

**立法會**  
*Legislative Council*

LC Paper No. CB(1)1494/09-10

Ref: CB1/PL/FA

**Panel on Financial Affairs**  
**Meeting on 8 April 2010**

**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), outlines FRC's key functions and funding arrangements, and summarizes the views and concerns expressed by members during the discussions at the Panel on Financial Affairs (the Panel) on the work of FRC.

**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> 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 investigatory council to take charge of investigation of complaints involving public interest lodged against auditors. The Government conducted a public consultation on the proposals in September 2003. According to the Administration, there was

---

<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.

overwhelming support from the respondents for the establishment of an independent investigatory council. The 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, after consultation with HKICPA, the Stock Exchange of Hong Kong Limited (SEHK) 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>2</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>3</sup> and the Financial Reporting Review Panel (FRRP)<sup>4</sup> have been set up to assist the Council of FRC in discharging its key functions. The AIB is tasked to investigate into complaints on audit irregularities. An Advisory Panel consisting of three highly experienced certified public accountants has been set up to provide advice to

---

<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).

<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).

the AIB on audit investigations. For each complaint on non-compliance in financial reporting, FRC would appoint a Financial Reporting Review Committee comprising five members drawn from the FRRP to conduct an enquiry.

6. To avoid overlap of work with 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 any non-compliances relevant to the Listing Rules will be referred to 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. FRC is not empowered to discipline or prosecute listed entities.

#### Structure of FRC

7. 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 Committee, the Corporate Communications Committee, the Tender Committee and the Remuneration Committee have been established to advise FRC on relevant areas of its work.

#### Funding arrangements for FRC

8. FRC is funded by four parties, namely, the Companies Registry Trading Fund, SFC, SEHK and HKICPA. The four parties 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 (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. As for the funding arrangements beyond 2009, FRC informed the Panel in April 2009 that the Government was discussing with the four funding parties on the arrangements having regard to the actual operational experience gained by FRC.

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.

## **Deliberations of the Panel on the work of FRC**

10. At the Panel meetings on 5 July 2007, 8 April 2008 and 6 April 2009, members were briefed by the Administration and FRC on the work of FRC since it came into full operation in July 2007. Members' views and concerns and the responses of FRC are summarized in the following paragraphs.

### Investigation and enquiry work of FRC

#### *Disclosure of investment risks and timely issue of profit warnings*

11. At the Panel 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.

12. 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. FRC had taken a proactive approach since July 2008 to review all the modified auditor's reports on financial statements of listed entities to identify potential non-compliance. 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.

#### *Review of auditor's reports*

13. Some members expressed the view that FRC's review of only those auditor's reports containing modifications would unduly hamper the effectiveness of its work. The members urged FRC to consider conducting random review of auditor's reports which did not contain modifications. FRC advised that as there were about 1 300 listed entities each issuing two financial statements annually, FRC did not have the resources to take up such a task.

#### *Cross-border cooperation*

14. Members were concerned 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 had entered into agreement with the Ministry of Finance

for assistance in FRC's investigation and enquiry work in relation to these listed entities.

15. A member considered it of paramount importance that a mechanism could be put in place for cooperation between FRC and relevant authorities overseas for effective regulation of overseas accounting firms providing services to listed entities in Hong Kong.

16. FRC advised that it would require the accounting firms concerned to respond to its questions in the investigation of auditing irregularities, and would take the case to the court if the firms concerned refuse to cooperate. For accounting firms which wanted to continue serving as auditors of Hong Kong listed entities, they would be obliged to respond to FRC's questions. In line with international practice, the relevant regulatory bodies for the accountancy profession would establish agreements for cooperation in their work, but such agreement between FRC and relevant regulatory bodies overseas could not be established. Establishment of a formal mechanism for cooperation with overseas regulatory bodies for the accountancy profession would require a change in the accounting sector regulatory framework in Hong Kong, which would be beyond the ambit of FRC to decide.

#### *Taking a more proactive approach*

17. Some Panel members called on FRC to take a more proactive approach by carrying out investigations or enquiries on its own initiative instead of acting on complaints only. FRC advised that apart from acting on complaints, FRC would follow up liquidation cases of listed entities, and examine whether there were auditing irregularities in the cases.

18. On a member's suggestion 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.

#### *Transparency of FRC's work*

19. At the Panel 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 Panel 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.

### Corporate governance of FRC

20. At the Panel 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.

21. At the Panel meeting on 6 April 2009, members noted that the Chief Executive has appointed an independent Process Review Panel in November 2008. The Process Review Panel is tasked to ensure that the operation of the FRC is reasonable and fair by reviewing a selection of cases of FRC to determine if FRC has followed its internal procedures in handling cases.

### Statutory power and resource provision for FRC

22. In view of the outbreak of the global financial crisis in 2008, members expressed concern at the Panel meeting on 6 April 2009 about the adequacy of the statutory power and financial provision for FRC to uphold the standard of financial reporting by listed entities for protection of investors' interests.

23. FRC advised that the key functions of FRC were to conduct enquiries in non-compliances with accounting requirements and conduct independent investigations into possible auditing and reporting irregularities related to listed entities. There had been no significant increase in the number of complaints, and the manpower resources of FRC could cope with the existing workload. Yet, FRC had devised plans such as outsourcing arrangements to cope with possible sudden surge in workload.

### Appointment of members to FRC

24. To boost public confidence in FRC's impartiality and credibility, some Panel members expressed the 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. 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

25. Panel members noted that the numbers of complaints received by FRC in 2007, 2008 and 2009 (up to early April) were 17, 12 and four respectively.

Members raised concern on whether there was a lack of awareness of the role and functions of FRC in the community, and opined that publicity on the work of FRC should be stepped up. FRC responded that it would consider measures to publicize its work and conducting surveys to gauge public understanding of its work.

### **Recent developments**

26. On 26 February 2010, the Process Review Panel for FRC published its first Annual Report<sup>5</sup>, and concluded that the actions taken by FRC were consistent with its internal procedures. The first review cycle covered the 18-month period from July 2007 to December 2008. The Panel had recommended FRC to strengthen its internal procedures with respect to informal inquiries.

27. In line with the established practice, FRC will brief the Panel on its work in the past year at the meeting on 8 April 2010.

### **References**

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

[http://www.legco.gov.hk/yr11-12/english/panels/fa/papers/fa\\_c2.htm](http://www.legco.gov.hk/yr11-12/english/panels/fa/papers/fa_c2.htm)

Council Business Division 1  
Legislative Council Secretariat  
31 March 2010

---

<sup>5</sup> LC Paper No. CB(1)1283/09-10(01) issued on 2 March 2010