

**For Discussion  
8 April 2010**

**Legislative Council  
Panel on Financial Affairs**

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

**PURPOSE**

The Financial Reporting Council (“FRC”) is a statutory body established to conduct investigation of auditing irregularities and enquiries into non-compliance with accounting requirements in relation to listed entities. In addition to responding to complaints, the FRC has also taken a proactive approach since July 2008 by making reference to modified auditors’ reports on financial statements of all listed entities to identify potential non-compliance with accounting requirements and following up by reviewing the relevant financial statements. The FRC last briefed this Panel on its work progress on 6 April 2009. This paper updates the Panel on the work progress made by the FRC since then.

**WORK PROGRESS**

2. The FRC entered into its third year of operation in 2009 and a brief account of its work in the past year is set out below.

*Preliminary assessment of complaints*

3. The FRC received 13 complaints in 2009 and as of 28 February 2010, it has received a total of 43 complaints since establishment. 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 (“the Council”). The Council would then determine if the complaint justifies the initiation of an investigation or enquiry.

4. In 2009, the FRC completed the assessment of 19 complaints, including six complaints received in 2008. More than half of those complaints involved auditing irregularities. By the end of 2009, the review of all

complaints received was completed and amongst them, FRC initiated investigations into four cases and enquiry into one. In the first two months of 2010, one new complaint was received and is still in progress.

### ***Review of financial statements with modified auditors' reports***

5. In July 2008, the FRC started to adopt a proactive approach by making reference to modified auditors' reports on financial statements of all listed entities to identify potential non-compliance with accounting requirements and following up by reviewing the relevant financial statements. From 1 January 2009 to 28 February 2010, the FRC screened 134 modified auditors' reports and identified four cases of non-compliance with accounting requirements from the financial statements concerned, which were all related to impairment of assets.

6. Among those four cases, the FRC initiated two enquiries; one case was completed in 2009 and the other in March 2010.

7. The FRC considered that formal enquiries were unnecessary for the other two cases, since either the non-compliance is unlikely to cause a material mis-statement in the financial statements concerned or the auditor has sufficiently reported on the case. The FRC has advised the listed entities of the review findings and suggested measures for improvement where appropriate.

8. In addition to adopting a proactive approach in reviewing financial statements with modified auditors' reports, the FRC continues to monitor news and discussions relating to listed entities in the public domain to see if there are any possible auditing irregularities or non-compliance with accounting requirements which warrant FRC's follow-up.

### ***Investigation***

9. As a result of potential or suspected auditing irregularities identified in the review of complaints received, the Council initiated four investigations of auditing irregularities in the latter part of 2009 and directed the Audit Investigation Board ("AIB")<sup>1</sup> to conduct the investigations in accordance with the FRC Ordinance (Cap. 588). All four investigations were still in progress as of 28 February 2010.

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<sup>1</sup> 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 four professional Secretariat staff appointed by the Council as members.

10. In June 2009, the FRC published the report of its first investigation, which was initiated in October 2007 and completed in November 2008. The case was referred to the Hong Kong Institute of Certified Public Accountants (“HKICPA”) which, in turn, issued a disapproval letter to both the auditor and the engagement director concerned with regard to the need to exercise due care and to act with proper regard to their legal and professional obligations.

### *Enquiry*

11. As mentioned above, the FRC handled a total of three enquiries in 2009, including one initiated as a result of the review of complaints (paragraph 4 refers) and two as a result of the review of financial statements with modified auditors’ reports (paragraph 6 refers). In respect of each enquiry, the Council appointed a separate Financial Reporting Review Committee (“FRRC”)<sup>2</sup> under the FRC Ordinance to look into the possible non-compliance.

12. The enquiry initiated as a result of the review of complaints received by the FRC was in relation to whether the accounting treatment of convertible bonds with anti-dilutive provisions is appropriate. The FRRC of this enquiry concluded that there were variations in accounting treatment in the market and the accounting treatment adopted by the listed entity was not inappropriate. Therefore there was no non-compliance in the relevant financial statements and a report on the enquiry was published in September 2009.

13. For the other two enquiries initiated as a result of the review of financial statements with modified auditors’ reports, both have been completed and were published in September 2009 and March 2010 respectively.

### **THE SECRETARIAT**

14. The Secretariat is responsible for managing and administering the day-to-day operations of the FRC. The inaugural Chief Executive Officer (“CEO”), Mr. M.T. Shum, retired from his position on 31 January 2010 upon completion of his term, and Dr. P.M. Kam will commence his appointment as the new CEO on 1 April 2010. Dr. Kam was selected by a search committee through an open worldwide recruitment exercise.

15. All the 11 full-time positions in the Secretariat have been filled. The FRC will continue to assess its workload and decide if the team needs to be

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<sup>2</sup> 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-compliance with accounting requirement. At present, there are 5 Panel Convenors and 29 members in the FRRP.

strengthened. For any short-term increase in workload, the FRC will resort to short-term measures, such as the hiring of staff on short-term contracts.

## **CROSS BORDER COOPERATION**

16. In addition to establishing good working relationship with local regulators, the FRC also considers it important to strengthen ties with regulators outside Hong Kong, including especially Mainland regulators in view of the number of Mainland companies listed in Hong Kong.

17. The FRC had a number of meetings with the Ministry of Finance (MoF) and other Mainland regulators in the past year to exchange views and discuss cooperation arrangements in respect of mutual assistance in conducting cross-border investigations. The FRC has signed a Memorandum of Understanding with the MoF to set up an investigation cooperation framework with regard to handling of potential auditing irregularities which would enable the FRC to investigate, through the MoF, the relevant matters involving Mainland auditors of Hong Kong listed entities under the proposed new arrangements of accepting Mainland accounting and audit standards and qualified audit services provided to Mainland incorporated companies listed in Hong Kong.

## **PUBLICITY**

18. The FRC publicized its work through updating its website regularly and the distribution of annual reports to stakeholders. Staff of the FRC Secretariat attended seminars, meetings and conferences hosted by local accounting groups and international professional associates and institutions to strengthen its network both locally and overseas, and gave talks at universities to raise the level of public awareness of the role and functions of the FRC. The FRC is also in the process of developing a plan to step up publicity on the work of the FRC.

## **FINANCIAL SITUATION**

19. 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. The four funding parties each contributed an annual amount of HK\$2.5 million as recurrent funding for the first three years of operation, based on pre-establishment estimations of FRC's expenditure.

20. The combined contribution from the four funding parties has increased to HK\$16 million in 2010, with a 5% upward adjustment annually from 2011 to 2014. The increase has taken into account FRC's assessment of its funding requirements to perform its statutory functions in the light of its operational experience in the past three years.

21. The actual expenditure of FRC in 2009 was HK\$10.1 million and the approved budget of the FRC for 2010 is HK\$14 million which has taken into account the need to strengthen the professional team and an increase in the provision for legal expenses having regard to the number of investigations to be conducted in 2010.

## **CORPORATE GOVERNANCE**

22. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted in paragraphs 23 to 32 below.

### ***Independence***

23. Members of the FRC are appointed by the Chief Executive. The Council currently comprised 10 members and six of them, including the Chairman, 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. The Council meets once every two months and holds additional meetings as necessary. Committees provide advice to the Council on various matters and meet on a periodic basis and whenever necessary.

### ***Financial control***

24. The annual budget of the FRC is approved by the Secretary for Financial Services and the Treasury ("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 2009 Annual Report of the FRC will be tabled at the Legislative Council sitting of 14 April 2010.

### ***Internal control***

25. The Chief Executive Officer (“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.

26. 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 balances 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 balances and quality assurance, and the work of the CEO and the directors are all overseen by the Council.

### ***Process Review Panel (PRP)***

27. The PRP is an independent panel established on 1 November 2008 to review cases handled by the FRC and consider whether the actions taken by the FRC are fair and consistent with its internal procedures. The PRP comprises five members appointed by the Chief Executive including the FRC Chairman as an ex-officio member. It published its first Annual Report on 26 February 2010 (PRP’s 2009 Report) and concluded that the PRP was satisfied that the FRC had handled the cases in accordance with its internal procedures. The PRP had also recommended the FRC to strengthen its internal procedures with respect to informal inquiries. The FRC welcomes and fully accepts the PRP’s recommendation.

28. The first review cycle of the PRP covered the 18-month period from July 2007, when the FRC became fully operational, to the end of December 2008. Thereafter, the PRP’s review will be undertaken on a calendar year basis.

### ***ICAC review***

29. The FRC collaborated with the ICAC on a separate review of internal procedures in 2009. This review focused on corruption prevention and management control. The ICAC concluded that the FRC has in place a sound governance framework for its operations.

30. The ICAC has also put forward recommendations to further strengthen the systems and operations of the FRC. The FRC will strengthen its internal procedures as part of an on-going process to enhance its effectiveness and efficiency.

### ***Reporting of investment in securities by staff***

31. All FRC staff members must strictly follow the Code of Conduct in the context of personal investments while performing any role within or on behalf of the FRC. This includes regular declarations of their own and their spouse's investments and notifications in case of changes in holdings.

### ***Transparency***

32. The FRC continues to publish on its website the summary of completed complaints, statistics of its operation updates and publication of reports on investigation and enquiry on a timely basis.

## **LOOKING FORWARD**

33. The FRC has developed a Strategic Plan 2010-2012 based on its operational experience in the past two years. The FRC will focus on four major goals which include the adoption of a more proactive approach in the regulation of financial reporting by listed entities, increasing the effectiveness and efficiency of its operations, raising the level of understanding by the public on its role and functions, and raising public awareness of independent audit oversight regimes adopted by other major international financial centres.

34. The FRC will continue to perform its statutory duties to uphold the quality of financial reporting in Hong Kong, enhance protection for investors and increase investors' confidence.

**Financial Reporting Council  
March 2010**