

**For discussion  
on 6 May 2013**

**Legislative Council  
Panel on Financial Affairs**

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

**PURPOSE**

The Financial Reporting Council (“FRC”) last briefed this Panel on its work progress on 2 April 2012. This paper updates the Panel on the work progress made by the FRC since then.

**BACKGROUND**

2. The FRC is a statutory body established in 2006 to conduct independent investigations into possible auditing or reporting irregularities and enquiries into possible non-compliance with accounting requirements in relation to listed entities. Any auditing or reporting irregularities identified by the FRC will be referred to the Hong Kong Institute of Certified Public Accountants for follow-up action and initiating disciplinary actions as appropriate. On the other hand, the FRC is empowered under the Financial Reporting Council Ordinance (Cap. 588) (“the Ordinance”) to require listed entities involved in completed enquiries to remove any non-compliance with accounting requirements identified.

**WORK PROGRESS**

3. The FRC entered into its sixth year of operation in July 2012 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 (including complaints referred from other financial regulators) professionally and within the parameters of established policies and procedures. In respect of each complaint, 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. The Secretariat then 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 an enquiry.

5. Among the 19 pursuable complaints received in 2012, three related to auditing or reporting irregularities, one related to non-compliance with accounting requirements, and 15 involved both auditing or reporting irregularities and non-compliance with accounting requirements. As a result, the FRC initiated nine investigations/enquiries. After a preliminary review of the information received, the FRC has identified two cases of obvious auditing or reporting irregularities which did not require initiating an investigation, and has referred these cases to the Hong Kong Institute of Certified Public Accountants (the “HKICPA”) to determine if any disciplinary action is warranted. By the end of 2012, five of these 19 complaints were under review but they were less than six months old.

6. The FRC received two pursuable complaints in the first quarter of 2013. As of 31 March 2013, it has received 79 pursuable complaints since establishment.

### ***Review of modified auditor’s reports***

7. The FRC proactively screened all 138 modified auditor’s reports issued by listed entities in 2012. Of these, 75 related to emphasis of matter with no apparent auditing irregularities and/or non-compliance with accounting requirements. The FRC reviewed all other modified auditor’s reports and requested information from relevant parties where appropriate. As of 31 March 2013, it has screened 599 modified auditor’s reports since adoption of the proactive review approach in July 2008.

8. If the initial review of modified auditor’s reports identifies potential auditing or reporting irregularities and/or non-compliance with accounting requirements, the full sets of financial statements would be subject to a comprehensive review under the FRC’s risk-based financial statements review programme (paragraphs 9 to 12 refer). Only one set of financial statements warranted a comprehensive review by the FRC in 2012.

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

9. Since 2011, the FRC has been reviewing the financial statements of selected listed entities under a risk-based financial statements review programme. Each review cycle starts in July. The FRC would select the financial statements of listed entities with financial year-ends falling within the one-year period starting from the December preceding the review cycle for review based on various risk criteria, such as the financial statements of listed entities in specified industries and those with specified accounting themes. The FRC also looks at the financial statements of newly listed entities, entities which have changed their auditors and entities which have issued modified auditor's reports (see paragraph 8 above) during the year under review.

10. Besides, the financial statements to be selected for review under the programme also included companies using non-Hong Kong auditors, namely those of Hong Kong-listed Mainland companies which have opted to use Mainland auditors to audit their financial statements under the "Convergence Scheme"<sup>1</sup> and those prepared by overseas auditors approved by the Hong Kong Exchanges and Clearing Limited ("HKEx").

11. In 2012, the FRC completed its reviews of the 70 sets of financial statements selected during the 2011/2012 review cycle and initiated one investigation case. For the 2012/2013 cycle, the FRC selected 75 sets of financial statements which had financial year-ends falling between 31 December 2011 and 30 November 2012 for review. This represents approximately 5% of all listed entities. The industry focus for the 2012/2013 cycle is entities in the forestry and agriculture business and the accounting theme is deferred taxation.

12. As of 31 March 2013, the FRC has fully completed the review of 15 sets of financial statements. The reviews of the rest of the financial statements are expected to be completed by mid-2013.

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<sup>1</sup> On the basis of the Mainland and Hong Kong accounting and auditing standards achieving convergence in December 2007, the relevant Mainland authorities and Hong Kong regulators jointly developed a Convergence Scheme in 2009. Under the Scheme, Mainland incorporated companies listed in Hong Kong are provided with an option to prepare their financial statements using Mainland accounting standards and have them audited by approved Mainland audit firms using Mainland auditing standards. The Convergence Scheme was implemented in December 2010.

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

13. In cases where the FRC identified issues or concerns in the financial statements which do not affect the fair presentation of the financial statements, the FRC would issue letters of advice, including findings and suggestions on improvement or remedial measures, to the listed entities and/or their auditors, instead of initiating an investigation and/or an enquiry. The FRC issued 19 letters of advice in 2012 following a review of complaints and the relevant financial statements under the risk-based financial statements review programme.

### *Investigations*

14. Investigations are initiated by the FRC as a result of potential or suspected auditing or reporting irregularities identified. The Audit Investigation Board (the “AIB”)<sup>2</sup> is directed by the Council to conduct investigations in accordance with the Ordinance.

15. In 2012, the FRC initiated nine investigations and handled another eight cases which were brought forward from the previous year. Nine investigations were completed during the year, including all of the outstanding cases initiated over the previous few years. The auditing irregularities identified in the investigations have been referred to the HKICPA to determine if any disciplinary action is warranted. In this connection, it is noted that the disciplinary committee of the HKICPA has taken disciplinary action against a certified public accountant and a corporate practice in April 2012, based on the referral of an investigation report by the FRC in 2011. By the end of 2012, eight investigations were in progress. The FRC expects to complete the majority of these investigations in the first half of 2013.

16. As at 31 March 2013, the FRC has handled 26 investigations since establishment.

### *Enquiries*

17. Enquiries are initiated by the FRC into possible non-compliance with accounting requirements in relation to listed entities. In respect of each

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<sup>2</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 (the “CEO”) of the FRC with four professional staff from the Secretariat appointed by the Council as members.

enquiry, the Council appoints a separate Financial Reporting Review Committee (the “FRRC”)<sup>3</sup> under the FRC Ordinance to look into the possible non-compliance. In 2012, the FRC initiated three enquiries and completed one enquiry brought forward from the previous year. The FRC had requested the listed entity involved in the completed enquiry to remove the identified non-compliance with accounting requirements, and the listed entity made prior year adjustments in its subsequent financial statements to rectify such non-compliance.

18. As at 31 March 2013, the FRC has handled 10 enquiries since establishment.

## **ENCOURAGING MULTI-FACETED COLLABORATION**

19. The FRC has continued to maintain close communication with other Hong Kong regulators, including the Securities and Futures Commission (“SFC”), the HKICPA and the HKEx, through regular liaison meetings.

20. In 2012, the FRC maintained its discussions with the HKICPA and the HKEx in relation to each other’s financial statements review programmes. Information was shared on theme selection and the targeted number of reviews of financial statements for the year. At the FRC’s second joint forum with the HKEx and the HKICPA held in November 2012, the FRC shared with listed entities and their auditors the observations on its risk-based financial statements review programme.

21. In 2012, the FRC had a meeting with the Accounting Regulatory Department of the Ministry of Finance to exchange views on matters of mutual interest, and had also attended the International Auditing and Assurance Standards Board Asia-Pacific Roundtable in Kuala Lumpur. In January 2013, FRC attended the 2nd ASEAN Audit Regulators Group Inspection Workshop in Malaysia.

## **PUBLICITY**

22. The FRC has publicized its work mainly through radio advertisements and periodic publications, such as annual reports, eNews,

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<sup>3</sup> FRRCs are appointed by the Council from the Financial Reporting Review Panel (the “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.

operations statistics and press releases. Starting from 2012, the FRC has extended its communication channel by advertising its role and functions on two finance websites.

23. 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 in Hong Kong to raise the level of public awareness of the role and functions of the FRC.

## **FINANCIAL SITUATION**

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

25. The combined contribution from the four funding parties has increased to HK\$17.6 million in 2012, after a 5% upward adjustment according to an agreed arrangement among the FRC and the four funding parties. The actual expenditure of the FRC in 2012 was HK\$16.2 million.

## **THE SECRETARIAT**

26. The Secretariat is responsible for managing and administering the day-to-day operations of the FRC. The former Chief Executive Officer (“CEO”), Dr PM Kam, commenced his appointment on 1 April 2010 and retired on 31 March 2013. The current CEO, Mr Mark Dickens, commenced his appointment on 1 April 2013.

27. The FRC hired a legal counsel in 2012 to support its work on investigations and enquiries and the independent audit oversight reform that is in progress. All the 17 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. It is currently seeking to recruit a Deputy CEO.

## **CORPORATE GOVERNANCE**

28. The FRC strives to maintain corporate governance of the highest standard. Key areas are highlighted in paragraphs 29 to 43 below.

### ***Committees and panels established by the Council***

29. The Council has established five committees comprising members of the Council, namely Corporate Communications Committee, Finance Committee, Independent Audit Oversight Reform Committee, Operations Oversight Committee and Remuneration Committee, with specific responsibilities. These 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.

30. In particular, the FRC formed the Independent Audit Oversight Reform Committee in December 2012 to advise the Council on matters relating to the reform of auditor oversight systems in Hong Kong. The former Tender Committee has been replaced by the Finance Committee with a broader remit to provide advice concerning treasury, internal controls and financial management policies as well as financial strategy.

31. The FRC has also increased the number of Honorary Advisers and amended the terms of reference of the Honorary Advisory Panel to encompass a wider range of advice on the operations of and any professional, technical or strategic issues faced by the FRC.

### ***Independence***

32. Members of the FRC are appointed by the Chief Executive. The Council currently comprises 11 members. The Ordinance stipulates that the number of Council Members who are lay person is to exceed the number of those who are not. At present, eight 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.

33. 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 an interest in the case. Under the Ordinance, in general 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***

34. 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 SFST once a year. The 2012 Annual Report of the FRC was tabled at the Legislative Council sitting of 17 April 2013.

### ***Internal control***

35. 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.

36. 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 (the “PRP”)***

37. 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, and includes the FRC Chairman as an ex-officio member. It published its 2012 Annual Report on 27 March 2013.

38. The 2012 Annual Report concluded that the PRP was satisfied that the FRC had handled the cases in accordance with its internal procedures.



39. The PRP has made two recommendations to the FRC in its 2012 Annual Report, as follows –

- (a) the PRP recommended the FRC to consider the need to outsource its translation work to relevant professionals in future if internal resources and capabilities are challenged and to invite an appropriate person with relevant expertise to vet the translation work.
- (b) the PRP noted that for cases that had not reached the investigation stage, FRC could not use its statutory powers to compel the auditors concerned to comply with its request for information in a timely manner. PRP recommended that if there was a need for FRC to make informal requests for information before a formal investigation was initiated, it should put down a marker in its requests to the effect that if the party concerned was unable to provide the requested information by the deadline, the Council may consider initiating an investigation to compel the party to provide the information by law.

40. The FRC accepted PRP's recommendations and would take follow-up actions as appropriate.

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

41. 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.

42. 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***

43. 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**

44. Looking forward, the FRC’s goal is to continue to promote high quality financial reporting, providing investors with a framework which enables them to assess fair, balanced and reliable information, giving added confidence to the capital markets. The FRC will meet this goal by working with integrity, accountability and transparency, and cooperating with and supporting other regulatory bodies and government bureaux in Hong Kong.

45. In line with global trends towards enhancing the independence of regulatory regimes for the audit profession, the FRC will continue discussions with the Government and the HKICPA to formulate proposals to enhance independence of the regulatory framework for auditors, with a view to ensuring that Hong Kong’s future regulatory regime for the audit profession is benchmarked against international standards and is appropriate in the local context.

**Financial Reporting Council**  
**April 2013**