

**For discussion
on 7 March 2005**

**LEGISLATIVE COUNCIL PANEL
ON FINANCIAL AFFAIRS**

**The Legislative Proposals to Establish
the Financial Reporting Council**

PURPOSE

The wake of some notable corporate failures in other parts of the world in the past few years has highlighted the importance to enhance the effectiveness, transparency and accountability of the regulatory regime for the accounting profession in Hong Kong. This paper briefs Members on the detailed proposals to establish the Financial Reporting Council, which is a key initiative in enhancing this objective.

BACKGROUND

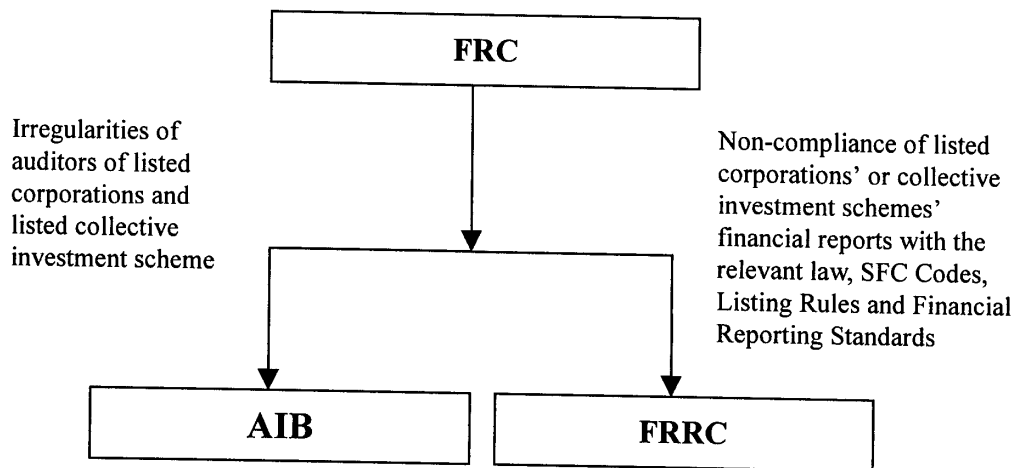
2. In December 2002, Secretary for Financial Services and the Treasury requested the Hong Kong Society of Accountants (now renamed as the Hong Kong Institute of Certified Public Accountants (HKICPA)) to put forward proposals¹ to strengthen the regulatory regime for the profession. One of the key proposals is to set up an independent investigation board to investigate irregularities of auditors of listed corporations. Moreover, the Administration, together with relevant parties, has also stated a financial reporting review panel should be established to check the compliance of financial reporting of listed corporations with relevant legal and accounting requirements.

3. As it is recognized that the quality of financial reporting of listed corporations may directly affect the investing public and is thus a matter of public interest, the Administration conducted a public consultation in late 2003. For this purpose, the consultation paper "Proposals to (a): Enhance the Oversight of the Public Interest Activities of Auditors; and (b) Establish a Financial Reporting Review Panel" was

¹ Parts of the proposals relating to the governance of the HKICPA have been effected through the Professional Accountants (Amendment) Ordinance 2004 which provide for the Chief Executive's appointment of lay persons to the governing Council and the Investigation and Disciplinary Panels of the HKICPA, with a view to enhancing the independence and transparency of the relevant bodies. The Amendment Ordinance 2004 was enacted by the Legislative Council in July 2004.

issued in September 2003. Most of the respondents generally supported the proposals.

4. Members were briefed on the aforesaid proposals respectively in June 2003 and April 2004, and generally agreed that these would be a step in the right direction and urged for early implementation. Building on the public support received, the Administration, in consultation with the Hong Kong Exchanges and Clearing Limited (HKEx), the HKICPA and the Securities and Futures Commission (SFC), proposes to establish a new statutory body to be named as the **Financial Reporting Council (FRC)**. The FRC would oversee both the independent investigation board (to be named as the **Audit Investigation Board (AIB)**) and the **Financial Reporting Review Committee(s) (FRRC)**. A diagrammatic illustration of the proposed institutional set-up is as follows -



5. The Administration intends to start consulting the relevant stakeholders and the public on the detailed proposals on 28 February 2005. A “**Consultation Paper on the Legislative Proposals to Establish the Financial Reporting Council**” is at the **Annex**. The proposals contained in the Consultation Paper and summarized in the following paragraphs aim to underpin a draft Bill being formulated by the Administration.

THE DETAILED PROPOSALS

Composition of the FRC

6. The Administration considers that the composition of the FRC should safeguard its independence in taking up a role to regulate the

profession. In this regard, we **propose** that the FRC would comprise not more than eleven members, namely -

- (a) One ex-officio member from the Administration, i.e. the Registrar of Companies or his representative;
- (b) One member nominated by the HKEx and appointed on an *ad personam* basis;
- (c) One member nominated by the HKICPA and appointed on an *ad personam* basis;
- (d) One member nominated by the SFC and appointed on an *ad personam* basis;
- (e) At least four and not more than six other appointed members; and
- (f) the Chief Executive Officer of the FRC.

Save for the ex-officio member, all members of the FRC would be appointed by the Chief Executive (CE), and a majority of whom must be lay persons (i.e. non-accountants). The non-executive Chairman of the FRC would be appointed by the CE from among the lay appointed persons, and supported by the Chief Executive Officer. Good corporate governance practices appropriate to the best standards of public bodies would be enshrined in the organizational set-up of the FRC under the Bill.

Accountability and Independence of the FRC

7. We have prescribed safeguards corresponding to the powers vested in the new regulatory watchdog, which would be expected by the public to function independently, fairly, properly, efficiently and with due propriety. In this regard, we **propose** to put in place accountability measures which include, among other things, the approval of the FRC's budget by Secretary for Financial Services and the Treasury; the audit of the FRC's accounts by the Director of Audit; and the laying of the annual report and accounts together with the auditor's report before the Legislative Council. In addition, actions of the FRC may be subject to judicial review by the court and complaints against actions and staff members of the FRC may be lodged with the Ombudsman. The Bill would also contain provisions in respect of the avoidance of conflict of interests to uphold the independence and credibility of the FRC.

Funding Arrangement for the FRC

8. The Companies Registry, HKEx, HKICPA and SFC have agreed to contribute to the funding of the FRC on an equal share basis. The sharing of the costs of the FRC among the four parties is considered appropriate, as the establishment of the FRC will further enhance the regulation of auditors and the quality of financial reporting of listed corporations, hence contributing to the improvement of the overall market quality. As to the amount of contributions, it is agreed that for the first three years, each party will contribute \$2.5 million *per annum*, plus a one-off contribution of up to \$2.5 million as Reserve. The amount of contributions from the fourth year onwards will be reviewed in the third year in the light of the actual experience. The agreement would be effected through a Memorandum of Understanding among the four parties.

Audit Investigation Board (AIB)

9. One of the key functions of the FRC is, through the AIB, to investigate suspected irregularities of auditors of listed corporations in relation to the audit of published accounts or financial statements of such corporations and the preparation of any auditors' reports for inclusion in prospectuses. Investigation of irregularities of auditors and accountants outside this scope would continue to be undertaken by the HKICPA under the Professional Accountants Ordinance (Cap. 50, PAO), as would decisions on discipline on the HKICPA members.

10. The AIB would need to be given sufficient investigatory powers to enable it to undertake its function effectively, namely investigation into suspected irregularities of auditors of listed corporations². In this connection, the proposed investigatory framework of the AIB is modelled on the SFC's powers of investigation under sections 179 and 183 of the SFO. In short, where it appears to the AIB that there are circumstances suggesting the occurrence of auditors' irregularities, the AIB may require the auditor of a listed corporation or other persons (e.g. the corporation itself and its officers and employees) to produce records or documents relating to the affairs of the corporation. The AIB would also be empowered to ask for an explanation of not only an entry in a record or an omission of an entry, but also the reasons for or circumstances under which the entry was made or omitted. These proposed powers would enable the AIB to conduct a relatively quick and discreet enquiry into the

² Apart from listed corporations, collective investment schemes (CIS) such as real estate investment trusts that are listed in Hong Kong may also be covered by the AIB. This means that AIB may also investigate into any irregularities of the auditor of a listed CIS in the course of his/her audit work.

suspected irregularities. Furthermore, when the AIB has reasonable cause to believe that an auditor of a listed corporation may have engaged in irregularities, it is proposed that the AIB should be empowered to conduct an investigation with powers similar to section 183 of the SFO. The proposed powers will enable the AIB to require the person under investigation to attend before the AIB, answer any relevant questions and give the AIB all reasonable assistance in connection with the investigation. The AIB may exercise the said proposed powers of investigation without necessarily having first considered an enquiry.

11. The AIB would also be given the power to require the person giving an explanation to verify the explanation by statutory declaration, or to seek assistance from the court in case of unreasonable refusal or failure to comply with its request. With a warrant granted by the Magistrate, officers of the AIB may also enter and search premises and seize relevant documents.

12. The proposed design set out in paragraphs 10 and 11 above represents an enhancement over the relatively limited powers vested in the Investigation Committees of the HKICPA under the PAO in respect of investigation into suspected irregularities of the Institute's members. The enhancement is considered justified, given the need to promote confidence in the integrity of the auditing profession and that AIB would only investigate cases where a listed corporation is involved; and would be subject to checks and balances to be prescribed in the Bill similar to the relevant provisions under the SFO.

Financial Reporting Review Panel (FRRP) and Financial Reporting Review Committees (FRRC)

13. The other key function of the FRC is, **through the FRRC**, to enquire into suspected non-compliance of the financial reports of listed corporations³ with relevant accounting requirements under the Companies Ordinance (Cap. 32), the relevant SFC Codes, Listing Rules, and Financial Reporting Standards, with a view to promoting confidence in the quality of financial reporting of listed corporations.

14. We **propose** that a FRRC would be constituted to enquire into a case of questionable financial reports by at least five members drawn from a Financial Reporting Review Panel (FRRP). The FRRP would comprise not less than 20 members who would be appointed by the CE in

³ FRRC may also enquire into the financial reports of a listed collective investment scheme. See footnote 2 above.

consultation with the FRC. They would be from a wide range of financial reporting, auditing, banking, financial services and commercial expertise. We consider that members of the FRRP, being experts on their own, should be in a position to conduct enquiries into a case on the basis of the information provided by the corporation.

15. To enable a FRRC to enquire effectively, we **propose**, with reference to the similar set-up in the United Kingdom, to empower it to require information from relevant persons; request for a voluntary rectification of accounts and financial statements; seek a court order to mandate such a rectification; and consult other professional and regulatory bodies in the course of the enquiries.

Referral and Publication of Investigation / Enquiry Reports

16. The majority views revealed in the consultation in September 2003 were that the function of the FRC should remain purely investigatory. In view of this, we **propose** that upon completion of the investigation/enquiry, the AIB or a FRRC should submit an investigation/enquiry report to the FRC for consideration. It would be for the FRC to make direction as to the necessary follow-up action, having regard to the evidence found during the investigation/enquiry. These follow-up actions would include referring a case or disclosing the relevant information obtained during the investigation/enquiry to an authority, regulatory organization or a professional accountancy body in Hong Kong or elsewhere for disciplinary action, further investigation or any other necessary actions. To illustrate, the FRC would be empowered to refer a case of auditors' irregularities to the HKICPA for disciplinary action under the PAO; or to other enforcement agencies, say, the Police or the Independent Commission Against Corruption, for criminal investigation.

PUBLIC CONSULTATION

17. The consultation paper at Annex will be circulated to stakeholders, such as the relevant professional bodies, chambers of commerce, financial service regulators, industry associations in the financial sector, the Standing Committee on Company Law Reform, as well as persons who had made submissions in response to our first consultation in late 2003. It will also be posted on the website of the Financial Services and the Treasury Bureau. Members of the public are invited to give us their comments on the subject. The consultation period will end on 15 April 2005.

WAY FORWARD

18. To maintain Hong Kong's position as a leading international financial centre and the premier capital formation centre for China, the Administration considers that the proposed establishment of the FRC would have a significant bearing on the upholding of our corporate governance regime and the maintenance of investor confidence. With this in mind, we will consider carefully the comments received during the consultation. Subject to the outcome of the consultation exercise, we aim to introduce a Bill into the Legislative Council within the 2004/05 legislative session to take forward this initiative.

19. Members are invited to give views on the proposals set out above and detailed in the Consultation Paper at the **Annex**.

Financial Services and the Treasury Bureau
28 February 2005