

For 6 April 2009

**Legislative Council
Panel on Financial Affairs**

**Progress Report on
the work of the Financial Reporting Council**

PURPOSE

The Financial Reporting Council (“FRC”) was established on 1 December 2006 and became fully operational on 16 July 2007. Its main functions are to conduct investigation of auditing irregularities and enquiries into non-compliance with accounting requirements in relation to listed entities. The FRC last briefed Members on its work progress on 8 April 2008. This paper serves to update Members of the work progress of the FRC since April 2008.

WORK PROGRESS

2. The FRC entered into its second year of operation in 2008 and below is a brief account of its work in the past year.

Preliminary assessment of complaints

3. The FRC received 12 complaints in 2008 and as of 28 February 2009, it has received a total of 33 complaints. The Secretariat of the FRC (the “Secretariat”) reviews information provided by complainants together with information available in the public domain and additional information collected from listed entities and auditors concerned. In respect of each complaint, the Secretariat submits a complaint assessment report for the consideration of the members of the FRC in meeting (“the Council”). The Council would then determine if the complaint justifies the initiation of an investigation or enquiry.

4. In 2008, the FRC completed the assessment of 15 complaints, including nine complaints received in 2007. At of end February 2000, four complaints were still in progress.

5. Of the 15 cases completed in 2008, 60% were completed within 40 working days, compared with 87% in 2007. This is mainly due to the fact that the complaints completed in 2008 were relatively more complicated than those in 2007.

Investigation

6. The Council initiated one formal investigation of auditing irregularity in October 2007 and directed the Audit Investigation Board (“AIB”)¹ to conduct the investigation in accordance with the FRC Ordinance (Cap. 588) and this was made public via the FRC website.

7. The investigation was completed in December 2008. The AIB considered there was evidence suggesting that there was an auditing irregularity. The investigation report of the AIB was adopted by the Council on 4 December 2008 and referred to the Hong Kong Institute of Certified Public Accountants (“HKICPA”). In accordance with the Memorandum of Understanding between the FRC and the HKICPA, the latter would consider what follow-up actions, including disciplinary proceedings, should be taken.

Enquiry

8. As of March 2009, the Council has initiated three formal enquiries, in October 2007, November 2008 and March 2009 respectively since its inception. In respect of each enquiry, the Council appointed a separate Financial Reporting Review Committee (“FRRC”)² under the FRC Ordinance to look into the possible non-compliance.

9. The FRRC of the first enquiry concluded that there were non-compliances in the financial statement of the listed entity concerned and a report on the enquiry was published in March 2009. The second and third enquiries are in progress.

¹ The AIB was established under section 22 of the FRC Ordinance to conduct investigation as directed by the Council. The AIB is chaired by the Chief Executive Officer of the FRC with three professional Secretariat staff appointed by the Council as members.

² FRRCs are appointed by the Council from the Financial Reporting Review Panel (“FRRP”) established under section 39 of the FRC Ordinance to conduct formal enquiries into cases of possible non-compliances with accounting requirement. At present, there are 5 Panel Convenors and 29 members in the FRRP.

Proactive approach

10. In the briefing last April, Members requested the FRC to consider taking a more proactive role in initiating investigations and enquiries, apart from acting on complaint.

11. After consideration and liaison with other regulators, the FRC has commenced review of auditor's reports on financial statements of all listed entities as and when they are issued since July 2008 to identify potential non-compliances. The FRC considers that this approach would enable the FRC to take prompt follow-up action against them.

12. Since July 2008, 33 auditor's reports containing modifications were reviewed and four of them involved possible non-compliance. After preliminary assessment by the Secretariat, the Council initiated an enquiry in November 2008.

13. The FRC continues to monitor news and discussions relating to listed entities in the public domain to see if there is any possible auditing irregularity or non-compliance with accounting requirements.

FINANCIAL SITUATION

14. The FRC is jointly funded by the Companies Registry Trading Fund, the Hong Kong Exchanges and Clearing Limited, the HKICPA, and the Securities and Futures Commission ("SFC"). The four parties each contributes an annual amount of HK\$2.5 million as recurrent funding for the first three years of operation. In 2007 the four parties had also each contributed a lump-sum amount of HK\$5.0 million to make up a reserve fund of HK\$20.0 million for meeting any unexpected inadequacies of the recurrent funding and other exigencies of circumstances.

15. The expenditure of FRC in 2008 was HK\$8.7 million and the budget of the FRC for 2009 as approved by the Secretary for Financial Services and the Treasury ("SFST") is HK\$13.6 million, which exceeds the original plan of HK\$10 million per annum which was estimated before the FRC was in operation, due mainly to the need to strengthen the professional team and to provide for an increase in legal expenses.

16. The four funding parties are supportive of FRC's work. The Government is discussing with them on the future funding arrangements having regard to the actual operational experience gained by the FRC since full

operation in July 2007. It is expected that an agreement will be reached later this year.

CORPORATE GOVERNANCE

17. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted below.

Independence

18. Members of the FRC are appointed by the Chief Executive of the HKSAR. Six out of the eleven members (i.e. majority) are lay persons, i.e. non-accountants. They are required to observe the provisions of the FRC Ordinance to avoid conflicts of interests in the performance of duties under the Ordinance. They have all actively participated in the work of the FRC through Council meetings and committees.

Financial control

19. The annual budget of the FRC is approved by the SFST. The financial statements of the FRC are audited by the Director of Audit. The FRC submits a report on its operation together with a set of financial statements and the report of the Director of Audit on the financial statements (i.e. the Annual Report) to the SFST once a year. The 2008 Annual Report of the FRC will be tabled at the LegCo sitting of 1 April 2009.

Checks and balance

20. The CEO is the administrative head of the FRC. He leads the administration and operation. The Council provides directions to and oversees the performance of the CEO and the Secretariat.

21. The CEO is supported by the Operation team in the Secretariat. For each operational case, one director takes charge while a different director is assigned to review that case for the purpose of checks and balance and quality assurance. On top of this, the CEO oversees the work of the directors in the Operation team to provide the second level of checks and balance and quality assurance, and the work of the CEO and the directors are all overseen by the Council.

Process Review Panel (PRP)

22. The Chief Executive has appointed an independent PRP for the FRC in November 2008. The PRP is tasked to ensure that the operation of the FRC is reasonable and fair by reviewing a selection of cases of the FRC to determine if the FRC has followed its internal procedures in handling cases. The PRP will also provide advice on the adequacy of the operation procedures to the FRC. In establishing the PRP, the Government has made reference to the work of the PRP for the SFC as well as the Operations Review Committee of the Independent Commission Against Corruption. The first report of the PRP, covering the period from July 2007 to December 2008, will be published later in 2009.

Reporting of investment in securities by staff

23. Following discussion at last April's Panel meeting on the adequacy of the declaration of interest mechanism by FRC staff, staff members of the FRC are now required to report transactions in securities listed in Hong Kong within 14 days of the day of transaction. In addition, staff members are required to report their securities holdings upon reporting duty and at the end of each calendar year thereafter.

Transparency

24. Also following the advice of the Panel, the FRC has decided to publish on its website a summary of completed complaints since July 2008. The summary contains information of the allegations in the complaints and findings of the Council. The FRC continues to publish statistics of its operation updates on a monthly basis.

25. As stipulated by the FRC Ordinance, the Council will consider the publication of reports on investigation and enquiry in accordance with the provisions of the FRC Ordinance. The report on the above-mentioned completed enquiry (para. 9) has been published on 5 March 2009. Since there may be follow-up actions on the investigation referred to in para. 7, its report cannot be published for the time being.

LOOKING FORWARD

26. The FRC has been in full operation for almost two years. While it is pleased to see the achievement so far, the Council and the Secretariat will not be complacent and will continue to build on the experience gained to further improve the performance in the future.

Financial Reporting Council
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