

# CONSULTATION PAPER ON LEGISLATIVE PROPOSALS TO ESTABLISH FINANCIAL REPORTING COUNCIL

Financial Services and the Treasury Bureau  
Government of the Hong Kong Special Administrative Region

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1. The Financial Services and the Treasury Bureau (FSTB) publishes this paper to consult the public on the legislative proposals to establish the Financial Reporting Council (FRC), which will oversee the Audit Investigation Board (AIB) and the Financial Reporting Review Committee(s) (FRRC). The AIB is aimed to further enhance the regulation of auditors of listed corporations, while the FRRC is intended to further enhance the quality of financial reporting of these corporations.
2. This consultation exercise is a follow-up of FSTB's "Consultation Paper on the Proposals to: (a) Enhance the Oversight of the Public Interest Activities of Auditors and (b) Establish a Financial Reporting Review Panel", which was published in September 2003.
3. Respondents are welcome to send their comments to us on or before **15 April 2005**, by one of the following means –

By mail to: Financial Services and the Treasury Bureau  
(Attn: Consultation Paper on Legislative Proposals to  
Establish Financial Reporting Council)  
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By email to: [consult-frc@fstb.gov.hk](mailto:consult-frc@fstb.gov.hk)

4. Please note that the names of respondents and their comments may be posted on the website of the FSTB or referred to in other documents we publish. If you do not wish your name to be disclosed, please state so when making your submission.

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## EXECUTIVE SUMMARY

1. The Administration conducted a public consultation on the “Proposals to: (a) Enhance the Oversight of the Public Interest Activities of Auditors; and (b) Establish a Financial Reporting Review Panel” in September 2003. Most of the respondents generally supported the proposals to enhance the regulatory regime for the accounting profession. We also briefed the Legislative Council Panel on Financial Affairs on the proposals in June 2003 and April 2004 respectively. Members of the Panel generally agreed that the proposals were a step in the right direction and urged their early implementation.
2. Building on the public support for the proposals, the Administration proposes to set up a new statutory body to be named the **Financial Reporting Council** to oversee an **Audit Investigation Board** and **Financial Reporting Review Committee(s)**. A Bill is now being formulated by the Administration for this purpose. This Consultation Paper consults the public on the detailed proposals underpinning the Bill before it is introduced into the Legislative Council.
3. The Administration considers that the composition of the Financial Reporting Council (FRC) would underline its independence in taking up a role to regulate the accounting profession. In this regard, we propose that the FRC would comprise not more than eleven members, including (a) an ex-officio member from the Administration; (b) one member nominated by the Hong Kong Exchanges and Clearing Limited (HKEx) and appointed on an *ad personam* basis; (c) one member nominated by the Hong Kong Institute of Certified Public Accountants (HKICPA) and appointed on an *ad personam* basis; (d) one member nominated by the Securities and Futures Commission (SFC) and appointed on an *ad personam* basis; (e) at least four and not more than six other members; and (f) the Chief Executive Officer of the FRC. Save for the ex-officio member, all members would be appointed by the Chief Executive (CE). A majority of the FRC members must be lay persons, i.e. non-accountants. The Chairman of the FRC would also be appointed by the CE from among the lay appointed members.
4. The Administration, HKEx, HKICPA and SFC agree to contribute to the funding of the FRC on an equal share basis. 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 annual contributions from the fourth year onwards will be reviewed in the third year in the light of

actual experience. The agreement will be effected through a Memorandum of Understanding among the four parties.

5. Accountability measures which correspond to the powers vested in the new regulatory watchdog will be proposed in the Bill. These measures include, among others, the approval of the FRC's budget by the 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.
6. One of the key functions of the FRC is, through the **Audit Investigation Board (AIB)**, to carry out investigations into suspected irregularities concerning auditors of corporations and collective investment schemes listed in Hong Kong, in view of the wider public interests of their activities. We propose to empower the FRC to request information from relevant persons and to investigate, with reference to the investigation powers presently afforded to the SFC under the Securities and Futures Ordinance (Cap. 571). This represents enhancement over the relatively limited powers vested in the Investigation Committees of the HKICPA under the Professional Accountants Ordinance (Cap. 50) in respect of investigations into irregularities of the Institute's members.
7. The other key function of the FRC is, through the **Financial Reporting Review Committee(s) (FRRC)**, to enquire into suspected non-compliance of the accounts and financial statements of corporations and collective investment schemes listed in Hong Kong with relevant legal and accounting requirements. A FRRC would be constituted to enquire into an individual case by at least five members drawn from a **Financial Reporting Review Panel (FRRP)** appointed by the CE. The FRRP will comprise members with a wide range of financial reporting, auditing, banking, financial services and commercial expertise. With reference to the similar set-up in the United Kingdom, we propose to empower a FRRC to require information from relevant persons, request the voluntary rectification of the 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.
8. The majority views revealed in the Consultation in September 2003 were that the function of the FRC should remain purely investigatory. Consequently, we propose that upon completion of any investigation and enquiry conducted by the AIB and FRRC, the FRC should decide whether to refer the case and evidence obtained to a relevant enforcement agency or a professional accountancy body for necessary legal and/or

disciplinary action.

9. The detailed proposals set out in this Consultation Paper represent the latest ideas worked out by the Administration, in consultation with the HKEx, HKICPA and SFC, on the arrangements to establish the FRC. We would like to invite public comments on the proposals, as we recognize that public expectations regarding the accounting profession are high, more so than ever in the light of some notable corporate failures in other parts of the world in the past few years or so. 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 establishment of the FRC would have a significant bearing on the upholding of our corporate governance regime and the maintenance of investor confidence.
10. We will consider the public comments received carefully before finalizing the proposals. Subject to the outcome of this consultation exercise, we aim to introduce the Bill into the Legislative Council within the 2004/05 legislative session to take forward this initiative.



## **CHAPTER 1            BACKGROUND OF THE PROPOSAL TO ESTABLISH THE FINANCIAL REPORTING COUNCIL (FRC)**

*Quality financial reporting underpins our corporate governance regime and investor confidence. We are committed to ensuring that Hong Kong's regulatory regime for the accounting profession is effective, transparent, and accountable. The proposal to establish the Financial Reporting Council is a key initiative in achieving this objective.*

- 1.1 Quality and reliable financial reporting is of paramount importance for upholding our corporate governance regime and maintaining investor confidence. In this regard, the accounting profession plays a number of key roles. Corporate accountants are expected to assist directors to prepare financial statements which are in accordance with the relevant legal requirements and accounting standards and give a true and fair view of the corporation's results and state of affairs. Auditors are expected to be an independent "watchdog" in providing assurance for the quality, accuracy and integrity of financial reporting.
- 1.2 To maintain Hong Kong's position as a leading international financial centre and the premier capital formation centre for China, the Administration is aware of the need to maintain and enhance an effective, transparent and accountable regulatory regime for the accounting profession that is on a par with international standards. In response to the request from the Secretary for Financial Services and the Treasury (SFST) in 2002, the Hong Kong Society of Accountants (now renamed as the Hong Kong Institute of Certified Public Accountants (HKICPA)), has put forward a number of proposals to strengthen the regulatory regime. The Professional Accountants (Amendment) Ordinance 2004 was enacted in July 2004 to, among other things, provide for the Government's appointment of lay persons<sup>1</sup> to the governing Council and to the Investigation and Disciplinary Panels of the HKICPA, with a view to enhancing the independence and transparency of the HKICPA's regulatory function.

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<sup>1</sup> As defined in section 2 of the Professional Accountants Ordinance (Cap. 50) (PAO), "lay person" means a person who is not – (a) a certified public accountant; or (b) a member of an accountancy body which is a member of the International Federation of Accountants.

- 1.3 Another key proposal put forward by the then HKSA as mentioned in paragraph 1.2 above is to set up an independent investigation board to investigate suspected accounting, auditing and/or ethical irregularities of the auditors of listed corporations. The Administration, together with relevant parties, has also stated that a financial reporting review panel would be established. The panel is intended to check the quality of financial reporting of listed corporations and their compliance with relevant legal and accounting requirements. The scope of investigations and enquiries of the proposed bodies are proposed to be confined to listed corporations because the quality of financial reporting of such corporations may directly affect the investing public and is thus an issue of public interest.
- 1.4 In September 2003, the Administration issued a Consultation Paper on “Proposals to: (a) Enhance the Oversight of the Public Interest Activities of Auditors; and (b) Establish a Financial Reporting Review Panel”. In response to the Consultation Paper, we received 22 submissions, most of which generally supported the proposals. We also briefed the Legislative Council (LegCo) Panel on Financial Affairs on the proposals in June 2003 and April 2004 respectively. At these meetings, Members of the Panel generally agreed that the proposals would be a step in the right direction and urged their early implementation.
- 1.5 Since then, the Administration has been actively pursuing the proposals together with the Hong Kong Exchanges and Clearing Limited (HKEx), HKICPA and the Securities and Futures Commission (SFC). We have also given thought to matters such as the composition, mode of operation, powers, financial arrangements and accountability measures relating to the proposed bodies.
- 1.6 We now **propose** that a **Financial Reporting Council (FRC)** should be set up to oversee both the independent investigation board (proposed to be renamed as the **Audit Investigation Board (AIB)** to better reflect its functions) and the **Financial Reporting Review Committee(s) (FRRC)**. Details of the proposals are set out in this Consultation Paper.
- 1.7 In the course of working out these proposed arrangements in greater detail and preparing the legislative proposals to establish the FRC, we have elaborated, and refined where necessary, the proposals as set out in the Consultation Paper issued in September 2003. The detailed proposals set out in this Consultation Paper represent the latest ideas worked out by the Administration, in consultation with HKEx, HKICPA and SFC, on the arrangements to establish the FRC. Subject to the

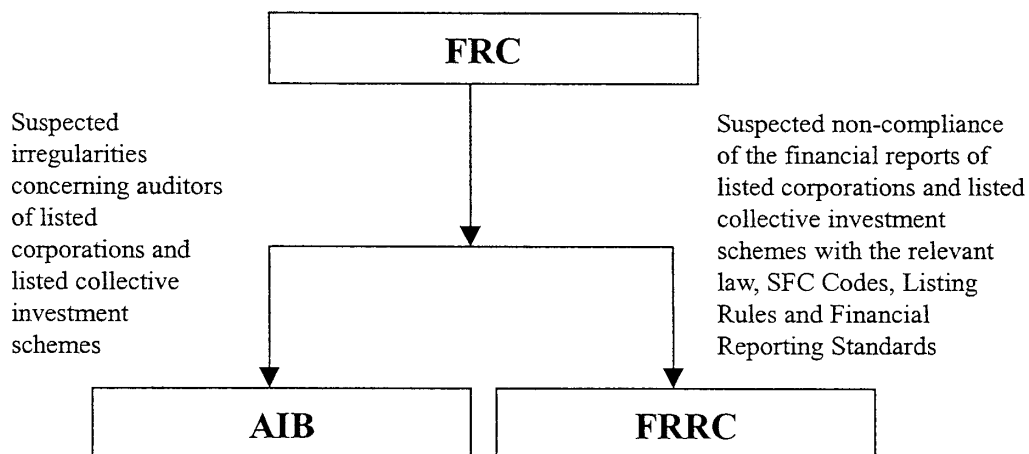
outcome of the consultation, we aim to introduce the Bill into the LegCo within the 2004/05 legislative session.

## CHAPTER 2 COMPOSITION AND OPERATION OF THE FRC

*Taking up part of the investigatory role for the accounting profession in Hong Kong, the FRC shall maintain accountability to the public and effectiveness of its work by adopting corporate governance practices appropriate to the best standards of public bodies and operating under a lean and efficient structure.*

### ESTABLISHMENT OF A STATUTORY BODY

- 2.1 As set out in the Administration's paper updating the LegCo Panel on Financial Affairs on the establishment of a proposed regulatory body in April 2004, the AIB and FRRC will be under the oversight of a governing board, i.e. the FRC. Such a proposed set-up will facilitate the sharing of resources. Moreover, in the light of the nature of the work and duties of the AIB and FRRC, we believe that putting them under one roof will lead to synergies in areas such as referral of cases and exchanges of expertise. A diagram illustrating the proposed institutional set up of the FRC is as follows -



- 2.2 As far as the legal status of the FRC is concerned, we have been considering whether to set up **(a) an independent statutory body**, or **(b) a company limited by guarantee**. We note that the Financial Reporting Council in the United Kingdom (UK) is a company limited by guarantee, with certain statutory powers to regulate the accounting profession being granted or delegated to it through the exercise of the

Secretary of State's order-making power under relevant legislation. In this regard, we note that it is uncommon in the regulatory framework in Hong Kong for substantive investigatory powers to be conferred on a non-statutory body outside Government. On balance, we **propose** to set up **an independent statutory body** given that, in any case, the FRC must possess statutory investigation and enquiry powers in order to carry out its work effectively. We consider the setting up of an independent statutory body to be a tidier approach as this would give it the status like that afforded to, for example, the HKICPA (as a statutory body of the profession) and the SFC (as a statutory regulator).

## COMPOSITION

- 2.3 As regards the composition of the FRC, our latest **proposal** is that the FRC should comprise not more than eleven members, including -
- (a) One ex-officio member from the Administration, i.e. the Registrar of Companies (R of C) or his representative;
  - (b) One member nominated by the HKEx and appointed, on an *ad personam* basis, by the Chief Executive (CE);
  - (c) One member nominated by the HKICPA and appointed, on an *ad personam* basis, by the CE;
  - (d) One member nominated by the SFC and appointed, on an *ad personam* basis, by the CE;
  - (e) At least four and not more than six other members appointed by the CE; and
  - (f) The Chief Executive Officer (CEO) of the FRC appointed by the CE.

This proposed composition will enable the FRC to secure the necessary independence in the eyes of the public.

- 2.4 To ensure the independence of the FRC, we **propose** that a majority of the members must be lay persons. Moreover, the Chairman of the FRC should be appointed by the CE from among the lay members (other than the R of C or his representative, and the CEO even if they are lay persons).

- 2.5 We **propose** that appointments to the FRC should be for a term not exceeding three years, although members can be reappointed. Moreover, the terms and conditions of the appointment shall be determined by the CE. We envisage that, in appointing a maximum of six other members to the FRC (c.f. paragraph 2.3(e) above), the CE would take into account the background of the relevant candidates, so that at least some appointed members would possess some knowledge of, or experiences in, the fields like accounting, auditing, business administration, financial management, law, etc.
- 2.6 As a good corporate governance measure and following the general practice of other statutory bodies, we **propose** that the FRC should have a non-executive Chairman supported by an executive CEO. The CEO will be the administrative head of the FRC and be responsible, subject to the direction of the governing board, for administering the affairs of the FRC. It is envisaged that the CEO would not necessarily be an accountant, but it would be preferable if he has some background in the financial services sector. In any case, we consider it not necessary to set out in the Bill the qualifications required for a person to be eligible for the appointment as the CEO of the FRC.
- 2.7 We **propose** that the Bill should contain reserve provisions to empower the CE –
- (a) to appoint a lay member of the FRC to be the acting Chairman, and any other persons to be the acting CEO or acting member of the FRC, in the event that the Chairman, the CEO or any other members of the FRC is for any reason unable to perform the functions of his office; and
  - (b) to remove any member of the FRC, who for reasons such as bankruptcy, incapacity caused by physical or mental illness, or conviction of an offence, is unable or unfit to perform his functions as a FRC member, from his office.

## **OPERATIONAL STRUCTURE**

- 2.8 In general, the detailed procedures for convening meetings or conducting businesses should be determined by the FRC. We, therefore, consider that it should suffice for the Bill to set out the broad framework and key provisions in respect of the operational structure of the FRC.
- 2.9 We **propose** that at least two-third of the members constitute the quorum

of any meetings of the FRC<sup>2</sup>. Every question for decision shall be determined by a majority of votes of the members present at the meetings, subject to a minimum threshold of four votes. The minimum threshold would ensure that all decisions of the FRC would not be passed by a thin “minority” of members. Moreover, in case of an equality of votes, the Chairman should have a casting vote, which should not be double-counted for the purpose of satisfying the aforementioned minimum threshold of four votes in passing a decision.

- 2.10 In practice, the FRC would function more like a governing board and play an overseer’s role. Provisions will be included in the Bill to empower the FRC to employ employees, engage consultants, agents and advisers and delegate its powers and functions accordingly.
- 2.11 To enhance the transparency and consistency of its operation, the FRC may find the need to issue guidelines from time to time on matters such as the procedures for handling complaints. We **propose** that the Bill should empower the FRC to issue non-statutory guidelines, which must not be inconsistent with the provisions of the Bill, indicating the manner in which the FRC intends to perform its functions or exercise its powers.

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<sup>2</sup> To illustrate, if the FRC consists of 11 members, the quorum will be eight members. If the FRC consists of ten or nine members, the quorum will be seven or six members respectively.

## CHAPTER 3      FINANCIAL ARRANGEMENTS FOR THE FRC

*The financial arrangements for the FRC shall ensure a fair share of costs among all key stakeholders and reasonable oversight over its budget and accounts.*

### FUNDING ARRANGEMENTS

- 3.1 In April 2004, we briefed the LegCo Panel on Financial Affairs on the proposal for HKEx, HKICPA, SFC and the Administration to share the set-up and running costs of the new body. This arrangement 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 overall market quality. The FRC will also help relieve part of work of the relevant parties in the investigation of suspected misconduct involving their regulatees/members. Furthermore, the proposal is in line with the underlying philosophy of the regulatory regime underpinning the financial services sectors of Hong Kong under which the industry concerned should fund the regime by which it is regulated. We are aware that in overseas jurisdictions like the UK, Australia and the United States (US), the funding of the oversight body for the auditing profession is shared by parties including the profession, the business community and the government.
- 3.2 Since the Panel briefing, the Administration has discussed the proposed funding arrangements for the FRC with HKEx, HKICPA and SFC. The four parties have now agreed to contribute to the funding of the FRC on an equal share basis. 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 annual contributions from the fourth year onwards will be reviewed in the third year in the light of actual experience. The agreement would be effected through a Memorandum of Understanding among the four parties.
- 3.3 The Administration's contribution will be funded by the Companies Registry Trading Fund established under the Trading Funds Ordinance (Cap. 430) and administered by the R of C.



## **BUDGET AND ACCOUNTS OF THE FRC**

- 3.4 In addition to the above, we **propose** that the FRC should prepare estimates of the income and expenditure of the FRC in each financial year for approval by SFST. Moreover, the FRC shall keep and maintain proper accounts and submit a copy of the statement of the accounts to SFST after the end of a financial year. We **propose** that the Director of Audit should be the auditor of the FRC, and that the auditor's report and the accounts should be laid before the LegCo and published for public information.

## CHAPTER 4      ACCOUNTABILITY AND INDEPENDENCE OF THE FRC

*The public is rightly entitled to expect that there are measures to ensure that the FRC is performing its functions independently, fairly, properly, efficiently and with due propriety.*

### ACCOUNTABILITY MEASURES

#### Checks and Balances in the Bill

- 4.1 After its establishment, the FRC is expected to be an important player in the oversight of the auditing profession and the financial reporting of listed corporations, both of which would have a direct impact on the quality of our regulatory regime. To enable it to carry out its functions, the Bill will give the FRC various investigatory and enquiry powers.
- 4.2 Given the need to uphold the public interest and to ensure that the powers are properly exercised, we consider that there should be an effective mechanism whereby the FRC is accountable for its work and subject to public oversight. At the same time, the FRC is expected to exercise its powers in an effective way without undue hindrance. Consequently, we have exercised due care in prescribing adequate safeguards which correspond to the powers vested in the new regulatory watchdog.
- 4.3 With this objective in mind, and after making references to the arrangements of other statutory bodies such as the SFC and the recently established Hong Kong Deposit Protection Board<sup>3</sup>, we **propose** to put in place in the Bill a range of checks and balances including -
- (a) **Appointment of FRC members** – Other than the ex-officio member, all members of the FRC, including the Chairman and CEO, shall be appointed by the CE;
  - (b) **CE's direction** - After consultation with the Chairman of the FRC, CE may, upon being satisfied that it is in the public interest to do so, give the FRC written directions as he thinks fit as to the performance of

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<sup>3</sup> The Hong Kong Deposit Protection Board is established pursuant to Deposit Protection Scheme Ordinance (Cap. 581) (DPSO) passed by the LegCo in May 2004.

any of its functions;

- (c) **FRC to furnish information** – The FRC shall, when required by the SFST, furnish to him such information as he specifies, on the principles, practices and policy that it is pursuing or adopting in performing its functions or exercising its powers as well as the reasons therefor;
- (d) **FRC's budget** – The annual estimates of the FRC's income and expenditure shall be subject to the approval by SFST (c.f. paragraph 3.4 in Chapter 3);
- (e) **Annual Report** – The FRC will be required to submit a report to the SFST on an annual basis on the activities of the body, its financial statement and auditor's report. The relevant reports and statements shall be laid before the LegCo and be published to the public;
- (f) **Presence of an Administration representative** – The R of C will sit on the FRC as an ex-officio member. He will participate in the decision-making process of the FRC. Moreover, he will act as an interface between the Administration and the FRC; and
- (g) **The Director of Audit** shall be the auditor of the FRC. He is entitled to have access to the books and records of the FRC and to require such information and explanation as he considers necessary to perform his functions. Each year, he will prepare a report to be attached to the annual report of the FRC and be laid before LegCo (c.f. paragraph 3.4 in Chapter 3).

#### **Other General Accountability Measures**

- 4.4 In addition to the checks and balances set out in paragraph 4.3 above, actions by the FRC may be subject to judicial review by the court, and complaints against the actions of the FRC or any of its staff members may be lodged with the Office of the Ombudsman. Moreover, in practice, we envisage that the FRC will consider and put in place a series of administrative measures to ensure proper control of its operation, for instance, internal guidelines on the exercise of powers and memorandum of understandings on cooperation with relevant regulators or professional bodies.

## Need for a Separate Appeal Tribunal?

- 4.5 We have given considerable thought to the need and desirability of setting up an independent tribunal to hear appeals from parties aggrieved by actions of the FRC. On balance, we do **not** see a strong need for such a tribunal. Our reasoning is set out in paragraphs 4.6, 4.7 and 4.8 below.
- 4.6 As mentioned in Chapters 5 and 6 of this Consultation Paper, the two main functions of the FRC (as performed through the AIB and FRRC respectively) are -
- (a) to investigate into any suspected irregularities of an auditor of a listed corporation and listed collective investment scheme in the course of his audit work; and
  - (b) to make enquiries if there is a question that the relevant financial reports of a listed corporation and listed collective investment scheme may not comply with the relevant legal and accounting requirements.

Thus, the FRC's role will be mainly confined to investigatory and enquiry work. Whenever the FRC considers that there is sufficient evidence to substantiate a case or complaint, the FRC will refer it to the relevant enforcement and disciplinary agencies (such as the HKICPA, the Police, etc.) for follow-up action, or will seek an order from the court to require the necessary rectification of defective accounts. Other than providing the necessary assistance to such agencies, the FRC is not vested with enforcement or disciplinary powers to sanction anyone or impose a penalty on its own.

- 4.7 As for the investigation and enquiry powers held by the FRC, we consider that necessary checks and balances are put in place sufficiently (c.f. paragraphs 4.3 and 4.4 above). The Bill will also set out the specific statutory threshold, the passing of which is necessary to trigger the exercise of the powers (c.f. paragraphs 5.18(a) and 6.12(a) in Chapters 5 and 6 respectively). In any case, any parties aggrieved by the action of the FRC may apply to the court for a judicial review of the action concerned.
- 4.8 To sum up, given the **nature** of the functions and powers vested in the FRC, we do not consider it necessary, and justified, to establish a separate tribunal to handle and hear appeals against the decisions of the FRC.

## INDEPENDENCE: AVOIDANCE OF CONFLICT OF INTERESTS

- 4.9 The auditing profession is the frontline guardian of quality financial reporting for maintaining corporate governance. Auditors are thus regarded as a corporate “watchdog”. The FRC, being a “watchdog of a watchdog”, can only win public trust and confidence if it performs its duties, and is seen to be doing so, in an independent and impartial manner. In addition to the necessary checks and balances in areas like the composition of the FRC (e.g. a majority of the members and the Chairman must be lay persons), the FRC must have a proper system to ensure that its members, employees and persons performing a function under the Bill are not involved in any possible conflict of interest, as such conflicts, whether genuine or perceived, would undermine the credibility of the FRC and the effectiveness of the whole new set-up.
- 4.10 Consequently, to ensure transparency and effective deterrence, we consider that the key elements of such a system shall be embodied in the Bill. Our current thinking is that the key elements may be modelled on section 379(3) and (4) of the Securities and Futures Ordinance (Cap. 571) (SFO) as well as section 7(4), (5) and (6) of Schedule 1A to the Mandatory Provident Fund Schemes Ordinance (Cap. 485). Specifically, we **propose** that the Bill should include the following provisions in respect of the avoidance of conflict of interests –
- (a) Any member of the FRC, or any person performing any function or exercising any powers of the FRC, shall disclose to the FRC if he is required to consider any matter relating to –
    - (i) a listed corporation or its subsidiary, or a listed collective investment scheme, in which he has an interest; or
    - (ii) his past or present employers, employees, clients, associates, and other related parties;
  - (b) After the relevant member or person has disclosed the nature of any interest in any matter, he must not be present during any deliberation of or take part in any decision of the FRC with respect to the matter, unless the FRC otherwise determines in the absence of that relevant member or person; and
  - (c) A member of the FRC or person who, without reasonable excuse, contravenes the disclosure requirements commits an offence and is liable to a fine and/or imprisonment.

## CHAPTER 5      AUDIT INVESTIGATION BOARD (AIB)

*To protect the interests of investors, the Audit Investigation Board (AIB) shall promote confidence in the integrity of the auditing profession through independent and effective investigation into irregularities of auditors of listed corporations and listed collective investment schemes.*

### BACKGROUND

- 5.1 An independent and effective investigation regime is a fundamental building block on which the public trust in the auditing profession rests. The Professional Accountants (Amendment) Ordinance 2004, which commenced operation in November 2004, has enhanced the independence of the Investigation Committees of the HKICPA by Government's appointments of lay members to the hitherto Committees comprising professional accountants only. However, as pointed out in the HKICPA's Proposal to Strengthen the Regulatory Framework of the Accountancy Profession in January 2003, there remain the outstanding issues of –
- (a) the perception that greater independence is needed for the investigations of the audits of listed corporations; and
  - (b) the lack of adequate powers under the PAO to compel non-HKICPA members to provide information or produce documents.
- 5.2 During the Consultation conducted in September 2003, we received overwhelming support for the establishment of an independent investigation board to investigate complaints against the public interest activities of the auditing profession. Most respondents agreed that the board's function should be confined to investigation and not extended to disciplinary decisions. In this regard, we **propose** to set up, under the overall structure of the FRC, an **Audit Investigation Board (AIB)**.

### OBJECTIVE OF THE AIB

- 5.3 We **propose** that the objective of the AIB is to, whether acting on complaints or otherwise, deal with suspected irregularities of auditors in relation to their audits of and preparation of reporting accountants' reports for listed corporations and listed collective investment schemes.

## ORGANIZATIONAL STRUCTURE OF THE AIB

- 5.4 The AIB does not operate on its own but is part and parcel of the FRC and will act under the delegated authority of the FRC. We **propose** that the AIB should consist of employees of the FRC (including the CEO), and other consultants, agents or advisers engaged and authorized by the FRC. At the level of the AIB, we do not consider it either appropriate or necessary to set up a separate layer of supervision by lay members independent from the FRC, like the combination of both lay persons and certified public accountants (CPA) in the Investigation Committees of the HKICPA constituted under the PAO. This is because the AIB should be supervised directly by the FRC which will already comprise a majority of lay members. It should also be stressed that the AIB shall only carry out investigations as directed by the FRC. The AIB may, and if so directed by the FRC, shall make interim reports on its investigation to the FRC and on the conclusion of the investigation, shall make a final report to the FRC.

## JURISDICTION OF THE AIB'S INVESTIGATION

### "The Auditors"

- 5.5 In respect of the investigation of the irregularities of the accounting profession, the set-up of the AIB is **not** intended to effect the transfer of all the duties of the HKICPA to the AIB. Rather, as set out in the Administration's paper issued to the LegCo Panel on Financial Affairs in April 2004, the AIB is aimed at dealing with activities of the "auditing profession" with a wider public interest dimension. In this regard, we **propose** to define "auditors" in accordance with section 381(5) of the SFO to mean, in relation to a listed corporation<sup>4</sup>, with appropriate adjustment to include auditors of listed collective investment schemes –
- (a) a person appointed to be an auditor for the purposes of auditing the accounts of the corporation (irrespective of whether such person is qualified for the appointment under the PAO); or
  - (b) a person appointed to be an auditor of the corporation for the purposes of any enactment of a place outside Hong Kong which imposes on such person responsibilities comparable to those imposed on an auditor by the CO.

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<sup>4</sup> This includes a corporation in relation to which the irregularities have occurred, even though the corporation has ceased to be listed any time thereafter.

- 5.6 Although section 29(2) of the PAO prescribes that a person shall not hold any appointment or render any services as an auditor within the meaning of CO or any other Ordinances unless he is either the holder of a practising certificate or it is a corporate practice, it is necessary to extend the definition to “an auditor for the purposes of any enactment of a place outside Hong Kong which imposes on such person responsibilities comparable to those imposed on an auditor by the CO”, given that a non-Hong Kong incorporated listed corporation is not subject to the relevant provisions of the CO<sup>5</sup>.
- 5.7 It should be stressed that the term “auditor” should not only be confined to mean a firm of professional accountant(s) (who operate in his own account as a sole proprietorship or in a partnership) or a corporate practice. We **propose** that the term “auditor” should also cover the proprietor or partner of the CPA firm, members or directors of a corporate practice, **as well as** the employees of the firm or corporate practice, who are or have been involved or engaged in the audit of the listed corporation concerned, notwithstanding that the person concerned may cease to be an “auditor” or an employee of the “auditor” after the occurrence of the irregularities.

### “Listed Corporations”

- 5.8 The responses to the Consultation in September 2003 also revealed that the AIB should concentrate only on cases involving public interest. In this light, we **propose** that the AIB should deal with cases concerning listed corporations within the meaning of the SFO. Both “listed” and “corporations” are defined terms in Schedule 1 to the SFO. In essence, a corporation shall be regarded as listed if any of its securities<sup>6</sup> are listed, and the term “corporation” shall mean a company or other body corporate incorporated either in Hong Kong or elsewhere. To protect investors, we **propose** that this definition should also include collective investment schemes<sup>7</sup> listed on the Stock Exchange of Hong Kong Limited (SEHK)<sup>8</sup>,

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<sup>5</sup> Under the Listing Rules, where accounts are required to be audited or reported upon under the Rules, the accounts shall be audited or reported upon by a person, firm, or corporation which is qualified under the PAO for appointment as an auditor of a corporation; or is a firm of accountants which has an international name and reputation and is a member of a recognized body of accountants. Therefore, it is possible, though relatively rare, that the auditor of a listed corporation which is not incorporated in Hong Kong is not registered with the HKICPA as a CPA firm or a corporate practice under the PAO.

<sup>6</sup> “Securities” are defined under Schedule 1 to the SFO. In essence, they would include shares, stocks, loan stocks, debentures, funds, bonds, notes, options, warrants, interests in any collective investment schemes, etc.

<sup>7</sup> “Collective investment schemes” are defined in Schedule 1 to the SFO to apply to investment products of a collective nature. In essence, they embrace the concepts of “unit trusts”, “mutual funds”, and “real estate investment trusts”.

<sup>8</sup> The SEHK is the operator of the Main Board and the Growth Enterprise Market and is a subsidiary of the HKEx.



so that any irregularities involving the auditors in relation to the audit of such listed *schemes* will be subject to the AIB's jurisdiction. This definition will thus cover all listed corporations, be they incorporated in Hong Kong or elsewhere, and listed collective investment schemes on the SEHK.

### **“Public Interest Activities”**

- 5.9 An auditor of a corporation or a collective investment scheme may provide some other services (for example, an internal review assignment), as well as the audit of the accounts or financial statements. Again, the AIB's focus should be only on those services that attract a wider public interest. Insofar as listed corporations and listed collective investment schemes are concerned, we **propose** that the AIB should only deal with cases in relation to –
- (a) the audit of accounts pursuant to the requirements under the CO (applicable to any listed corporations incorporated in Hong Kong);
  - (b) the audit of published financial statements of any listed corporations and listed collective investment schemes as required under the relevant SFC Codes<sup>9</sup> and/or the Listing Rules<sup>10</sup>; and
  - (c) the preparation of published auditor's reports for prospectuses required under the CO by an auditor acting as a reporting accountant of a corporation listed or to be listed on the SEHK.

The proposed scope would be reviewed from time to time in the light of market development.

- 5.10 The proposed scope will ensure that the auditing process of accounts or financial statements of listed corporations and listed collective investment schemes published for information of the investing public will be subject to the investigation regime of the AIB. In addition, we note that an auditor of a corporation has an important role to play as a reporting accountant to

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<sup>9</sup> The SFC is empowered under section 104(1) of the SFO to authorize collective investment schemes subject to such conditions as the SFC considers appropriate. These collective investment schemes may be listed on the SEHK. In this connection, the SFC has issued Codes under section 399 of the SFO establishing guidelines for the authorization of collective investment schemes. The Codes have stipulated provisions on the appointment of auditors for collective investment schemes and on the financial reporting requirements required for such schemes. Pursuant to section 399(8) of the SFO, these Codes are not subsidiary legislation.

<sup>10</sup> Listing Rules are non-statutory rules made by the SEHK governing the listing of securities on the SEHK and are commonly referred to by market practitioners as the “Red Book”. These rules are subject to the approval by the SFC under section 24 of the SFO. The Administration and SFC are currently consulting the public on the proposal to give statutory backing to major listing requirements.

prepare for corporate financial reports which are included in a prospectus, under sections 38 and 342 of the CO, offering any shares in or debentures of the corporation for public subscription. We believe that the preparation of such reports is also a public interest activity of the auditing profession that the AIB may look into. We therefore **propose** that the AIB should also be empowered to investigate any irregularities of an auditor in this respect. It should be noted that the requirement of preparing such reports under the CO applies to any corporation, be it incorporated in Hong Kong or elsewhere.

### **“Irregularities”**

5.11 There is a need to define clearly in the Bill the “irregularities” of the auditor, in the course of performing the above-mentioned “public interest activities” of listed corporations and listed collective investment schemes, that the AIB may investigate. Using areas of “irregularities” (set out in sections 34(1), 34(1AA) and 41A of the PAO) subject to the investigation by an Investigation Committee constituted by the HKICPA as a benchmark, we **propose** that the AIB may investigate when the FRC suspects that an auditor, so far as it is applicable -

- (a) has falsified or caused to be falsified any document, made any statement which is material and which he knows to be false or does not believe to be true, in respect of any document;
- (b) has been negligent in the conduct of his profession;
- (c) has been guilty of professional misconduct or dishonourable conduct;
- (d) has failed or neglected to observe, maintain or otherwise apply a professional standard issued by the HKICPA;
- (e) has refused or neglected to comply with the provisions of any bylaw or rule made or any direction lawfully given by the Council of the HKICPA;
- (f) while a director of a corporate practice or such a practice, has rendered any service as, or purporting to be, a director of a company or a company name other than the name which appear in the registers of the HKICPA;
- (g) being such a director of a corporate practice or such a practice, has practised accountancy without being covered by professional indemnity insurance either not at all or not to the extent required by

the PAO; or

- (h) being a corporate practice, did or omitted to do something which, were the practice an individual CPA, would reasonably be regarded as being dishonourable conduct by an individual.

5.12 To sum up the above, we **propose** that the AIB should carry out investigations into suspected irregularities of an auditor, in relation to an audit of published accounts or financial statements of a corporation or a collective investment scheme which is or was listed and to the preparation of any reports for inclusion in prospectuses (notwithstanding that in which case such irregularities might be committed before the listing). It should be emphasized that investigation of accountants' irregularities outside the above proposed scope of the AIB would continue to be undertaken by the HKICPA (so long as the accountants concerned are members of the Institute and such irregularities are those set out in sections 34(1), 34(1AA) and 41A of the PAO), as would decisions on discipline.

## **POWERS CONFERRED ON THE AIB**

5.13 In our Consultation Paper issued in September 2003, we noted the HKICPA's suggestion that the power of the AIB to request information and to investigate should be similar to those presently afforded to the SFC under the SFO. The HKICPA has identified that the "inherent weaknesses" under the current regime empowering the Investigation Committee of the HKICPA to investigate pursuant to the PAO lie with the lack of adequate powers to require non-HKICPA members (e.g. corporate directors and officers who may not be a CPA) to produce documents and information. It is necessary to sufficiently empower the AIB in order for it to carry out investigations effectively.

5.14 The proposed investigatory framework of the AIB is modelled heavily on the SFC's powers of investigation under sections 179 and 183 of the SFO. The specific powers are as follows –

- (a) **Enquiries:** We **propose** to introduce provisions modelled on section 179 of the SFO to empower the AIB to require the auditor of a listed corporation or its subsidiaries, the corporation and its subsidiaries themselves (including present and past officers and employees thereof), banks, and any other person who has had dealings with the corporation or its subsidiaries, or is otherwise in possession of any required record or document relating to the affairs of the corporation or its subsidiaries, to produce records and documents, where it appears

to the FRC that **there are circumstances suggesting** the occurrence of auditors' irregularities. The records and documents an auditor would be required to produce may include "audit working papers", as defined by section 178 of the SFO<sup>11</sup>. The AIB should 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 which it was made or for which it was omitted, the circumstances under which it was prepared or created, and the details of any instructions given in connection with the making of that entry or any omission of an entry. These proposed powers will enable the AIB to conduct a relatively quick and discreet enquiry into the suspected irregularities;

- (b) **Investigation:** When the FRC 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 powers will apply to any person whom the AIB has reasonable cause to believe has in his or its possession any record or document which contains or is likely to contain information relevant to the investigation, or whom the AIB has reasonable cause to believe otherwise has such information in his or its possession. Together with the powers to require production of documents or records and the giving of explanations thereon, the proposed powers will enable the AIB to require the person under investigation to attend before the AIB, answer any question relating to the matters under investigation, and give the AIB all reasonable assistance in connection with the investigation. It should be stressed that the AIB may exercise the above powers of investigation without having first considered the need for or conducted an enquiry, should the FRC, with the evidence or information available, already have reasonable cause to believe that an auditor of a listed corporation may have been engaged in irregularities;
- (c) **Statutory declaration:** We **propose** that the AIB may in writing require the person giving an explanation to verify the explanation by statutory declaration. If a person does not give an explanation for the reason that the explanation was not within his knowledge, the AIB may in writing require him to verify by statutory declaration that he

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<sup>11</sup> Pursuant to section 178 of the SFO, "audit working papers" means –  
(a) any record or document prepared by or on behalf of an auditor; and  
(b) any record or document obtained and retained by or on behalf of an auditor, for or in connection with the performance of any of his functions relating to the conduct of any audit of the accounts of a corporation.

was unable to comply with the requirement for that reason. Similar powers are vested in the SFC under sections 179 and 183 of the SFO;

- (d) **Order from the court:** We **propose** to empower the AIB to seek assistance from the court in case of unreasonable refusal or failure to comply with a request by the AIB made pursuant to a proper exercise of its investigatory powers. This will be modelled on section 185 of the SFO;
- (e) **Magistrate's Warrants to Enter and Search:** We **propose** to empower the AIB to apply to a Magistrate for a warrant to enter and search premises and seize relevant documents. This will be modelled on section 191 of the SFO.

## **RELATED OFFENCES AND RECOVERY OF INVESTIGATION COSTS**

- 5.15 We **propose** to introduce provisions modelled on sections 179, 184 and 192 of the SFO to prescribe criminal offences to enforce compliance with the information-gathering requirements of the AIB. Similar to the situation under the SFO, a person who does not comply with the relevant requirement is protected from the "double jeopardy" of criminal prosecution to punish non-compliance with the requirements and a court order to compel compliance (c.f. paragraph 5.14(d) above). This means when a person who has not complied with an AIB requirement and is found guilty of contempt of court, he will not face a separate prosecution for non-compliance with the same AIB requirement and vice versa.
- 5.16 We also **propose** that where an auditor's irregularities constitute criminal offences for which he is subsequently convicted by the court, or where an auditor's irregularities amount to market misconduct and the auditor is subsequently identified by the Market Misconduct Tribunal as having engaged in the market misconduct pursuant to the SFO, or where the Disciplinary Committee of the HKICPA is satisfied that the case of "irregularities" is proved under the PAO, the court, the Market Misconduct Tribunal or the Disciplinary Committee of the HKICPA, as the case may be, may order the auditor to pay to the FRC the whole or part of the costs and expenses incurred by the FRC in relation to the investigation.

## **CHECKS AND BALANCES**

- 5.17 To address any concern about the proposed powers for the AIB, particular care has been taken to ensure that they are prudent and then only to the extent necessary. Care has also been taken to ensure that with these

proposed powers, the high standards of procedural fairness expected of an independent, professional, fair and transparent investigator will not be compromised. It is recognized that this balance is crucial to maintaining the integrity of the auditing profession and ensuring that the AIB has the trust and confidence of the profession, market participants and investing public.

5.18 To this end, apart from the general checks and balances set out in Chapter 4, we **propose** a range of further checks and balances in relation to the exercise of the proposed investigatory powers. These further checks and balances are set out below -

- (a) **Statutory thresholds:** We **propose** to introduce provisions modelled on the statutory thresholds applicable to the SFC under sections 179 and 183 of the SFO. The AIB may only exercise its investigation powers in very specific circumstances. On the one hand, the AIB may only initiate the preliminary enquiries as mentioned in paragraph 5.14(a) when there are **circumstances suggesting** the occurrence of auditors' irregularities. The AIB then will be required to "have a reasonable cause to believe" that the person is in possession of relevant documents and that the documents sought are relevant to the grounds for the investigation. Although the powers of enquiry may cover persons other than the auditors, the corporation and its subsidiaries, banks etc., the AIB may exercise its powers only when the documents sought cannot be obtained from the auditor, the listed corporation itself and its subsidiaries or their banks. On the other hand, the AIB may only exercise its investigation powers as mentioned in paragraph 5.14(b) above when the FRC has **reasonable cause to believe** that an auditor may have been involved or engaged in any irregularities. Again, the AIB will have to demonstrate that it has reasonable cause to believe that the person under investigation is in possession of the relevant documents. In either case, the requirements of statutory thresholds must be certified by the AIB as having been satisfied;
- (b) **Consultation with other regulatory bodies:** We **propose** that before issuing a direction to a person which is itself an authorized financial institution (i.e. a bank), an insurer, a licensed person of the SFC or an approved trustee of Mandatory Provident Fund schemes, the FRC shall consult the Hong Kong Monetary Authority, the Insurance Authority, the SFC or the Mandatory Provident Fund Schemes Authority as appropriate;

- (c) **Privilege against self-incrimination:** We **propose** to introduce provisions modelled on section 187 of the SFO to provide that, where a person is asked to answer written or oral questions, he must first be reminded of the right to claim privilege against self-incrimination<sup>12</sup>; and
- (d) **Magistrate's warrants:** As in section 191 of the SFO, the AIB is not empowered to forcibly enter any premises unless it has first obtained a warrant from a Magistrate.

## **ENHANCEMENT OVER THE INVESTIGATORY POWERS UNDER THE PAO**

5.19 Comparing the existing investigatory powers vested in the Investigation Committee of the HKICPA under the PAO with the above investigatory powers to be vested in the AIB, the following key enhancements are noted -

- (a) **The Triggering Point to Initiate Enquiry or Investigation:** Under section 42C(2)(a) of the PAO, an investigation can be pursued only where the Council reasonably suspects or believes that a CPA (i.e. a member of the HKICPA), a CPA firm, or a corporate practice has engaged in irregularities. However, as explained above, the AIB will be empowered to initiate enquiries when there are circumstances suggesting the occurrence of auditors' irregularities. Furthermore, the scope of the definition of "auditors' irregularities" under the proposed Bill is wider such that it is intended to cover irregularities of a non-CPA (i.e. a non HKICPA-member) who is or was an employee of the auditor or a member or director of a corporate practice;
- (b) **Information-gathering Powers:** Section 34(1) of the PAO prescribes that a failure to comply with the requirement of the Investigation Committee may constitute a complaint subject only to the disciplinary proceedings under the PAO. Although section 42D(2) of the PAO empowers an Investigation Committee of the HKICPA to extend its powers to any person whom the Investigation Committee reasonably believes to be in possession of the required documents, a person who fails to comply with the Investigation Committee's directions will not be subject to any disciplinary action by the HKICPA if he is not its member nor any other criminal or civil sanctions. This relatively limits the effectiveness of the investigation undertaken by the

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<sup>12</sup> Article 11(2)(g) of the Bill of Rights Ordinance (Cap. 383) provides that a person shall not be compelled to testify against himself or to confess guilt, in the determination of any criminal charge against him.

Investigation Committee. However, as demonstrated above, a failure to comply with the information-gathering requirements of the AIB may result in either criminal offences or court orders. Moreover, a person may be required to make statutory declaration regarding his explanation. This provides a stronger deterrent effect against non-compliance with the requirements relating to the production of information as necessitated by an investigation; and

- (c) **Magistrate's Warrant to Enter and Search:** The Investigation Committee constituted by the HKICPA has no power to apply for a Magistrate's warrant to enter and search premises. We consider that, for timely investigation and avoidance of important evidence from being destroyed, the AIB should be empowered to apply for a warrant from a Magistrate to enter premises and search for and seize records to facilitate investigation.

5.20 We consider the proposed enhancement justified, given the need to promote confidence in the integrity of the auditing profession.



## CHAPTER 6      FINANCIAL REPORTING REVIEW PANEL (FRRP) AND FINANCIAL REPORTING REVIEW COMMITTEE(S) (FRRC)

*To promote confidence in and enhance the quality of corporate financial reporting, the Financial Reporting Review Committee(s) (FRRC) will make enquiries as to whether the provision of financial information by listed corporations and listed collective investment schemes complies with relevant legal and accounting requirements.*

### BACKGROUND

- 6.1 The proposal to establish a FRRP dates back to July 2001 when the Standing Committee on Company Law Reform (SCCLR) issued its Consultation Paper on Phase I of the Corporate Governance Review. Submissions received then indicated support for the establishment of a FRRP to enquire into financial reports and enforce any necessary changes thereto. The Administration further consulted the public on the FRRP proposal through the Consultation Paper issued in September 2003. Most respondents agreed to the proposal set out therein, and took the view that the Panel should adopt a reactive approach to carry out enquiries in response to complaints, at least at its initial stage.
- 6.2 Internationally, in 2004 the UK passed the Companies (Audit, Investigations and Community Enterprise) Act 2004 to, *inter alia*, extend the remit of the UK FRRP and give statutory powers to the FRRP to require companies and their auditors to provide information for the enquiries. Having considered the latest development in the UK, we have refined our earlier proposal and set out below the refined *modus operandi* of the FRRP.

### OBJECTIVES OF THE FRRP AND FRRC

- 6.3 We **propose** that the objective of the FRRP and FRRC is to, whether acting on complaints or otherwise, check whether the provision of financial information by listed corporations and listed collective investment schemes complies with the relevant legal and accounting requirements thereby upholding the quality of financial reporting.

## ORGANIZATIONAL STRUCTURE OF THE FRRP AND FRRC

### Financial Reporting Review Panel

- 6.4 We **propose** that while the FRRP should be part of the overall structure of the FRC, members of the Panel should come from a wide range of financial reporting, auditing, banking, financial services and commercial expertise. We therefore **propose** that the FRRP should consist of not less than 20 members appointed by the CE in consultation with the FRC, of whom not less than three members appointed by the CE concurrently to be the Panel Convenors.

### Financial Reporting Review Committee(s)

- 6.5 We note that the UK FRRP operates through smaller groups of members drawn from the Panel and all groups are normally chaired by the Panel Chairman or the Deputy Chairman. When we consulted the public in September 2003, we did not receive any adverse comments on following this “group” approach adopted in the UK. We therefore **propose** that the FRC may, where necessary and on an *ad hoc basis*, constitute a **Financial Reporting Council Committee (FRRC)** to enquire into a case and appoint at least five members from the **FRRP** to be FRRC members. A FRRC would only look at a single case under enquiry and more FRRCs would be formed from the FRRP members as and when necessary. Each FRRC will be chaired by one of the three appointed Panel Convenors to help ensure consistency in the *modus operandi* of enquiries across the committees.
- 6.6 As set out in the Consultation Paper issued in September 2003, members of the FRRP, being experts on their own, should be in a position to conduct enquiries into cases on the basis of the information provided by the corporation in question. We **propose** that each FRRC should act under the delegated authority of the FRC and such power may be further sub-delegated to the executive staff of the FRC who may be appointed to provide support to a FRRC.
- 6.7 Similar to the reporting relationship in the case of the AIB, each FRRC shall only carry out an enquiry as directed by the FRC. The FRRC may, and if so directed by the FRC, shall make interim reports on its enquiry to the FRC and on the conclusion of the enquiry, shall make a final report to the FRC.

## JURISDICTION OF FRRC'S ENQUIRY

### “Relevant Financial Reports” with “Public Interests”

- 6.8 In response to the September 2003 Consultation, most respondents considered it desirable for a FRRC to limit its remit to the statutory annual financial statements of listed companies, at least initially. However, it is relevant to note that the UK Companies (Audit, Investigations and Community Enterprise) Act 2004 has extended the UK FRRP's scope beyond annual accounts under the Companies Act, so that it can also look at interim accounts and other accounts and reports required under the UK Listing Rules to check for compliance with the accounting requirements of those Rules.
- 6.9 In the local context, if we limit the remit of a Hong Kong FRRC to the accounts required to be filed under the CO, we might not be able to cover corporations<sup>13</sup> listed in Hong Kong but incorporated elsewhere, as they are not required to follow the accounting requirements of the CO in the preparation of their annual accounts other than those specified in Part XI. Such corporations, at present, comprise more than 80% of the corporations listed in Hong Kong. There is also a public interest to cover the published financial reports in relation to listed collective investment schemes. In this light, we have refined the earlier proposal with reference to the latest UK development, and **propose** that the “relevant financial reports” subject to the FRRC's enquiry should include –
- (a) the profit and loss account and balance sheet of listed corporations laid before the corporations' general meetings, or sent to members of the corporations or other persons so entitled, or delivered to the R of C pursuant to the CO;
  - (b) the summary financial reports of listed corporations sent to entitled persons pursuant to section 141CA of the CO<sup>14</sup>;

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<sup>13</sup> “Corporation” is defined in Schedule 1 to the SFO to mean a company or other body corporate incorporated either in Hong Kong or elsewhere.

<sup>14</sup> Section 141CA of the CO enables a listed company incorporated in Hong Kong to send to an entitled person of the company a summary financial report in place of the full set of financial documents for the purpose of a general meeting of the company if the entitled person so agrees. The financial documents comprise a copy of the balance sheet, including every document required by law to be annexed to it (for example, the profit and loss accounts); a copy of the directors' report; and a copy of the auditors' report.

- (c) the financial reports by auditors (in the capacity of reporting accountants), referred to in Part II of Schedule 3 to the CO for inclusion in the prospectuses of listed corporations under sections 38 and 342 of the CO; and
- (d) any annual, interim, quarterly accounts, *pro forma* financial information, or preliminary announcement of results of listed corporations and listed collective investment schemes required under the SFC Codes<sup>15</sup> and Listing Rules for public disclosure.

The scope would be reviewed from time to time in the light of the market development.

6.10 As the investing public would rely on the above-mentioned financial reports to appraise the results of listed corporations, these reports have a significant public interest dimension and should be subject to enquiries by a FRRC. Moreover, it should be noted that one of the initiatives of the Administration, together with the SFC, is to give statutory backing to major listing requirements. Certain financial disclosure requirements under the existing Listing Rules have been included in the SFC's proposed amendments to the Securities and Futures (Stock Market Listing) Rules, on which the public is being currently consulted by the SFC. We will keep in view the progress of this package of legislative proposals which may have a bearing on, in particular, item (d) of the "relevant financial reports" as set out above.

### **"Relevant Accounting Requirements" under CO, SFC Codes, Financial Reporting Standards and Listing Rules**

6.11 The objective of a FRRC is to enquire into the compliance of the "relevant financial reports" of listed corporations with the "relevant accounting requirements" under the CO, SFC Codes, Financial Reporting Standards, and Listing Rules<sup>16</sup>. We would like to highlight that even though

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<sup>15</sup> In this context, "listed corporations" shall also cover listed collective investment schemes, so that the financial reports of the schemes issued pursuant to the applicable SFC Codes in relation to listed collective investment schemes would be under the jurisdiction of FRRC enquiries. For the definition of "collective investment schemes" and existing regulatory framework, please refer to footnotes 7 and 9.

<sup>16</sup> The Listing Rules require that where accounts of corporations primarily listed on SEHK are required to be prepared, audited, or reported upon under the Rules, they shall conform with either the Hong Kong Financial Reporting Standards (HKFRSs) or International Financial Reporting Standards (IFRSs). HKFRSs are issued by the HKICPA pursuant to section 18A of the PAO and are in virtually all material aspects converged with the IFRSs since 1 January 2005. The IFRSs are issued by the International Accounting Standards Board, which is the most widely recognized accounting standards setting body in the world. It should also be noted that overseas companies with a secondary listing on the Main Board, and GEM companies which are also listed on the New York Stock Exchange or Nasdaq of the US (except for property development and/or property investment companies) are permitted to use US generally accepted accounting principles.

chairman's reports, directors' reports and management discussion and analysis reports may form part of the annual or interim reports issued by listed corporations, strictly speaking these disclosures are, by their very nature, not governed by matters of **accounting** requirements set out in the CO, SFC Codes, Financial Reporting Standards or Listing Rules. Consequently, we **propose** that a FRRC should limit its remit to relevant financial reports (in the form of accounts or financial statements) presented in accordance with the relevant accounting requirements.

## **POWERS CONFERRED ON THE FRRC**

6.12 The UK Companies (Audit, Investigations and Community Enterprise) Act 2004 has given statutory powers to the UK FRRP to require directors, corporate officers and employees, and auditors to provide the FRRP with the information it needs to carry out enquiries. The UK FRRP is also gradually adopting a more proactive approach to enforcement. With reference to the latest legislative changes to the UK Companies Act, we **propose** that a FRRC should be given the following powers -

- (a) **Power to require documents, information and explanations:** We **propose** to empower a FRRC to require the listed corporation and its subsidiaries, as well as any present or past officers, employees or auditors thereof, to provide information and explanations to facilitate enquiries by a FRRC. The power may be exercised in response to a complaint received or otherwise, when **it appears to the FRC that there is, or may be, a question** on whether the relevant financial reports comply with relevant accounting requirements. This will be modelled on section 245F of the UK Companies Act 1985, newly added after the passage of the Companies (Audit, Investigations and Community Enterprise) Act 2004;
- (b) **Request for voluntary rectification of the accounts and financial statements:** Where the FRC agrees to the recommendation of a FRRC that there is a question on whether the relevant financial reports comply with the relevant accounting requirements, it may give notice to the preparers of the relevant reports (namely, the directors or the reporting accountant) to indicate the respects in which it appears that such a question has arisen and may request the preparers to make voluntary rectification in accordance with a more appropriate

accounting treatment or take other remedies<sup>17</sup> as the FRC thinks fit;

- (c) **Order from the court:** We **propose** to give a FRRC two further powers to seek assistance from the court as follows –
  - (i) **Court's order to mandate production of information:** In line with the proposed power afforded to the AIB for its investigation, we **propose** to empower a FRRC to seek assistance from the court in case of any unreasonable refusal or failure to comply with a request by a FRRC made pursuant to a proper exercise of its enquiry power set out in (a) above. This will be modelled on section 185 of the SFO and section 245F(5) of the UK Companies Act 1985;
  - (ii) **Court's declaration of non-compliance and order to make mandatory rectification:** In the event that the relevant listed corporation refuses to make a voluntary rectification of the defective accounts, we **propose** that a FRRC should be empowered to seek a court order declaring non-compliance and directing the preparers of the relevant financial reports to rectify the defects, and/or to take other appropriate actions with respect to the audit of the rectified financial reports, such as notification of relevant stakeholders. This will be modelled on section 245B of the UK Companies Act 1985;
- (d) **Power to consult other professional and regulatory bodies:** As the enquiries by a FRRC may involve technical judgement regarding interpretation of financial reporting standards and other relevant rules, we **propose** to empower a FRRC to consult other professional and regulatory bodies in the course of its enquiries, as and when it sees appropriate.

6.13 The proposed powers for a FRRC are less extensive when compared with those for the AIB. The main differences are that -

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<sup>17</sup> In some cases, it is envisaged that the FRRC will be able to accept alternative corrective action by the directors or reporting accountants – for example, a corrective statement published by the company either separately or, if the timing is conducive, in the next interim report, together with a corrective statement in the following annual accounts and adjustment of the relevant comparative figures. According to the experience of the UK FRRP, what form of corrective action is acceptable to the Panel would have to depend on the circumstances of individual cases.

- (a) An investigation by the AIB may cover any persons relevant to the investigation, whereas an enquiry by a FRRC would be limited to listed corporations and their subsidiaries as well as any present or past officers, employees or auditors thereof; and
- (b) Failure to comply with a direction by the AIB to facilitate an investigation may result in criminal sanctions or an application by the AIB for a order from the court compelling compliance or punishing non-compliance. However, there is no criminal sanction for failing to co-operate with a FRRC with respect to an enquiry, but a FRRC may apply to the court to secure compliance by persons subject to the enquiry.

We believe that it is more prudent, and also justifiable, to have differences regarding the regulatory teeth of the AIB and FRRC. In this regard, a FRRC would be tasked to enquire into suspected non-compliance with the relevant Financial Reporting Standards, which may arise from, say, different interpretations of such Standards and therefore not involve any misconduct or negligence. This can be contrasted with the AIB which would be tasked to investigate into suspected irregularities of auditors, which may, more often, include misconduct or even offences. Thus, we consider that AIB should be given stronger regulatory teeth. Our current proposal for the FRRC is also modelled on the *modus operandi* of the UK FRRP pursuant to the UK Companies Act 1985.

## Recovery of Enquiry Costs

- 6.14 We **propose** to empower the court in making the declaration of non-compliance, as mentioned in 6.12(c)(ii) above, to order that all or part of the costs and expenses incurred by a FRRC in making the enquiry and applications to the court and those incurred by the corporation in connection with or in consequence of the preparation of revised financial reports shall be borne by the directors if they were parties to the approval of the defective financial reports, or the reporting accountant, as the case may be. A similar provision is found in section 245B of the UK Companies Act 1985.

## Checks and Balances

- 6.15 Again, care has been taken to ensure that there are adequate checks and balances on a FRRC's powers. Apart from the general checks and balances, we wish to highlight that the enquiry powers exercisable by a FRRC should be subject to **(a) statutory threshold** (c.f. paragraph 6.12(a)); **(b) consultation with other professional and regulatory bodies** (c.f.

paragraph 5.18(b) in Chapter 5 and paragraph 6.12(d)); and (c) **privilege against self-incrimination** (c.f. paragraph 5.18(c) in Chapter 5).



## CHAPTER 7      REFERRAL AND PUBLICATION OF INVESTIGATION/ENQUIRY REPORTS, SECREC Y AND IMMUNITIES, AND OTHER MISCELLANEOUS MATTERS

*The investigations and enquiries of the AIB and FRRC will facilitate enforcement and disciplinary actions by regulatory authorities or professional accountancy bodies, with a view to discouraging any illegal, dishonourable and improper practices in the accounting profession and upholding the quality of financial reporting of listed corporations.*

### REFERRAL OF INVESTIGATION / ENQUIRY REPORTS

- 7.1 The majority views revealed in the Consultation in September 2003 were that the function of the FRC should remain purely investigatory. When there is sufficient evidence, the independent investigation board should refer cases to the relevant law enforcement agency and/or professional bodies for legal and/or disciplinary actions.
- 7.2 In view of this, we **propose** that upon completion of the investigation / enquiry, the AIB and a FRRC shall submit an investigation / enquiry report to the FRC for consideration. It will be the FRC, but not the AIB or FRRC, to make directions as to the follow-up action necessitated, having regard to the evidence found during the investigation / enquiry. We **propose** that the FRC may direct the AIB and a FRRC to -
- (a) close a case without further action; or
  - (b) suspend the investigation or enquiry for a fixed or indefinite period of time; or
  - (c) refer a case or the investigation / enquiry report or any part thereof to a relevant body; or
  - (d) disclose the information obtained during the investigation / enquiry to a relevant body; or

- (e) for cases subject to an enquiry by a FRRC, to request the corporation in question to make a voluntary rectification with respect to the defective accounts, or seek the court's declaration of the corporation's non-compliance and order for the corporation to make mandatory rectification (c.f. paragraphs 6.12(b) and (c)(ii) in Chapter 6); or
- (f) do any other follow-up action as the FRC thinks fit.

The AIB and a FRRC will also be required to report to the FRC periodically on the progress of all cases under investigation.

7.3 We **propose** that the FRC should be empowered to refer a case or disclose the relevant information obtained therein to a "relevant body" which means an authority, regulatory organization or a professional accountancy body in Hong Kong or elsewhere. We **propose** that –

- (a) An authority, regulatory organization, or a professional accountancy body in Hong Kong shall include but not be limited to the Police, the Independent Commission Against Corruption, the HKICPA, the HKEx, the SFC, the Companies Registry, the Hong Kong Monetary Authority, the Insurance Authority, the Mandatory Provident Fund Schemes Authority, the Inland Revenue Department, the Official Receiver's Office, and the Market Misconduct Tribunal established under the SFO;
- (b) If the FRC needs to refer a case to a professional accountancy body other than the HKICPA, the professional accountancy body concerned shall be a member of the International Federation of Accountants<sup>18</sup>.

7.4 As the jurisdiction of the AIB's investigation is benchmarked against the "irregularities" as set out in sections 34(1), 34(1AA) and 41A of the PAO and subject to the investigation by an Investigation Committee constituted by the HKICPA, we envisage that the FRC should be allowed to refer a case to the HKICPA for disciplinary action under the PAO if the auditor concerned is registered with the HKICPA. However, given that the disciplinary function rests entirely with the HKICPA and that the FRC's role should be purely investigatory, the AIB would only assist the Registrar of the HKICPA who shall present a case against the auditor during the Institute's disciplinary proceedings under the PAO. Such assistance will

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<sup>18</sup> The International Federation of Accountants is a global organization for the accountancy profession. It works with its 163 member organizations in 119 jurisdictions to protect the public interest by encouraging high quality practices by the world's accountants. The Federation members represent 2.5 million accountants employed in public practice, industrial and commercial sectors, governments, and the academia.

include disclosing the evidence obtained during the investigation to the Registrar for the preparation of the proceedings and giving evidence during the proceedings. Nonetheless, we have to emphasize that the FRC would not act as a “complainant”, referred to in section 37(1)(a) of the PAO, to present the case in the disciplinary proceedings, lest the FRC would become both the “investigator” and “prosecutor”.

- 7.5 To facilitate the conduct of the proceedings after the referral, we also **propose** that a copy of any report referred by the FRC signed by the CEO and counter-signed by the Chairman shall be admissible in any legal proceedings including disciplinary proceedings under the PAO as evidence of any fact stated therein. The provision will be modelled on section 149 of the CO in relation to an inspector’s report arising from a company investigation.

## **PUBLICATION OF THE INVESTIGATION / ENQUIRY REPORTS**

- 7.6 We have given consideration as to whether we should propose to stipulate a clause to empower the FRC to publish investigation / enquiry reports. We believe that having regard to the public interest and the need to maintain the transparency of the FRC, there is a case for the FRC to publish investigation / enquiry reports. However, since the function of the FRC would be only investigatory, care should be taken to ensure that such publication would not (a) prematurely “name and shame” any corporation or person involved in a case still under investigation or enquiry; and (b) be prejudicial to any proceedings subsequent to the referral by the FRC to a relevant body.
- 7.7 On balance, we **propose** that the FRC *may* cause the investigation / enquiry reports or any part thereof to be published. This will be modelled on section 146(3)(b) of the CO. The provision would provide the FRC with the discretion to publish investigation / enquiry reports **as and when it sees fit**<sup>19</sup>, after taking into account considerations like the public interest in the matter and the timing of such a publication.

## **PRESERVATION OF SECRECY**

- 7.8 As regulators in the financial services sector are generally required to preserve the secrecy of the information obtained in the course of

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<sup>19</sup> As in the position of the UK FRRP, the FRC is expected to make an announcement at the conclusion of a FRRP enquiry where, as a result, the preparers of accounts have agreed that the accounts in question would require corrective actions or other remedies (examples of which are set out in footnote 17).

performing their functions and duties, the FRC will not be an exception. There are strong policy grounds to **propose** the establishment of a stringent regime imposing secrecy obligations on any person –

- (a) who is or has been a member of the FRC, the AIB, a FRRC or committees set up by the FRC and an employee of the FRC performing any function under the Bill;
- (b) who is or has been appointed as an agent, advisor or consultant by the FRC; and
- (c) who is or has been authorized by the FRC to exercise any powers provided in the Bill.

7.9 We **propose** to prescribe that the persons mentioned in paragraph 7.8 above **shall**, except so far as it is necessary for the performance of any function under the Bill or for carrying into effect the provisions of the Bill, -

- (a) **not** suffer or permit any other person to have access to any matter relating to the affairs of any person that comes to their knowledge in the performance of any function under the Bill; and
- (b) **not** communicate any such matter to any person other than the person to whom such matter relates.

7.10 Moreover, to enable the FRC to properly discharge its duties and functions, we **propose** certain exemption clauses so that the prohibition does not apply to disclosure of information in specified circumstances as necessary for the performance of any function of the FRC or for carrying into effect the provisions of the Bill. For example, the exemption clauses will cover the disclosure of information for the purpose of criminal proceedings or to a relevant body including those specified in paragraph 7.3 above to enable the relevant body to perform its function.

7.11 We also **propose** that anyone who breaches the secrecy obligations would be subject to criminal prosecution. As there is a need for the stringency of the proposed secrecy obligations to be on a par with those applicable to other regulators in the financial services sector, we would make reference to Ordinances such as the DPSO, the SFO, the PAO in drawing up the relevant provisions.

## IMMUNITY

- 7.12 We **propose** stipulating provisions to cover immunity from liability for any person acting in good faith with respect to anything done or omitted to be done in the performance or purported performance of any function pursuant to the Bill. The immunity provision will be in line with section 42H of the PAO in respect of the immunity protection afforded to any members of the Investigation Committee of the HKICPA. Moreover, we **propose** to introduce provisions modelled on section 380(4) of the SFO to protect legal professional privilege.

## IMMUNITY IN RESPECT OF COMMUNICATIONS WITH THE FRC BY AUDITORS OF LISTED CORPORATIONS AND THEIR ASSOCIATED UNDERTAKINGS

- 7.13 We are conscious of the rapid development of the financial market and the increasing complexity of financial transactions, which may provide greater scope for persons responsible for fraud or other irregularities to disguise the true nature of their activities. In the course of conducting an audit for a listed corporation or its associated undertakings, auditors may identify the possible existence of fraud or irregularities, in relation to another auditor in the group, past auditor of the corporation or undertaking, or any corporate accountants, directors or officers. They wish to serve the public interest by reporting their concerns to the FRC. However, in doing so, they could face a civil claim from, for example, the listed corporation for, among other things, breach of confidentiality and consequently suffer financial loss.
- 7.14 In this light, we **propose** to introduce provisions modelled on section 381 of the SFO that auditors of listed corporations and their associated undertakings, who choose to report to the FRC any suspected fraud or irregularities in the past and present audit or preparation of the relevant financial reports for the corporations or undertakings in question, would be protected by the statutory immunity.

## CONSEQUENTIAL AMENDMENTS

- 7.15 We will also draw up consequential amendments to the relevant Ordinances including the CO and the PAO to take account of the operation of the FRC.
- 7.16 In particular, there are no provisions at present in the CO for the revision of accounts after they have been laid at a company's general meetings and delivered to the R of C. The SFC Codes and Listing Rules also do not have similar provisions. We will take this opportunity to implement the

recommendation of the SCCLR set out in its Consultation Paper on Phase I of the Corporate Governance Review to allow such revisions. In short, we **propose** to amend the CO to provide for the laying and filing of revised accounts, and for the filing of a “caution” with the R of C before any defective accounts are revised. The SFC and SEHK will be invited to consider similar amendments to the SFC Codes and Listing Rules to provide for the issue of revised accounts or other relevant financial reports.

- 7.17 Furthermore, the HKICPA will consult its members and draw up a separate proposal to amend the PAO so as to give effect to the proposed registration system for firms or corporate practices engaged to provide auditing services for listed corporations and a levy from these firms or corporate practices to fund the Institute’s contribution to the FRC (c.f. Chapter 3).

## CHAPTER 8 SUMMARY OF ISSUES FOR CONSULTATION

- 8.1 The Administration is committed to maintaining and enhancing an effective, transparent, and accountable regulatory regime for the accounting profession, thereby upgrading corporate governance and our market quality. With this in mind, we have proposed in this Consultation Paper specific legislative proposals for the establishment of the FRC which will be tasked to oversee the AIB and the FRRC. We summarize here the matters on which public comments are invited -
- (a) The matters in relation to the establishment of the FRC, its composition and operational structure (c.f. Chapter 2);
  - (b) The proposed financial arrangements for the FRC (c.f. Chapter 3);
  - (c) Whether the proposed accountability measures are appropriate in ensuring that the FRC would perform its functions independently, fairly, properly, efficiently and with due propriety (c.f. Chapter 4);
  - (d) whether the proposed jurisdictions for the AIB's investigations, investigation powers for the AIB, and the proposed safeguards in relation to the exercise of these powers, are sufficient and appropriate (c.f. Chapter 5);
  - (e) Whether the proposed jurisdictions for a FRRC's enquiry, enquiry powers for a FRRC, and the proposed safeguards in relation to the exercise of these powers, are sufficient and appropriate (c.f. Chapter 6); and
  - (f) The proposed *modus operandi* in relation to the referral and publication of investigation / enquiry reports, as well as the proposed secrecy and immunity provisions (c.f. Chapter 7).
- 8.2 We shall consider the public comments received carefully before finalizing the relevant proposals. Subject to the outcome of the consultation, we aim to introduce a Bill into the LegCo within the 2004/05 legislative session.