

立法會 *Legislative Council*

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Panel on Financial Affairs

Meeting on 4 May 2020

Updated background brief on the work of the Financial Reporting Council

Purpose

This paper provides background information on the Financial Reporting Council ("FRC") including its establishment, key roles, organization structure, and funding arrangements. The paper also provides a summary of the major views and concerns expressed by members of the Panel on Financial Affairs ("FA Panel") on the work of FRC since the 2014-2015 session.

Background

Establishment of the Financial Reporting Council

2. In the wake of the Asian financial crisis in the late 1990s and various corporate scandals in the United States¹ in the early 2000s, there was considerable public demand for enhancing the regulation of the accountancy profession in Hong Kong. Following two rounds of public consultation conducted by the Administration in 2003 and 2005 on the proposals for establishing an independent investigatory council, i.e. FRC, to take charge of investigation of complaints concerning public interest lodged against auditors, the Legislative Council ("LegCo") enacted the Financial Reporting

¹ Scandals involving large corporations such as Enron and Worldcom revealed in the early 2000s have aroused global concern for regulation of the accountancy profession. In order to rebuild public confidence in the information disclosed in company financial reports, various international financial centres, such as the United States and the United Kingdom, had actively introduced reforms to strengthen regulation of the profession.

Council Ordinance (Cap. 588) ("FRCO") in July 2006. FRC was established in December 2006 and became fully operational in July 2007.

Roles and organization structure of the Financial Reporting Council

3. The initial roles of FRC at its inception were to (a) conduct independent investigations into possible auditing and reporting irregularities in relation to listed entities through the Audit Investigation Board; and (b) enquire into possible non-compliances with accounting requirements on the part of listed entities through a Financial Reporting Review Committee.² As FRC was not empowered to discipline when it was established, it had signed Memoranda of Understanding ("MoUs") with the Hong Kong Institute of Certified Public Accountants ("HKICPA") and other regulators including the Securities and Futures Commission ("SFC"), the Hong Kong Exchanges and Clearing Limited ("HKEX"), the Hong Kong Monetary Authority and the Insurance Authority on the protocols for referring cases/complaints to FRC for investigation or conduct of enquiry, as well as for referring auditing or reporting irregularities identified by FRC to the relevant parties for follow-up.³

4. Section 7 of FRCO stipulates that FRC is to consist of: (a) a chairperson, who is a non-executive director of FRC; (b) a chief executive officer, who is an executive director of FRC; and (c) at least seven other members, who are either executive or non-executive directors of FRC. The section also provides that:

² Section 22(2) of the Financial Reporting Council Ordinance (Cap. 588) ("FRCO") provides that the Audit Investigation Board ("AIB") is to consist of the Chief Executive Officer of the Financial Reporting Council ("FRC") (as an ex-officio member and chairman of AIB) and at least one other member appointed by FRC. Section 39 of FRCO provides that the Chief Executive shall, in consultation with FRC, appoint a Financial Reporting Review Panel ("FRRP") of at least 20 suitable persons (including at least three Panel Convenors). If FRC decides to conduct an enquiry into a non-compliance with financial reporting requirements 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 FRRP to conduct the enquiry.

³ By the Memoranda of Understanding signed, auditing or reporting irregularities identified by FRC will be referred to the Hong Kong Institute of Certified Public Accountants ("HKICPA"); non-compliances relevant to the Listing Rules will be referred to the Securities and Futures Commission ("SFC") or the Hong Kong Exchanges and Clearing Limited ("HKEX"), and cases involving criminal offences will be referred to the Police or the Independent Commission Against Corruption for necessary follow-up actions.

- (a) all members of FRC must be non-practitioners and the number of non-executive directors of FRC must exceed the number of executive directors; and
- (b) at least one-third of the members of FRC must be appointed from among persons who appear to the Chief Executive to be suitable for appointment, because of their knowledge and experience in public interest entity engagements.

5. FRC has established several committees to advise on various areas of its work. An independent Process Review Panel was established in November 2008 for reviewing the handling of cases by FRC to ensure its actions and decisions adhere to internal procedures and guidelines. An Honorary Advisory Panel was formed in December 2012 to advise FRC on its operations and any professional, technical and strategic issues it faces. An organization chart of FRC is given in the **Appendix I**.

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

Implementation of a new regulatory regime for auditors under the Financial Reporting Council (Amendment) Ordinance 2019

7. Against the international trend for auditor regulatory regimes to be independent of the audit profession and be subject to independent oversight by bodies acting in the public interest, Hong Kong's regulatory regime is considered as largely a self-regulatory regime. This has rendered Hong Kong ineligible for representation at the International Forum of Independent Audit Regulators ("IFIAR"), thus hindering cooperation between Hong Kong and other jurisdictions in the regulation of auditors.

8. The Administration introduced the Financial Reporting Council (Amendment) Bill 2018 ("the Bill") into LegCo in January 2018 aiming to reform FRC by establishing a new regulatory regime for public interest entity ("PIE") auditors ("the new regulatory regime"). The Bill was passed by LegCo at the meeting of 30 January 2019 and was enacted as the Financial Reporting Council (Amendment) Ordinance 2019 ("the Amendment

Ordinance").⁴ The Amendment Ordinance commenced operation on 1 October 2019.⁵

9. Following the commencement of the Amendment Ordinance, FRC becomes an independent oversight body for regulating PIE auditors responsible for the inspection, investigation and disciplinary functions of these auditors.⁶ FRC also oversees HKICPA's functions of (a) registration of PIE auditors; (b) establishing and maintaining the PIE auditors register; and (c) setting continuing professional development requirements, standards on professional ethics, as well as auditing and assurance practices for registered PIE auditors. The Amendment Ordinance also provides for the new composition of FRC,⁷ an appeal mechanism regarding decisions made against PIE auditors, and levies payable to FRC.

10. A new funding model is introduced under the new regulatory regime.⁸ FRC is funded by three new levies on (a) securities transactions (to be paid by sellers and purchasers in securities transactions); (b) PIEs; and (c) PIE auditors. Contributions from the three parties are in the ratio of 50:25:25. To facilitate FRC's transition to the new regulatory regime, the Chief Executive announced in the 2018 Policy Address that no less than \$300

⁴ The Legislative Council ("LegCo") has formed a Bills Committee to scrutinize the Financial Reporting Council (Amendment) Bill 2018. The report of the Bills Committee is provided by hyperlink in **Appendix II**.

⁵ The Financial Reporting Council (Amendment) Ordinance 2019 (Commencement) Notice was tabled before LegCo at the meeting of 22 May 2019. By the Notice, the Secretary for Financial Services and the Treasury ("SFST") has appointed 1 October 2019 as the day on which the Financial Reporting Council (Amendment) Ordinance 2019 ("the Amendment Ordinance"), except sections 62 and 85 (concerning payment and calculation of levies payable to FRC by specified parties), comes into operation. SFST has also appointed 1 January 2022 as the day on which sections 62 and 85 of the Amendment Ordinance come into operation.

⁶ FRC can initiate investigations to ensure that misconduct on the part of public interest entity ("PIE") auditors and registered responsible persons are detected which will be referred to the Department of Discipline to consider appropriate follow-up actions including imposition of sanctions or referral to other regulators or law enforcement agencies for conduct falling within their jurisdiction. Furthermore, FRC has the power to direct an inspector to carry out an inspection in relation to PIE engagements for ascertaining whether the PIE auditor has complied with, or is likely to be able to comply with, provisions of FRCO or a professional standard.

⁷ The new composition of FRC is set out in paragraph 4 of the background brief.

⁸ Before the commencement of the Amendment Ordinance, FRC was jointly funded by the Companies Registry Trading Fund, SFC, HKEX and HKICPA on an equal share basis.

million would be injected into a seed capital for FRC. In the 2019-2020 Budget, the Financial Secretary announced that the seed capital for FRC would be increased to \$400 million in order to help FRC migrate to the new regulatory regime, and exempt the levies for the first two years upon the implementation of the new regime.

Views and concerns expressed by members of the Panel on Financial Affairs

11. Since the establishment of FRC in 2006, the Administration and FRC have been conducting annual briefings for FA Panel on FRC's work. The major concerns and views expressed by Panel members during the discussions since the 2014-2015 session are summarized in the ensuing paragraphs.

Investigation and enquiry work of the Financial Reporting Council before implementation of the new regulatory regime for public interest entity auditors

Efficiency of handling complaints

12. At the meetings on 4 May 2015, 23 May 2016, 5 June 2017 and 15 May 2018, some members enquired about the reasons for the surge in the number of pursuable complaints received by FRC, and measures taken by FRC to expedite its investigations and enquiries.

13. FRC responded that the time required to complete an investigation or enquiry was influenced by a host of factors including the complexity of the case and the irregularities or non-compliances involved. As FRC had reached its full staff complement, it was confident that the present manpower would be sufficient for handling the outstanding investigations and enquiries. Should there be a dramatic increase in the number of pursuable complaints, FRC would consider the need of increasing its manpower resources.

14. At the meetings on 5 June 2017 and 15 May 2018, FRC explained that in 2016 and 2017 it had received a series of complaints, apparently from the same party, directed at one audit firm. Under FRC's new measures for dealing with vexatious complaints, such complaints would be handled in a simplified manner and hence would not affect the resources in handling other complaints. While none of the above mentioned complaints was found to have met the required investigation threshold subsequently, FRC had referred them to HKICPA for necessary follow-up. As FRC understood, HKICPA did not consider any investigation was warranted for the complaints

referred. FRC had also been informed by the audit firm concerned that it had already undertaken remedial actions.

Procedural fairness of investigations

15. At the meetings on 5 June 2017 and 6 May 2019, some members remarked that there was a perception among small-sized accounting firms that FRC's investigation was targeted at them as audits performed by the "Big Four" accounting firms were seldom the subject of investigation. Members also enquired about the trend of proportion of complaints against the accounting firms of various sizes received in recent years.

16. FRC stressed that it would not be biased when handling complaints against accounting firms, and would not avoid taking action against the "Big Four" accounting firms. FRC would respond to complaints and would not target any firm because of its size. The trend of proportion of pursuable complaints against accounting firms of various sizes between 2014 and 2018 remained steady. For instance, 31% of the pursuable complaints received in 2016 involved the "Big Four" accounting firms, 50% were against medium-sized accounting firms (i.e. firms with six or more partners/directors), and 19% were against small-sized accounting firms (i.e. firms with five or less partners/directors).

Transparency of work

17. At the meetings on 4 May 2015, 15 May 2018 and 6 May 2019, members enquired about the disclosure of complaints-related information by FRC, and the actions taken by FRC to monitor the progress of the complaints referred to other specified enforcement bodies. There was also a call for FRC to strengthen publicity on the various areas of its work.

18. FRC responded that after completion of each investigation, where appropriate, FRC would refer the investigation report to HKICPA, which would then determine if any disciplinary action was warranted. FRC would monitor the progress of complaints referred to HKICPA during its quarterly meetings with HKICPA. At the same time, FRC would issue a press release on a no-name basis summarizing the major issues covered in the investigation and its major findings. After HKICPA had completed its disciplinary proceedings, an executive summary of the report containing the names of the parties concerned would be uploaded on FRC's website. Among the cases referred to HKICPA since FRC's inception, some ended up with sanctions while others were still under HKICPA's disciplinary process. On the publicity of FRC's work, FRC advised that it would include issues identified in the investigations in its newsletter with the identities of the parties

concerned in anonymous form. Such information would serve as a form of public education for the accounting and auditing profession

Sanctions guidelines for imposing pecuniary penalty

19. At the meeting on 6 May 2019, members noted that FRC had conducted a consultation on the proposed sanctions guidelines ("the Guidelines") for FRC in imposing pecuniary penalty,⁹ and enquired about the views collected during the consultation and when the Guidelines would come into force.

20. FRC advised that it issued the draft Guidelines on 17 March 2019 to all the stakeholders including professional bodies and audit firms of listed companies, and had arranged from March to April 2019 a number of meetings and briefings for the stakeholders which had resulted in fruitful discussions on the draft Guidelines. On the whole, FRC had received positive comments from the stakeholders. FRC would hold a council meeting in mid-May 2019 to discuss the written views received during the consultation and the formulation of FRC's responses.¹⁰

Cross-border cooperation of the Financial Reporting Council

21. At the meetings on 4 May 2015 and 5 June 2017, members expressed concern about the difficulty encountered by some accounting firms in Hong Kong in bringing the audit working papers out of the Mainland for meeting FRC's requirements as disclosure of such documents might be prohibited by the Mainland laws and regulations for reason of "state secrets". They urged FRC to assist accounting firms to resolve the problem. Some members also noted at the meetings on 15 May 2018 and 6 May 2019 that as some of FRC's investigations could not be pursued until an MoU with the Ministry of Finance ("MoF") was concluded to allow FRC to access audit working papers in the Mainland, they enquired about the timetable for concluding the MoU and difficulties FRC had encountered in the process.

⁹ Under sections 37D(3)(b)(iv) and 37E(3)(b)(iii) of FRCO, FRC might order a person who was or had been an auditor of a public interest entity ("PIE auditor") or a registered responsible person of a registered PIE auditor and had committed a misconduct to pay a pecuniary penalty. The maximum pecuniary penalty was the greater of \$10 million, or three times the amount of the profit gained or loss avoided as a result of the misconduct.

¹⁰ The FRC Guidelines for Exercising the Power to Impose a Pecuniary Penalty, which are available on the web site of FRC at: <https://www.frc.org.hk/en-us/Documents/discipline/Gazette%20Notice%20EN.pdf>, have become effective on 1 October 2019.

22. FRC responded that due to tightening of the relevant regulations in 2015 by the Mainland authorities, neither FRC nor HKICPA could access audit working papers kept in the Mainland without the MoU. FRC would not require the firms to hand over the audit working papers concerned until the MoU with MoF was in place. Regarding documents involving state secrets, which mainly concerned the defence industry, the Hong Kong regulators including FRC were exploring possible means to address the issue by making reference to the practices in overseas jurisdictions, e.g. requiring an auditor to sign a statement declaring its conformity to the relevant official secrets law before it was exposed to state secrets, or asking the relevant authorities to confirm the general tenor of a document without disclosing the actual document to the auditor. FRC had been liaising with MoF on the MoU, which aimed to promote cross-boundary collaboration on audit regulation, and would facilitate FRC in gaining access to audit working papers located in the Mainland. With FRC taking up the new role as an independent oversight body for regulating auditors under the Amendment Ordinance, FRC and MoF planned to sign the MoU in May 2019.¹¹

International collaborations of the Financial Reporting Council

23. At the meeting on 6 May 2019, some members asked when Hong Kong would be eligible for membership of IFIAR, i.e. immediately after the passage of the Amendment Ordinance or when it took effect.

24. FRC advised that it was making preparations for applying for IFIAR's membership. Representatives of FRC had recently attended IFIAR's plenary meeting as an observer to better pave the way for Hong Kong in joining IFIAR, as well as to update IFIAR members on FRC's new regulatory regime under the Amendment Ordinance.

Relevant questions raised at Council meetings

25. At the LegCo meeting of 17 January 2018, Hon Kenneth LEUNG raised an oral question on Hong Kong accountancy firms' compliance with laws and regulations of different jurisdictions. The question covers whether the Administration has plans to require FRC when the latter becomes an independent oversight body of PIE auditors to establish a mechanism with the Mainland authorities to facilitate FRC in obtaining audit papers from Mainland enterprises, and setting out in the mechanism the procedure for handling audit papers involving state secrets and sensitive information.

¹¹ The Ministry of Finance and FRC signed a Memorandum of Understanding on cooperation in respect of audit regulation on 22 May 2019.

Details of the question and the Government's reply are given in the hyperlinks in **Appendix II**.

Latest development

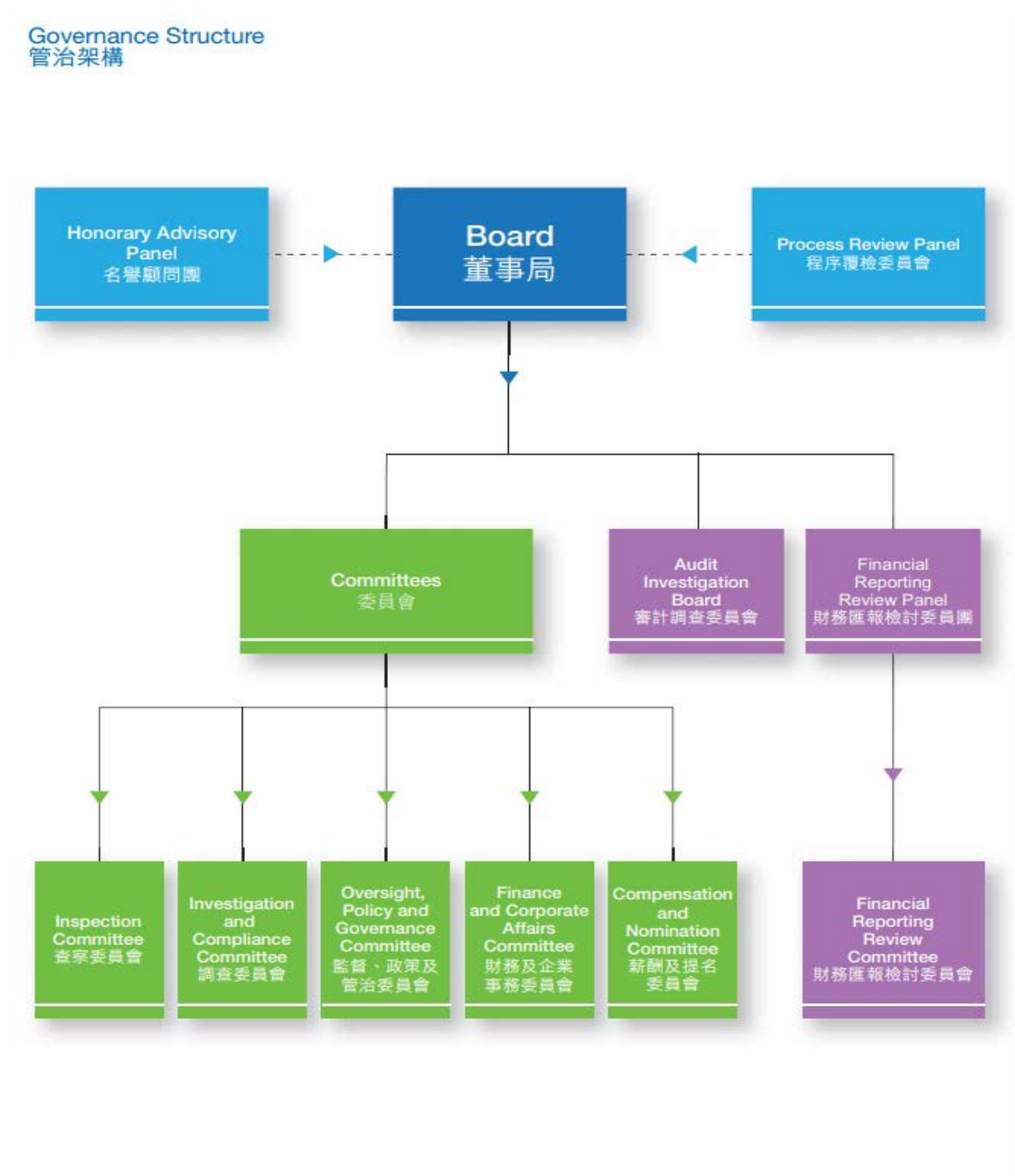
26. FRC will brief FA Panel on its work in the past year at the meeting on 4 May 2020.

References

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

Council Business Division 1
Legislative Council Secretariat
24 April 2020

Organization structure of the Financial Reporting Council



Source: Financial Reporting Council Annual Report 2019

List of relevant papers

Date	Event	Papers/Minutes of meeting
4 May 2015	The Panel on Financial Affairs ("FA Panel") discussed the work of the Financial Reporting Council ("FRC") since April 2014	<p><u>Powerpoint presentation materials at the meeting</u> (LC Paper No. CB(1)833/14-15(02))</p> <p><u>FRC's paper</u> (LC Paper No. CB(1)780/14-15(03))</p> <p><u>Minutes</u> (LC Paper No. CB(1)1070/14-15)</p>
6 July 2015	FA Panel discussed the consultation conclusions on the proposals to improve the regulatory regime for listed entity auditors	<p><u>Powerpoint presentation materials at the meeting</u> (LC Paper No. CB(1)1069/14-15(04))</p> <p><u>Administration's paper</u> (LC Paper No. CB(1)1034/14-15(08))</p> <p><u>Minutes</u> (LC Paper No. CB(1)1258/14-15)</p>
23 May 2016	FA Panel discussed the work of FRC since April 2015	<p><u>Powerpoint presentation materials at the meeting</u> (LC Paper No. CB(1)955/15-16(01))</p> <p><u>Administration's paper</u> (LC Paper No. CB(1)918/15-16(03))</p> <p><u>Minutes</u> (LC Paper No. CB(1)1142/15-16)</p>

Date	Event	Papers/Minutes of meeting
5 June 2017	FA Panel discussed the work of FRC since April 2016	<p>Powerpoint presentation materials at the meeting (LC Paper No. CB(1)1078/16-17(02))</p> <p>Administration's paper (LC Paper No. CB(1)1030/16-17(04))</p> <p>Minutes (LC Paper No. CB(1)1356/16-17)</p>
17 January 2018	Hon Kenneth LEUNG raised an oral question on "Compliance with laws and regulations of different jurisdictions by Hong Kong accounting firms"	<p>Hansard (pages 5147- 5156)</p>
13 February 2018	First meeting of the Bills Committee on Financial Reporting Council (Amendment) Bill 2018	<p>The Bill (LC Paper No. CB(3)287/17-18)</p> <p>Legislative Council Brief (File Ref: ACCT/2/1/2C)</p> <p>Legal Service Division Report (LC Paper No. LS25/17-18)</p>
15 May 2018	FA Panel discussed the work of FRC since April 2017	<p>Powerpoint presentation materials at the meeting (LC Paper No. CB(1)967/17-18(01))</p> <p>Administration's paper (LC Paper No. CB(1)926/17-18(03))</p> <p>Minutes (LC Paper No. CB(1)1305/17-18)</p>
30 January 2019	Council	<p>Report of the Bills Committee on Financial Reporting Council (Amendment) Bill 2018 (LC Paper No. CB(1)505/18-19)</p>

Date	Event	Papers/Minutes of meeting
6 May 2019	FA Panel discussed the work of FRC since April 2018	<u>Powerpoint presentation materials at the meeting</u> (LC Paper No. CB(1)1019/18-19(02)) <u>Administration's paper</u> (LC Paper No. CB(1)954/18-19(04)) <u>Minutes</u> (LC Paper No. CB(1)1315/18-19)
22 May 2019	The Financial Reporting Council (Amendment) Ordinance 2019 (Commencement) Notice was tabled before the Legislative Council	<u>The Notice</u> <u>Report of the Subcommittee</u> (LC Paper No. CB(1)1209/18-19)