

**For discussion  
on 2 April 2012**

**Legislative Council  
Panel on Financial Affairs**

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

**PURPOSE**

The FRC last briefed this Panel on its work progress on 4 April 2011. This paper updates the Panel on the work progress made by the FRC since then.

**BACKGROUND**

2. The Financial Reporting Council (“FRC”) is a statutory body established to conduct independent investigations into possible auditing or reporting irregularities and enquiries into possible non-compliance with accounting requirements in relation to listed entities. In addition to responding to complaints, the FRC has taken a proactive approach since July 2008 by making reference to modified auditors’ reports on the financial statements of all listed entities to identify potential non-compliance with accounting requirements. The FRC has further widened its scope of review with the introduction of a risk-based financial statements review programme which went into effect in January 2011.

**WORK PROGRESS**

3. The FRC entered into its fifth year of operation in 2011 and a brief account of its work in the past year is set out below.

### ***Review of pursuable complaints***

4. The FRC deals with each complaint it receives, irrespective of source, professionally and within the parameters of established policies and procedures. The Secretariat of the FRC (“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 (“Council”). The Council would then determine if the complaint justifies the initiation of an investigation or an enquiry.

5. Among the pursuable complaints received in 2011, four related to auditing or reporting irregularities and three involved both auditing or reporting irregularities and non-compliance with accounting requirements. The assessments of all pursuable complaints were completed by the end of 2011, except for one which was completed after the year end. Amongst the review of complaints completed in 2011, four investigations were initiated. The FRC received four pursuable complaints in the first quarter of 2012, and as of 23 March 2012, it has received a total of 62 pursuable complaints since establishment.

### ***Review of modified auditors’ reports***

6. The FRC screened 131 modified auditors’ reports in 2011 and as of 23 March 2012, it had screened 434 modified auditors’ reports since the proactive review approach was adopted in July 2008. Under the FRC’s existing procedures, if the screening of modified auditors’ reports reveals that there are apparent auditing or reporting irregularities and/or non-compliance with

accounting requirements, the full set of financial statements would be reviewed under the risk-based financial statements review programme.

7. Among all the modified auditors' reports screened in 2011, three required review of entire sets of financial statements under the risk-based financial statements review programme.

### ***Risk-based financial statements review programme***

8. The FRC introduced the risk-based financial statements review programme in January 2011. This programme selects financial statements based on various risk criteria, including indications of non-compliance with accounting requirements identified through the FRC's proactive reviews (paragraphs 6 and 7 refer) or media reports. The FRC also looks at financial statements of newly listed entities and listed entities which have changed their auditors during the year. In addition, the FRC also selects the financial statements of entities in a specified industry and/or with a specific accounting theme for review each year. In 2011, the FRC examined the financial statements of entities engaged in the pharmaceutical business and those who have adopted the revised accounting standard on business combinations.

9. In 2011, the FRC initiated the review of 70 sets of financial statements with financial year-ends which fell between 31 December 2010 and 30 November 2011, representing approximately 5% of the Hong Kong listed entities. Each set of financial statements was reviewed by a pair of external reviewers before it was re-examined by the Secretariat to ensure that all apparent non-compliance with accounting requirements was dealt with in a consistent manner. The first batch of financial statements was sent for external review in the second quarter of 2011. As of 23 March 2012, all 70 sets of financial statements selected were sent to external reviewers and the FRC has

completed the internal examination of 30 sets of financial statements and the rest is expected to be completed by mid-2012. Among the financial statements reviewed, one potential auditing irregularity was identified and resulted in the initiation of an investigation.

### ***Advice letters to listed entities and their auditors***

10. The FRC continues to optimize opportunities to advise listed entities and their auditors on improvements to the quality of financial reporting. In cases (arising from either complaints received or review of financial statements) involving potential non-compliance with accounting requirements which do not affect the fair presentation of the financial statements, the FRC issues letters of advice to the listed entities and/or their auditors outlining its findings and suggesting improvement measures, instead of initiating an investigation and/or an enquiry.

11. In 2011, the FRC issued 11 letters of advice after reviewing the complaints and the financial statements under the risk-based financial statements review programme.

### ***Investigations***

12. Investigations are initiated by the FRC as a result of potential or suspected auditing or reporting irregularities identified. The Audit Investigation Board (“AIB”)<sup>1</sup> is directed by the Council to conduct investigations in accordance with the Financial Reporting Council Ordinance (Cap. 588) (“FRC Ordinance”).

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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 (“CEO”) of the FRC with four professional staff from the Secretariat appointed by the Council as members.

13. The FRC handled 13 investigations of auditing or reporting irregularities in 2011, of which seven were initiated prior to 2011. Among those six cases initiated in 2011, one was initiated based on the findings of an enquiry completed during the year. The FRC completed five investigations in 2011 and another five investigations in the first quarter of 2012. The three outstanding investigations are expected to be completed in the first half of 2012.

14. In 2011, investigations of auditing or reporting irregularities involved different issues, including failure to adjust earnings per share for changes in the outstanding number of shares after the reporting period, failure to properly document the audit procedures on the review of working papers prepared by the auditor of an entity's subsidiaries, and failure to obtain sufficient appropriate audit evidence. Apart from one case where there was no evidence to support any auditing irregularities, all other completed investigations were referred to the Hong Kong Institute of Certified Public Accountants ("HKICPA") for follow-up action.

### ***Enquiries***

15. Enquires are initiated by the FRC into possible non-compliance with accounting requirements in relation to listed entities. In respect of each enquiry, the Council appoints a separate Financial Reporting Review Committee ("FRRC")<sup>2</sup> under the FRC Ordinance to look into the possible non-compliance.

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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 requirements. At present, there are 7 Panel Convenors and 34 members in the FRRP.

16. Two enquiries initiated in 2010 were completed in 2011. One enquiry was initiated in 2011 and is still in progress. One of the completed cases related to the non-recognition of deferred tax liabilities in respect of fair value gains arising from the acquisition of subsidiaries. At the request of the FRC, the listed entity concerned corrected the non-compliance with accounting requirements, and made prior period adjustments in its subsequent financial statements.

## **MAINLAND AUDITORS**

17. Following the amendments to the Listing Rules of the Hong Kong Exchanges and Clearing Limited (“HKEx”) in December 2010, four Hong Kong listed Mainland companies had opted to appoint Mainland auditors and prepared their 2010 financial statements in accordance with “China Accounting Standards for Business Enterprises” in the Mainland. These financial statements were included in the respective financial statements review programmes of the FRC, the HKEx and the HKICPA. By the end of 2011, the number had increased to 27. Any material non-compliance with accounting requirements on the part of these companies will result in the initiation of enquiries in accordance with the FRC Ordinance.

18. The FRC signed a Memorandum of Understanding with the Ministry of Finance (“MoF”) in 2009, which established a framework for investigative co-operation. The FRC continuously maintains dialogue with regulators in the Mainland. The FRC met with the Supervision and Inspection Department of the MoF in Beijing in 2011 to exchange views on refining the detailed procedures and guidelines for co-operation.

## **COLLABORATION WITH OTHER REGULATORS**

19. In 2011, the FRC continued to hold regular liaison meetings with other regulators, including the Securities and Futures Commission (“SFC”), the HKICPA and the HKEx. To maximize the effectiveness of work on the financial statements review programmes among regulators in Hong Kong, the FRC held discussions at regular meetings with the HKICPA and the HKEx in 2011. Information was shared on review cycles, selection themes and the targeted number of reviews of financial statements for the year. The FRC, the HKEx and the HKICPA shared the review of the financial statements of the four Hong Kong-listed Mainland companies which opted to use Mainland auditors for the 2010 financial year.

20. The FRC organized its first joint financial reporting forum with the HKEx and the HKICPA in October 2011, which aimed to promote quality financial reporting. The observations on the respective financial statements review programmes of the three organizers were also shared with listed entities and auditors.

## **PUBLICITY**

21. The FRC has publicized its work through updating its website regularly and the distribution of annual reports and leaflets to stakeholders in the past few years. Staff of the Secretariat attended seminars, meetings and conferences hosted by local accountancy bodies 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.

22. In 2011, the FRC further enhanced its engagement with stakeholders through advertising its role and functions on two radio stations and providing work updates in its bi-annual FRC eNews. In view of the increasing popularity of online trading of securities, the FRC will start to advertise its role and functions on two finance websites in mid-2012.

## **FINANCIAL SITUATION**

23. The FRC is jointly funded by the Companies Registry Trading Fund, the HKEx, the HKICPA, and the SFC.

24. The combined contribution from the four funding parties has increased to HK\$16.8 million in 2011, after a 5% upward adjustment. The actual expenditure of the FRC in 2011 was HK\$15.3 million and the approved budget of the FRC for 2012 is HK\$18 million which 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 years.

## **THE SECRETARIAT**

25. The Secretariat is responsible for managing and administering the day-to-day operations of the FRC. The current CEO, Dr. P.M. Kam, commenced his appointment on 1 April 2010.

26. The FRC appointed two full-time staff in 2011 to cope with the increased case load and the execution of the risk-based financial statements review programme. All the 15 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 further strengthened. For any short-term increase in workload, the

FRC will adopt flexible short-term measures, such as the hiring of staff on short-term contracts.

## **CORPORATE GOVERNANCE**

27. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted in paragraph 28 to 40 below.

### ***Committees established by the Council***

28. The Council established four committees, namely Corporate Communications Committee, Operations Oversight Committee (“OOC”), Remuneration Committee and Tender Committee, with specific responsibilities. Committees provide advice to the Council on various matters and meet on a periodic basis and whenever necessary. Each committee operates according to its terms of reference provided by the Council.

29. During 2011, the involvement of the OOC in providing advice on the initiation of cases has increased. Following the introduction of the risk-based financial statements review programme, the OOC would consider whether informal inquiries should be made based on the Secretariat’s initial review of financial statements. The experience and expertise of the OOC members, and their greater involvement, have facilitated the Council to make decisions on cases in a more effective and efficient manner.

### ***Independence***

30. Members of the FRC are appointed by the Chief Executive. The Council currently comprised 11 members, including the addition of one Member in December 2011. Seven of the Council Members, including the Chairman, are lay persons, i.e. non-accountants. 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.

31. Members of the Council are legally bound to declare any interest they may have in a case. Council Members who were present during the deliberation by the HKEx, the HKICPA and the SFC, or took part in any decision of these organizations, with respect to the referral of cases to the FRC, would be regarded as having interest in the case. Council Members having interest in a case could not (a) be present during any deliberation by the Council, (b) take part in any decision of the Council, or (c) be given any documents related to the case, in accordance with the FRC Ordinance.

### ***Financial control***

32. 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 2011 Annual Report of the FRC will be tabled at the Legislative Council sitting of 28 March 2012.

### ***Internal control***

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

34. The CEO is supported by the operations 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 operations 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)***

35. The PRP is an independent panel charged with the responsibility to undertake a review of the handling of cases by the FRC to ensure that actions taken and decisions made adhered to and were consistent with internal procedures and guidelines. The PRP comprises six members appointed by the Chief Executive including the FRC Chairman as an ex-officio member. It published its 2011 Annual Report on 21 March 2012.

36. The 2011 Annual Report 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 consider laying down objective principles to determine whether an extension of time should be granted to a party under investigation or enquiry, for complying with the FRC's request for information, in order to prevent it from repeatedly seeking time extension. It had also recommended the FRC to update the complainant on the progress of the review of a complaint at an appropriate juncture after an investigation or enquiry had been initiated. In the light of the introduction of the risk-based financial statements review programme in 2011, the PRP commended the FRC for establishing internal procedures which provide guidance for conducting such reviews. The PRP had recommended that the FRC should continue to review and modify its internal procedures and guidelines as and when new initiatives are launched in future. The FRC welcomes and fully accepts the PRP's recommendation.

### ***Code of conduct***

37. The FRC has developed a recognized culture and a set of values that fully support effective corporate governance. All staff members strictly adhere to the FRC's Code of Conduct when undertaking any role on its behalf. The Code of Conduct specifies standards to be followed in areas that may involve conflicts of interest, confidentiality of information, personal investments and data protection. This includes regular declarations of their own and their spouse's investments and notifications in case of changes in holdings.

38. The Code of Conduct is reviewed and updated on a regular basis to ensure that it remains consistent with the best practices currently undertaken across the areas in which the FRC operates.

### ***Transparency***

39. The FRC continues to publish on its website a summary of completed complaints, operations statistics and press releases on investigations and enquiries completed on a timely basis. In 2011, in addition to the annual report, the FRC has commenced publication of FRC eNews, which is also available on the FRC's website.

40. The FRC have adopted a policy on "Access to Information" which outlines the procedures for members of the public to access information and the limitations that need to be imposed on that access. The policy was designed to attain a balance between privacy of information and access to public records. The "Access to Information" policy is also available on our website.

## **LOOKING FORWARD**

41. The objectives set out in the Strategic Plan 2010-2012 have been further developed in 2011, focusing on four specific areas which include the adoption of a more proactive approach in the regulation of financial reporting of 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.

42. The FRC has participated in discussions with the Government and other stakeholders on how to inject new elements of independence into the regulatory framework for auditors. Any new regime must take into account local circumstances and global market needs.

43. The challenges facing Hong Kong's investment environment are likely to continue and this in turns gives the oversight role of the FRC heightened importance. The FRC will continue to work closely with other regulators as well as the industry to promote sound financial reporting and enhanced accounting and reporting standards of listed entities to safeguard investor interests.

**Financial Reporting Council  
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