has to refer its investigation reports to HKICPA for follow-up action. If the irregularities related to the Listing

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<sup>5</sup> The Process Review Panel comprises six 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 2013 Annual Report of the Process Review Panel was published in April 2014.

Rules, the reports may be referred to SEHK or SFC for follow-up 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).

#### *Review of modified auditors' reports*

14. The FA 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. According to FRC, as of 31 March 2013, it had screened 599 modified auditors' reports since July 2008. Out of the 138 reports reviewed in 2012, 75 related to emphasis of matter with no apparent auditing irregularities and/or non-compliance with accounting requirements.

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 it did not possess the necessary resources to implement such task. There was a suggestion 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.

#### *Risk-based review programme*

16. The FA 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.

17. At the meeting on 4 April 2011, FRC took note of members' views that the risk-based review programme should cover review of financial statements of listed companies of which the reported profit was at great variance with the profit forecast made by the companies before listing. 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.

18. In response to members' enquiries as 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.

19. 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.

*Procedural fairness of investigation*

20. At the meeting on 3 May 2013, some members expressed concern about how FRC would decide whether the financial statements or modified auditors' report under its review had any auditing/reporting irregularities or non-compliance given that accounting issues such as computation of asset depreciation were a matter of judgment based on information provided by the listed entities.

21. FRC responded that in respect of each pursuable complaint, the Secretariat of FRC would review information provided by complainants together with other available information, such as information collected from the listed entity and auditor concerned. FRC Secretariat would then prepare a complaint assessment report and make recommendations to the Council of FRC whether there was established prima facie evidence to initiate an investigation or an enquiry; and if so, the Council of FRC would direct its AIB to conduct an investigation. To ensure sufficient checks and balances on the process, the complaint assessment report would also be reviewed by the Operations Oversight Committee before the Council of FRC made a decision on the case. Moreover, relevant procedures were in place so that an

auditor/reporting accountant under AIB's investigation would be given a chance to make representation to AIB. For investigation reports referred to HKICPA for considering disciplinary or other follow-up actions as appropriate, the auditors/reporting accountants concerned would also be provided with an opportunity to be heard before HKICPA.

#### Cross-border cooperation

22. The FA Panel noted that FRC had been handling many complaint cases involving listed entities incorporated or with business operations in the Mainland and maintained close liaison with the Ministry of Finance ("MoF") in the Mainland and signed a MoU with it 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, enquiries were raised as 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. There were also concern about inconsistencies between the accounting and auditing standards used in Hong Kong and the Mainland, and suggestion for reviewing the arrangement to solely rely on MoF to investigate complaints relating to listed Mainland companies using Mainland auditors.

24. FRC responded that the MoU signed with MoF was in line with international practice, where the relevant regulator of the jurisdiction in which the company was incorporated would be responsible for investigating complaints against the company and making 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 the increasing number of Mainland companies listed in Hong Kong in the past years and that irregularities had been reported by the media or found in the audit reports of certain Hong Kong-listed Mainland private enterprises.

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 authorities. 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.

#### Independent auditor oversight reform

28. The FA Panel noted at the meeting on 3 May 2013 that FRC was assisting the Government in preparing the auditor regulatory reform in Hong Kong, and the Independent Audit Oversight Reform Committee was formed in December 2012 to advise the Council of FRC on matters relating to the reform. Members enquired about the progress of the reform and urged FRC to gauge the views of the accounting industry on the relevant proposals as early as possible.

29. FRC responded that it had made good progress in the studies relating to the relevant international standards, mainly the standards set by the International Forum of Independent Audit Regulators and the European Commission, and overseas practices including those of the US, UK, Canada, Australia and Singapore, for developing proposals on reform of the auditor



oversight system in Hong Kong. FRC stressed that it had the requisite financial and manpower resources to take forward the reform and would discuss with the Government and HKICPA to formulate the proposals. FRC also took note of members' suggestion on consulting the accounting industry.

### Transparency of work

30. Panel 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 FRC. FRC would also continue to publish statistics of its operation on a monthly basis. FRC further 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.

31. At the meeting on 3 May 2013, some members suggested that FRC should publish on its website the modified auditor's reports issued by listed entities; and a summary of FRC's advice and recommendations given to listed entities and auditors concerned under the risk-based financial statements review programme. Moreover, the financial regulators/bodies including FRC should explore the feasibility of establishing a one-stop platform for disseminating information to investors. These members considered that such measures would facilitate investors and enhance their knowledge about the listed entities in question, as well as increase transparency of FRC's work. FRC took note of members' suggestions and advised that information of listed entities (including their modified auditor's reports, if any) was currently available on the website of HKEx.

### Appointment of members to FRC

32. At the meeting on 8 April 2008, some members expressed the view that in order 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

33. At the meeting on 8 April 2010, some members 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/she 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.

### Resources provision for FRC

34. 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 asked whether the Administration was prepared to provide additional funds to FRC in the event that extra resources were required by FRC in performing its statutory functions.

35. FRC advised that it had deployed 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. As regards funding for FRC, the Administration advised that the annual funding for FRC had been increased with a 5% annual upward adjustment from the four funding parties 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**

36. At the Council meeting of 27 February 2013, Hon Kenneth LEUNG raised a written question regarding the regulation of accounting firms. The question conveyed the concerns of some practising accountants about their audit work being subject to a dual regulatory regime involving FRC and HKICPA, and the increase in the administration cost as a result. Details of the LegCo question and the Administration's reply are given in the hyperlinks in **Appendix II**.

## **Recent development**

37. On 10 October 2013, FRC published a report on independent audit oversight. At the meeting of the Establishment Subcommittee on 19 February 2014, during discussion of the staffing proposal to retain two supernumerary posts in the Financial Services and the Treasury Bureau, some members enquired about the legislative timetable for introducing the auditor regulatory reform. The Administration advised that HKICPA had recently conducted an internal consultation with its members on the subject. The Administration would soon discuss with FRC and HKICPA on the results of HKICPA's consultation. It was the Administration's plan to put forward a package of reform proposals for public consultation within the second quarter of 2014. Subject to the outcome of the consultation, the Administration planned to introduce the relevant bill into LegCo in the 2014-15 legislative session.

38. FRC will brief the FA Panel on its work in the past year on 5 May 2014.

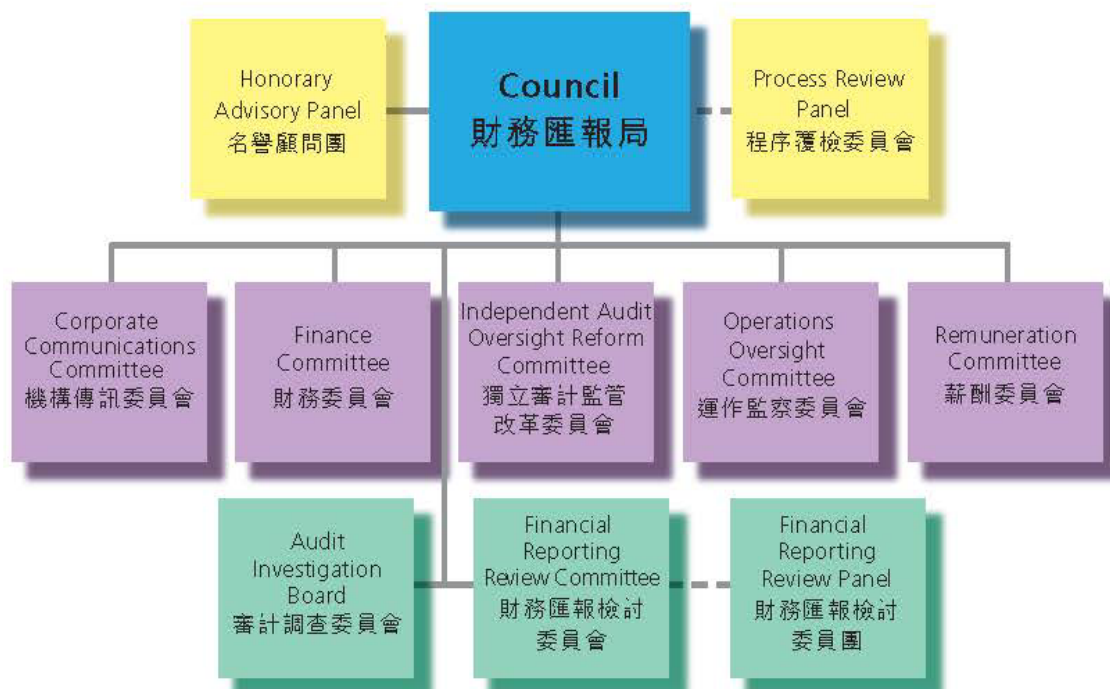
## **References**

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

Council Business Division 1  
Legislative Council Secretariat  
2 May 2014

Organization Structure

組織架構



(Source : Financial Reporting Council's Annual Report 2013)

## 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")	<a href="#">Financial Reporting Council's paper</a> (LC Paper No. CB(1)2008/06-07(01))  <a href="#">Minutes</a> (LC Paper No. CB(1)2364/06-07)
8 April 2008	FA Panel discussed the work of FRC since July 2007	<a href="#">Financial Reporting Council's paper</a> (LC Paper No. CB(1)1163/07-08(03))  <a href="#">Minutes</a> (LC Paper No. CB(1)1381/07-08)
6 April 2009	FA Panel discussed the work of FRC since April 2008	<a href="#">Financial Reporting Council's paper</a> <a href="#">Powerpoint presentation materials at the meeting</a> (Chinese version only) (LC Paper No. CB(1)1251/08-09(01))  <a href="#">FRC's paper</a> (LC Paper No. CB(1)1177/08-09(04))  <a href="#">Minutes</a> (LC Paper No. CB(1)1410/08-09)
8 April 2010	FA Panel discussed the work of FRC since April 2009	<a href="#">Financial Reporting Council's paper</a> <a href="#">Powerpoint presentation materials at the meeting</a> (Chinese version only) (LC Paper No. CB(1)1599/09-10(01))  <a href="#">FRC's paper</a> (LC Paper No. CB(1)1496/09-10(03))  <a href="#">Minutes</a> (LC Paper No. CB(1)1847/09-10)

Date	Event	Papers/Minutes of meeting
4 April 2011	FA Panel discussed the work of FRC since April 2010	<p><a href="#">Financial Reporting Council's paper Powerpoint presentation materials at the meeting</a> (Chinese version only) (LC Paper No. CB(1)1870/10-11(02))</p> <p><a href="#">FRC's paper</a> (LC Paper No. CB(1)1748/10-11(05))</p> <p><a href="#">Minutes</a> (LC Paper No. CB(1)2637/10-11)</p>
2 April 2012	FA Panel discussed the work of FRC since April 2011	<p><a href="#">Financial Reporting Council's paper Powerpoint presentation materials at the meeting</a> (Chinese version only) (LC Paper No. CB(1)1502/11-12(01))</p> <p><a href="#">FRC's paper</a> (LC Paper No. CB(1)1411/11-12(04))</p> <p><a href="#">Minutes</a> (LC Paper No. CB(1)2028/11-12)</p>
27 February 2013	Hon Kenneth LEUNG raised a written question regarding regulation of accounting firms	<a href="#">Hansard</a>
3 May 2013	FA Panel discussed the work of FRC since April 2012	<p><a href="#">Financial Reporting Council's paper Powerpoint presentation materials at the meeting</a> (LC Paper No. CB(1)976/12-13(02))</p> <p><a href="#">FRC's paper</a> (LC Paper No. CB(1)929/12-13(07))</p> <p><a href="#">Minutes</a> (LC Paper No. CB(1)1789/12-13)</p>

<b>Date</b>	<b>Event</b>	<b>Papers/Minutes of meeting</b>
10 October 2013	FRC published a report on independent audit oversight	<a href="#">Press release</a> <a href="#">Report by FRC</a>